Equity Research
March 31, 2010
BSE Sensex: 17590

# INDIA

# LIC Housing Finance

**BUY**

## In for a long haul

**Rs863**

Reason for report: Initiating coverage

## Banking

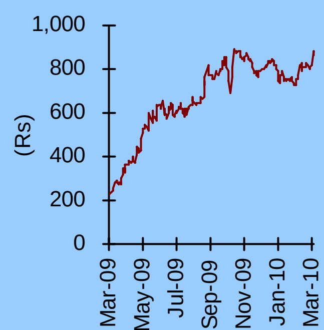
**Target price Rs994**

### Shareholding pattern

| | Jun '08 | Sep '08 | Dec '09 |
|---|---|---|---|
| Promoters | 40.8 | 36.5 | 36.5 |
| Institutional investors | 42.5 | 49.3 | 49.5 |
| MFs and UTI | 13.7 | 14.5 | 12.6 |
| Insurance Cos. | 5.3 | 4.5 | 4.2 |
| FIIs | 23.5 | 30.3 | 32.7 |
| Others | 16.7 | 14.2 | 14.0 |

Source: BSE India

### Price chart




**LIC Housing Finance (LICHF) has scripted a profitable turnaround story led by higher-than-industry disbursements growth, which in turn was due to strengthened risk monitoring and recovery systems. Further, increased efficiency and outsourced DSA model have led to sharp asset growth, improving operating leverage. Fortified with sufficient capital for runaway disbursement CAGR of 23.3% through to FY12E, we expect LICHF to improve its market share in the housing finance space from 7.6% in Q3FY10.**

**Despite valuations at 2x FY11E BV, we believe our target multiple of 2.25x FY11E BV is justified given strong core earnings CAGR of 25.2% in FY10E-12E, which will generate ~23% core RoE. Our target price of Rs994/share implies 15.2% upside. We initiate coverage on LICHF with BUY. Slowdown in disbursements growth, sharp rise in wholesale rates and any hiccups in asset quality are key concerns.**

- **Disbursements growth drivers in place.** Aggressive roll-out of own network complemented by subsidiaries, higher utilisation of DSAs/LIC agents, developers' focus on affordable housing given sufficient pent-up demand in the space and calibrated rise in lending yields should aid 23.3% disbursements CAGR over FY12E.
- **Slight spread/NIM compression likely** as wholesale rates rise given constricting systemic liquidity. Heavy dependence on non-convertible debentures (NCDs) – ~82% of which are placed with LIC – gives LICHF some funding flexibility. This, along with its well matched asset liability profile and headroom to pass on rise in funding cost should limit incremental spread compression. We expect spreads at ~1.8% through to FY12E.
- **Operating leverage, low credit costs should drive ~1.8% RoA.** Strong expansion in LICHF's own network and improved efficiency of off-payroll agents have led to robust asset growth, improving operating leverage. Further, credit costs are now lower as robust credit appraisal, approval & monitoring mechanisms and well-defined recovery systems are in place. Thus, low cost-to-assets at ~55-60bps and loan-loss provisions of ~12bps should drive RoAs to 1.8% by FY12E.
- **Earnings traction to drive core RoE of 23%, Buy.** Core earnings CAGR of 25.2% over FY10E-12E should result in 23% core RoE. CAR of 15.24% (buoyed by Rs6.58bn QIP in H2FY10) and strong internal generation capabilities compel us to value LICHF's core business at 2.25x FY11E BV or Rs977/share. Our target price stands at Rs994/share, which includes Rs17/share for 20% stake in LIC Asset Management Company (LIC AMC). We initiate coverage on LICHF with BUY.

| | |
|---|---|
| Market Cap | Rs81.9bn/US$1.8bn |
| Reuters/ Bloomberg | LICH.BO/LICHF IN |
| Shares Outstanding (mn) | 95.0 |
| 52-week Range (Rs) | 892/224 |
| Free Float (%) | 63.5 |
| FII (%) | 32.7 |
| Daily Volume (US$/'000) | 20,000 |
| Absolute Return 3m (%) | 7.5 |
| Absolute Return 12m (%) | 284.4 |
| Sensex Return 3m (%) | 0.7 |
| Sensex Return 12m (%) | 81.2 |

| Year to Mar | 2009 | 2010E | 2011E | 2012E |
|---|---|---|---|---|
| NII (Rs mn) | 7,417 | 8,900 | 11,354 | 14,527 |
| Net Profit (Rs mn) | 5,316 | 6,462 | 9,060 | 10,122 |
| EPS (Rs) | 62.5 | 68.0 | 95.4 | 106.6 |
| % Chg YoY | 37.3 | 8.8 | 40.2 | 11.7 |
| P/E (x) | 13.8 | 12.7 | 9.0 | 8.1 |
| P/BV (x) | 3.3 | 2.4 | 2.0 | 1.7 |
| Net NPA (%) | 0.2 | 0.4 | 0.3 | 0.3 |
| Dividend Yield (%) | 1.5 | 1.7 | 2.3 | 2.6 |
| RoA (%) | 2.1 | 2.0 | 1.8 | 1.8 |
| RoE (%) | 26.2 | 22.9 | 24.1 | 22.4 |

Note: We factor in profit from sale of 17.3% stake in LIC AMC in FY11E

**Abhishek Murarka**
abhishek.murarka@icicisecurities.com
+91 22 6637 7351
**Siddharth Teli**
siddharth.teli@icicisecurities.com
+91 22 6637 7298

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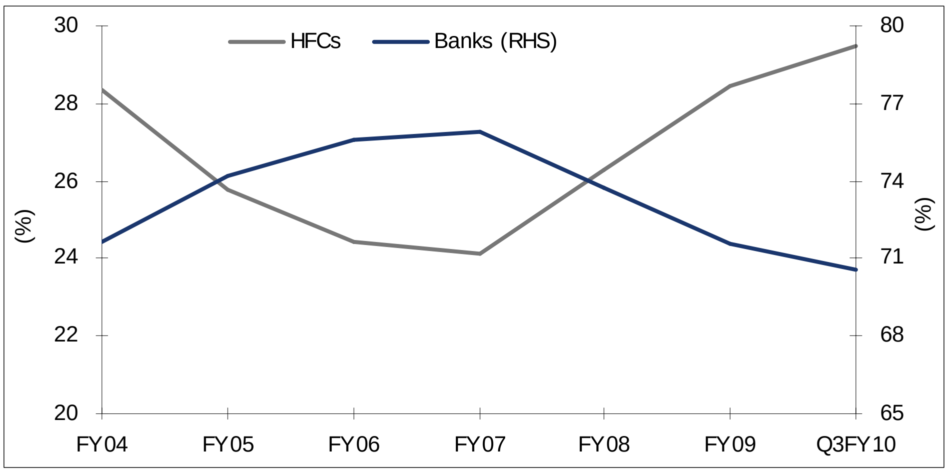
## Well-poised for strong disbursements growth

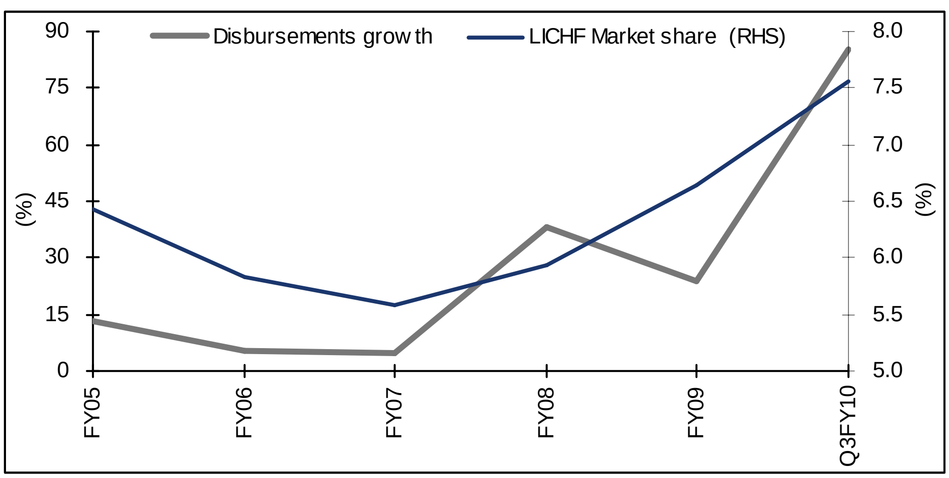
LICHF has scripted a turnaround in its operating performance on resurgence in disbursements, taking full advantage of the soft interest rate scenario coupled with price correction across the residential real estate market over FY08-09. This was supported by timely network expansion and a restructuring in the internal risk assessment systems, which gave the management the bandwidth to expand rapidly. As a result, disbursements CAGR was at 21.4% over FY06-09, leading to an increase in LICHF's market share (as calculated using outstanding loans) in the housing finance market to 7.6% in Q3FY10 from 5.6% in FY07.

**Chart 1: HFCs* gain market share from banks after a dismal FY04-07**




*Housing Finance Companies
Note: Market share calculated as a percentage of outstanding loans
Source: Company data, ICRA

**Chart 2: Rising disbursements growth leads to market share recovery for LICHF**




Source: Company data, I-Sec Research

After the Reserve Bank of India allowed banks to disburse home loans in 1998, HFCs steadily lost market share to banks, which had higher reach and low cost funds, as also a ready pool of customers to who they could cross-sell home loans. As a result, HFCs' market share reached a low of 24% in FY07, with LICHF's market share at 5.6%.

In the period through FY07, LICHF was unable to grow its disbursements faster than the market as it was dealing with a sharp increase in NPAs and was in the process of reorganising its operating model. Loan assessment took place across branches and was not subject to a uniform metric. This led to a sharp spike in GNPAs to 4.4% in FY04 with +300 frauds across branches. By end CY04, the company had centralised credit appraisal, accounting, disbursements and administrative functions and instituted a scoring mechanism for loan approvals. Branches were responsible for marketing or loan origination. As a result, LICHF's loan CAGR during FY04-07 was 21.5%, while CAGR for the housing finance industry was at 35%. **However, disbursements CAGR was at a low 7.7% through FY04-07.**

However, since FY07 strong disbursements growth (30.8% CAGR over FY07-09), higher average ticket size loans and slowdown by major private sector banks have helped LICHF expand its market share to 7.6% by Q3FY10. We expect LICHF to continue to acquire market share, driven by above-industry 23.3% disbursements CAGR through FY10E-12E.

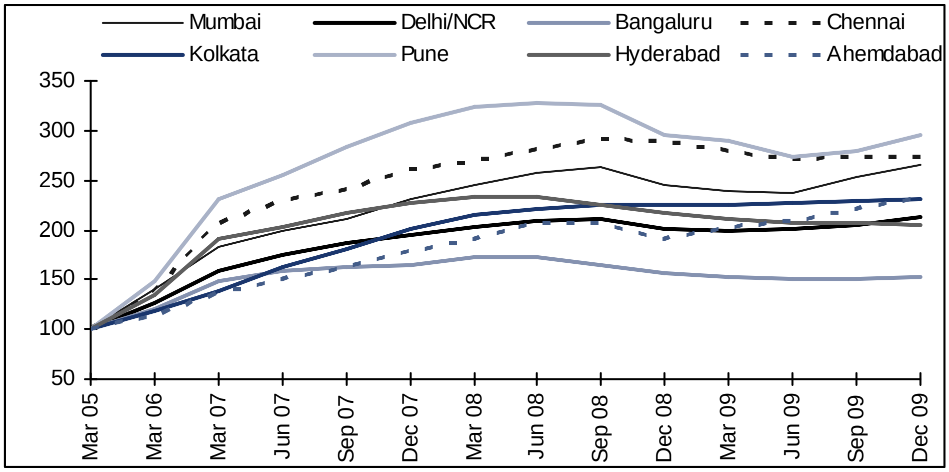
The momentum in disbursements will stem from the following: i) the *mantra* of 'affordable housing' will keep home prices at reasonable levels, ii) distribution expansion is expected to continue and will be well supported by rising productivity and reach of LICHFL Financial Services (LICHFL FS) and iii) although interest rates are looking to firm up at the margin, competitive pressures across the industry (including banks) are likely to lid the extent of appreciation in lending yields.

## Focus on 'affordable housing' to satisfy pent-up demand

Home prices in key urban and semi-urban regions of India had witnessed a sharp rise over FY03-08 driven by strong demand, rising per capita income and some speculative activity by investors. However, with the unfolding of the financial crisis, speculators fled the market, the housing-bubble burst and home prices corrected 35-50%. Market prices are now at 5-10% below their '08 peak in selected pockets, while they have crossed their earlier highs in other areas.

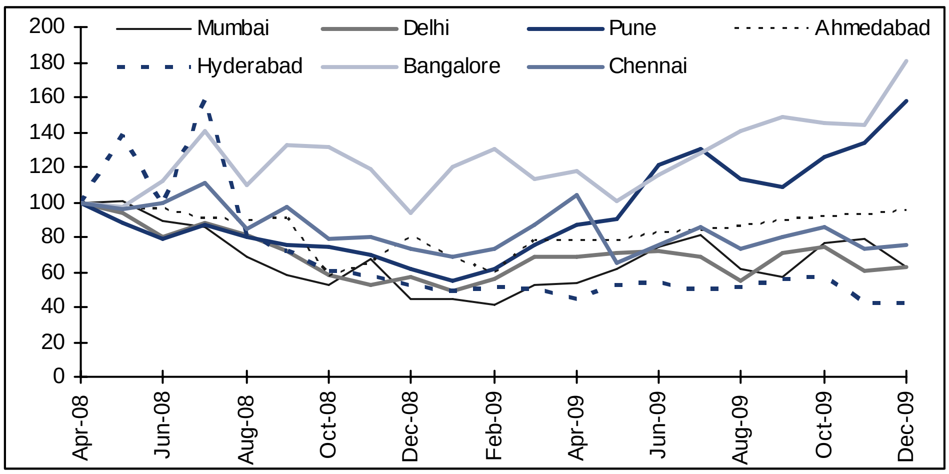
Even as property prices continue to rise, the absorption index – the ratio of property purchased in a given period (measured in mn sqft) to that purchased in the base period – is moving up. This indicates demand at reasonable price points, given strong supply of projects in the 'affordable housing segment'. This, coupled with improved affordability (measured as the property price divided by the annual income) for the average Indian household, will keep demand steady (Charts 3-5).

### Chart 3: Prices on an uptrend and approaching September '08 highs…



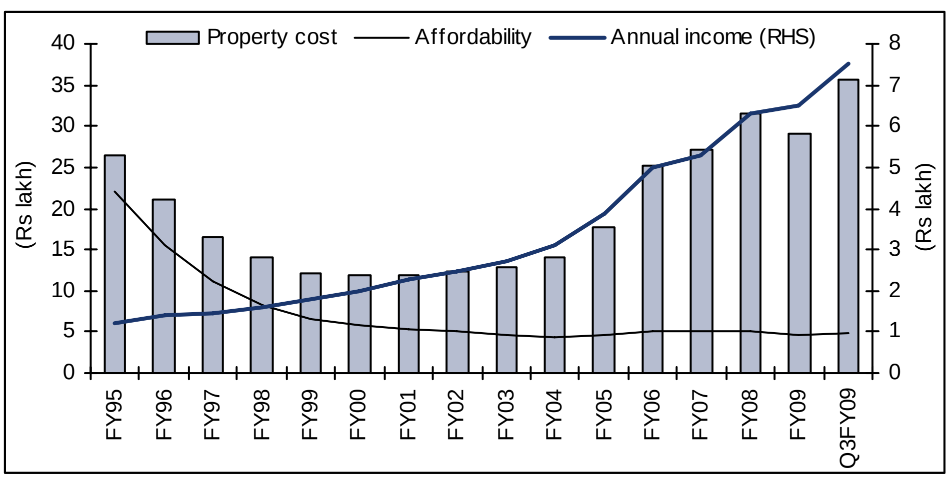

Source: Company data, I-Sec Research

### Chart 4:…despite which, absorption index is rising




Source: Company data, I-Sec Research

### Chart 5:…which, along with better affordability, signals steady demand outlook




Note: Rs10lakhs = Rs1mn
Source: Company data, I-Sec Research

## Aggressive roll-out of own network; subsidiaries to expand reach

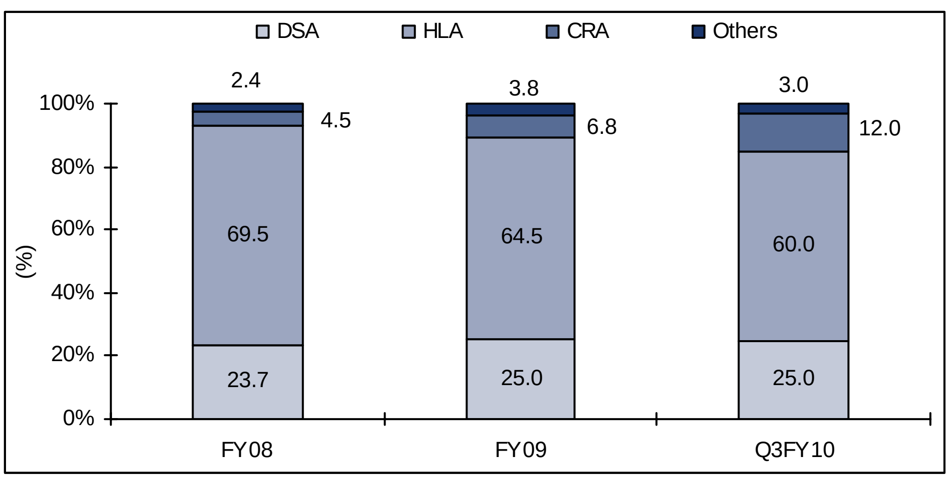
High disbursements CAGR of 30.8% over FY07-09 has been a result of LICHF rolling out a strong fleet – it has opened 40 branches in the past two years and 22 YTDFY10 to take its network to 158. Further, it has augmented its agent strength to 11,538 as on Q3FY10 compared with 4,625 in FY07. At present, it has 8,881 home loan agents (LIC agents), 1,580 DSAs and 1,077 customer relationship associates (CRAs). Such a rapid expansion has been a key driver of disbursements growth.

The current sales origination mix is heavily dependent on LIC agents who originate ~60% of incremental loans, while DSAs contribute 25% to sales and LICHF's tied-agency 12%. In future, we believe LICHF's own agency and LICHFL FS' sales force will increase their contribution to incremental sales. Already, the contribution of CRAs in incremental sales has significantly increased to 12% as on Q3FY10 from 4.5% in FY08 (Chart 6).

LICHF's distribution efforts will be further augmented by:

- LICHFL FS, the wholly-owned financial services subsidiary floated by LICHF, has +800 marketing agents and 33 offices. It is already contributing to home loan origination, among other products such as insurance and mutual funds, thus helping disbursements growth. We believe this channel will emerge into an important sales contributor going forward as it gains scale.
- LICHF has an arrangement with LIC, whereby it will take over the home loan portfolio of LIC employees which amounts to Rs13-14bn from April. The portfolio yield will be ~9.6% (at par) and LICHF will not bear any discounts that LIC might have given its employees. Going forward, home loans for LIC employees will be handled by LICHF.

**Chart 6: Contribution of channels to incremental sales**




Source: Company data, I-Sec Research

## Calibrated increase in lending yield ahead; demand will not be hurt

The banking regulator has made it clear that there will be a calibrated exit strategy from the accommodative monetary policy regime. It has supported its policy stance through a 75bps CRR hike in the last monetary policy followed by an increase of just 25bps each in repo and reverse repo rates. 10-year G-Sec rates have also witnessed a slow rise over the past few months. These factors reaffirm our view that interest rates in the system will gradually trend up (as opposed to a sudden increase) with LICHF resorting to a slow increase in lending rates.

At present, LICHF’s lending yields have to contend with teaser rates introduced by the banks. In our opinion, given PSU banks’ low efficiency, high turn-around time and relatively sluggish service record, the impact of teaser loans on the HFCs’ disbursements is likely to be limited. Differentiation and expertise provided by HFCs versus PSU banks allow the former to garner business, even at a marginal premium.

Banks have been aggressive in the home finance category thus far due to sluggishness in other avenues of loan growth. Resurgence in corporate credit and higher demand for advances from non-retail avenues will cause banks to turn less aggressive on this segment as regards lending rates and marketing efforts. This is likely to benefit HFCs such as LICHF and HDFC as they will have more headroom to raise lending rates, which will support spreads.

As a result, we expect LICHF’s incremental yields to rise from the current levels but at a slow pace. The HFC’s product pricing is hence likely to remain competitive in the medium term and will manifest into a strong disbursements CAGR of 23.3% through to FY10E-12E.

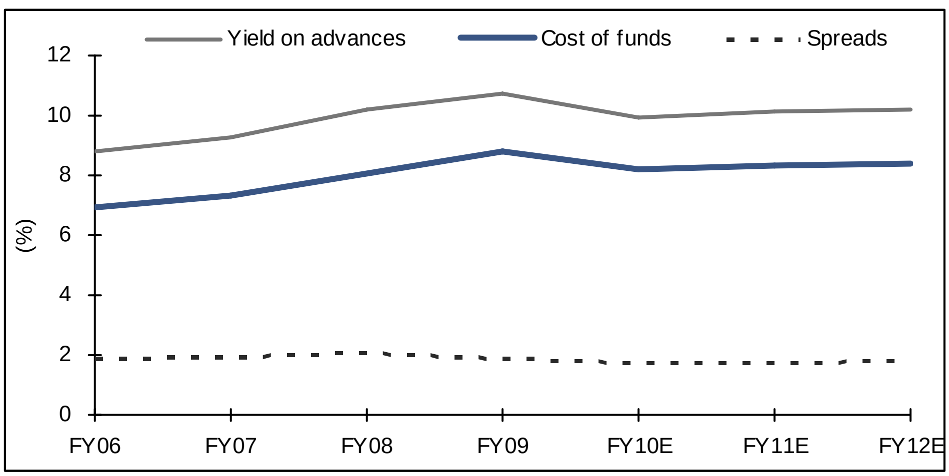
# Wholesale funding to pressure spreads/NIM

LICHF's spreads have been under pressure, given the competitive pressure on lending rates in the system on the one hand and increase in wholesale cost of borrowings on the other. This is likely to reflect in 14bps spread compression in FY10E. Going ahead, we expect a steady increase in lending rates with the HFC having enough headroom to increase rates as competitive pressure from the banks ease and teaser rates are withdrawn.

However, on the liabilities front, overall increase in interest rates is likely to push up the cost of wholesale funds, which will strain spreads to some extent. We expect LICHF's spreads to be steady at ~1.8% through FY12E compared with 1.9-2.1% in FY06-09. Despite spreads witnessing some compression, NIMs will remain elevated for a while due to the impact of capital infusion of Rs6.58bn, which we have factored in FY10E. As the impact of this infusion fades, we expect margins to trend lower to ~2.56% by FY12E.

Some compression in spreads looks imminent but it is likely to be offset by the following factors: i) diversified funding mix with higher proportion of NCDs provides flexibility and ~60% of loans from the banks demarcated for priority sector purposes will be outside the purview of base rate mechanism, ii) headroom to pass on the increases in costs and iii) well-matched asset-liability profile

**Chart 7: Spreads to steady at ~1.8%; some compression imminent**

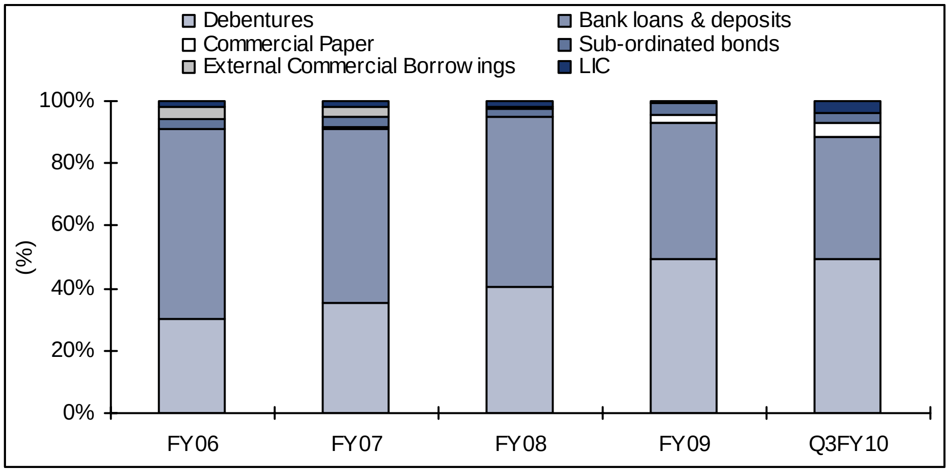



Source: Company data, I-Sec Research

## Well-diversified funding mix to enable flexible cost management

The HFC is funded by wholesale money, 49.1% of which is availed through issuing NCDs primarily parked with LIC. The remaining funds are availed through term loans from the banks, subordinated bonds, commercial paper and external commercial borrowing. The weighted average cost of borrowings for LICHF is at 8.08%.

**Chart 8: Deliberate move into NCDs has increased funding flexibility**




Source: Company data, I-Sec Research

A major shift in the funding strategy was visible in the decline in loans from LIC and the corresponding rise in NCDs issued. Term loans taken from LIC stood at 32% of the total borrowings in FY04 but now comprise just ~3%. Incidentally, ~82% of the outstanding NCDs are parked with LIC with a weighted average cost of 8.64% as on Q3FY10. The move towards NCDs has led to flexibility in funding, lowered funding costs and widened the potential funding avenues compared with peers (Table 1).

**Table 1: Advantage of NCDs over term loans**

| | Non-convertible debentures | Term loans |
|---|---|---|
| Costs | • Primarily dependent on credit rating and LICHF as a AAA-rated corporate would receive the most competitive rates<br>• Lower 50-80bps depending on liquidity. Average cost of NCDs by AAA-rated corporates +6.25% at present | • Depends on host of factors apart from rating<br>• Average cost of term loans taken by AAA-rated corporates +6.75% |
| Funding flexibility | Lower turnaround time as processing requirements are low | Much higher processing & compliance requirements and hence, it takes longer to secure a loan; amount of loans subject to sector and single party exposure norms |
| Active secondary market | Secondary market in NCDs is extremely active with multiple participants as mutual funds, insurance companies, banks and NBFCs# | Banks/NBFCs can exit from loans only through securitisation and sell-off. The loans securitisation market in India has fewer participants and is characterised by very low market action |

#Non Banking Finance Companies
Source: I-Sec Research

A key concern for NBFCs, which avail bank funding, is the base rate mechanism which will increase the minimum lending rate for banks and will, in turn, raise the cost of funds for NBFCs. As on Q3FY10, LICHF's loans from the banks formed 33.9% of borrowings. However, of this, 60% of the loans are to be on-lent to priority sector housing applicants (ticket size less than Rs2mn) and will be outside the purview of the base rate mechanism and hence, will not cause an increase in costs.

## Headroom to pass on costs will partly offset spread compression

What places LICHF on a better footing vis-à-vis peers is that it had passed on a cumulative 150bps cut in BPLR (effective in two tranches over H1CY09) to existing borrowers. With a rise in borrowing costs, LICHF is now well-placed to pass on the costs to those borrowers without creating any stress on their individual repayment capacity. In our view, this gives LICHF some headroom to pass on costs through increase in PLR without running the risk of NPAs. Thus, LICHF should be able to partly offset spread compression.

Further, this would deter the borrowers to opt for refinancing, which will help the HFC build a well-serviced loan book and maintain spreads & margins.

## Well matched asset liability profile

Typically, LICHF has a positive gap in its asset-liability mix across all maturities but the one month-one year and the 7-10 year buckets (Table 2). We would not be too concerned about the negative gap in the short-term bucket – wherein maturing assets are Rs13.8bn lower than liabilities. Generally, HFCs have to contend with a meaningful amount of prepayments through the year that part-fund excess liability. Further, with NCDs providing quick funding ability at a competitive cost, LICHF can easily meet any foreseen liabilities in a short time. We opine that this would be a better strategy rather than maintaining a positive gap and running a negative carry on the excess funds. In our view, the HFC effectively maintains a well-matched asset liability mix with varied funding options to meet any sudden requirements.

### Table 2: Asset liability profile as on March 31, '09

*(Rs mn)*

| | <1 month | 1 month - <1year | 1-3 years | 3-5 years | 5-7 years | 7-10 years | > 10 years | Total |
|---|---|---|---|---|---|---|---|---|
| Individual home loans* | 3,188 | 37,568 | 78,350 | 72,626 | 64,777 | 83,728 | 163,854 | 504,092 |
| Corporate and developer loans* | 437 | 7,109 | 20,273 | 2,035 | 798 | 1,074 | 168 | 31,894 |
| Total investments * | 105 | 6 | 13 | 12 | 10 | 601 | 215 | 963 |
| Other assets | 4,762 | 14,009 | 33 | 1 | 948 | - | 375 | 20,127 |
| **Total assets** | **8,493** | **58,692** | **98,669** | **74,675** | **66,533** | **85,403** | **164,612** | **557,076** |
| | | | | | | | | |
| Redeemable debentures * | 569 | 25,156 | 50,144 | 34,934 | 27,162 | 55,653 | - | 193,617 |
| Commercial paper * | - | 6,500 | - | - | - | - | - | 6,500 |
| External commercial borrowings * | - | - | - | - | - | - | - | - |
| Loans and advances from banks * | 2,521 | 12,542 | 26,608 | 22,189 | 26,496 | 31,026 | 540 | 121,923 |
| Refinance from NHB * | - | 4,251 | 7,115 | 5,039 | 1,537 | 377 | 198 | 18,517 |
| Loans and advances from LIC * | 636 | 3,440 | 5,946 | 3,735 | 1,747 | 626 | - | 16,130 |
| Other liabilities | 2,017 | 20,598 | 4,813 | 2,209 | 6,797 | 6,488 | 4 | 42,926 |
| **Total liabilities** | **5,744** | **72,486** | **94,625** | **68,105** | **63,739** | **94,170** | **742** | **399,612** |
| Capital | | | | | | | 22,341 | 22,341 |
| Total liabilities and capital | **5,744** | **72,486** | **94,625** | **68,105** | **63,739** | **94,170** | **23,083** | **421,953** |
| **Asset-liability gap** | **2,749** | **(13,794)** | **4,044** | **6,570** | **2,793** | **(8,767)** | **141,529** | **135,123** |

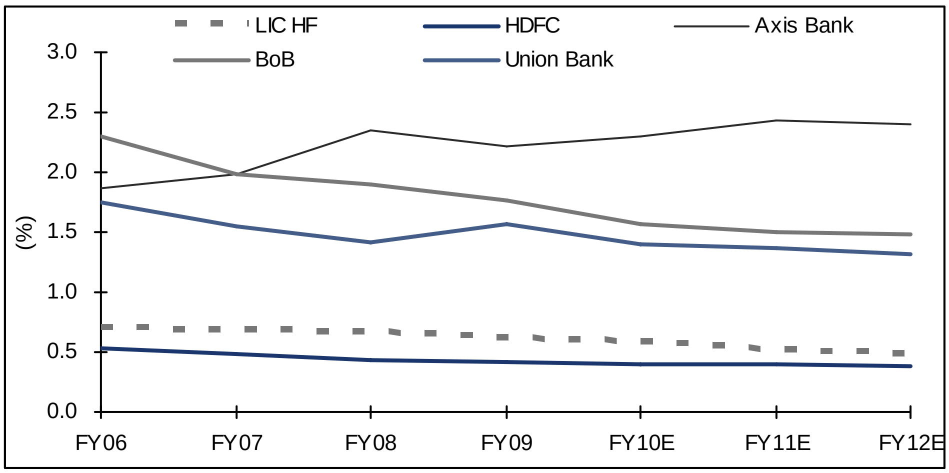
* Including interest

Source: I-Sec Research

## High operating efficiencies aid RoAs

HFCs have been able to effectively compete with banks, despite the relative disadvantage on funding costs by maintaining a low cost-to-income and cost-to-assets ratios. While LICHF is still to achieve efficiency levels similar to HDFC's, its cost ratios are much lower than banks'. On an average, LICHF cost-to-income and cost-to-assets in FY06-09 were at 21% and 0.7% respectively. This is in sharp contrast to banks with substantially higher operating ratios – cost-to-income and cost-to-asset at ~40-45% and ~1.7-2% respectively for banks.

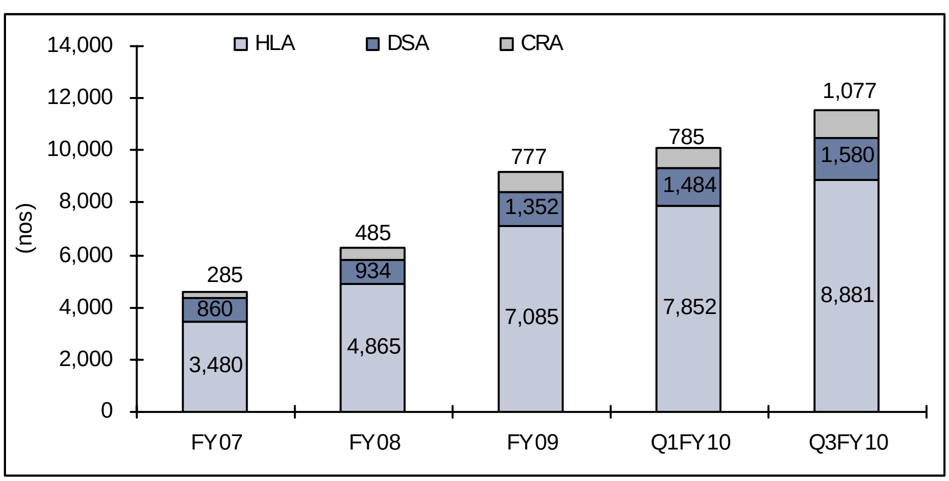
**Chart 9: HFCs' RoA much more leveraged to operating efficiencies**




Source: Company data, I-Sec Research

The current sales origination mix is heavily dependent on LIC agents who originate ~60% of incremental loans, while DSAs are responsible for 25% of sales. Thus, the company has to pay variable costs on ~85% of its incremental sales and incurs no fixed expenses. The fixed expenses on LIC agents are borne by LIC. This allows LICHF to reap significant operating leverage from its business model. Despite the contribution from LICHF's own agency set to rise at the margin, the current high contribution from LIC agents & DSAs helps reduce costs significantly.

**Chart 10: Rapid increase in strength of all delivery channels fuels sales**




Source: Company data, I-Sec Research

# Asset quality has improved markedly since FY05

During FY01-04, while the industry grew at significantly high rates, LICHF was plagued by problems on the asset quality front. Lack of adequate risk appraisal methodology coupled with focus on low ticket size led to high slippages in the initial years of the decade. As a result, GNPAs were as high as 4.4% in FY05. However, since FY06, LICHF has made significant efforts towards reining in slippages – introduction of stringent appraisal procedures and increasing focus on mid-market segment have helped control slippages over the past few years. Low loan-to-value (LTV) and instalment-to-income ratios coupled with the effective use of recovery mechanisms have helped LICHF reduce incremental slippages significantly over FY07-09.

**Table 3: Well-defined hierarchical approval mechanism as per loan size**

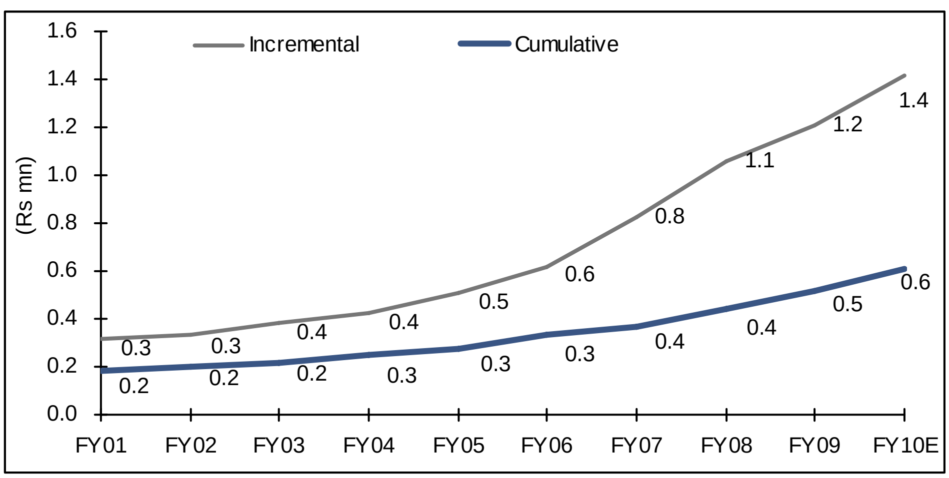
| | |
|---|---|
| Back office | Individual loans up to Rs6mn |
| Regional office | Individual loans up to Rs15mn |
| Corporate office | Individual loans up to Rs30mn and project loans up to Rs50mn |
| Executive committee | Individual loans above Rs30mn and project loans above Rs50mn |

Source: Company data, I-Sec Research

## Low LTV and instalment-to-income ensure lower slippages

Through FY07-10, LICHF's LTV ratio has averaged at ~54%, which ensures high equity participation from the borrowers at inception itself. Given the higher equity participation, the incentive for wilful defaults is low, which helps prevent slippages. Also, in the event of default, the company has enough cushion to recover dues given a low LTV ratio. Low instalment-to-income ratio also ensures that the borrower has higher repayment capabilities. These measures have enabled LICHF to disburse loans of higher ticket size with lower default risk than earlier.

**Chart 11: Rising average ticket size of loans**



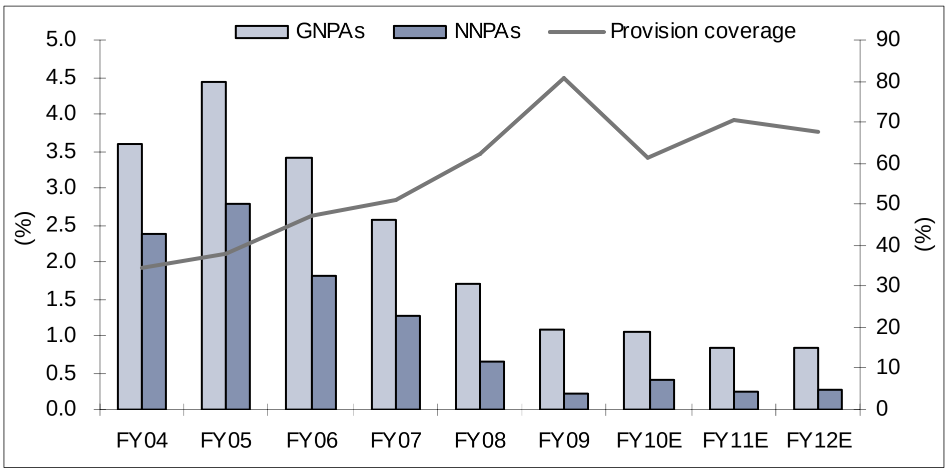

Source: Company data, I-Sec Research

## Developer portfolio in good health

Developer portfolio comprised 8.44% of LICHF's outstanding portfolio as on December 31, '09. While the proportion of this portfolio has steadily increased from 3.1% in FY07, implying a higher focus on this segment of business, we do not foresee significant risks emanating out of this. As per prudential guidelines, no single developer can account for >10% of the net worth.

The collateral for commercial lending includes a mortgage over the property as well as a personal or corporate guarantee in respect of amount due under the loan. Hence, the collateral is at least 2x the value of the property. We note that while retail loans are typically long-duration in nature, the tenure for commercial lending varies over six months to five years. As per the management, there is only a single NPA in the commercial segment (0.15% or Rs50mn).

**Chart 12: Explicit improvement in asset quality; coverage ratio healthier**




Source: Company data, I-Sec Research

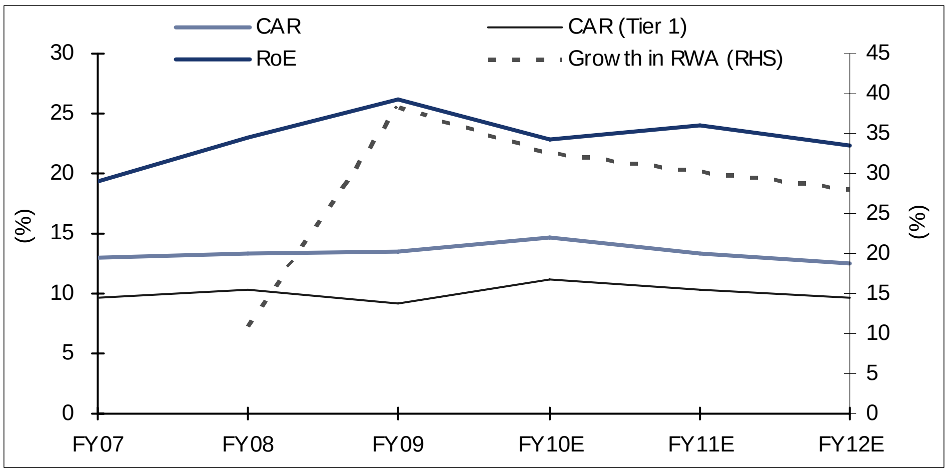
Overall, we believe that the asset quality is likely to remain sanguine despite the high growth envisaged in the coming years. After having witnessed a marked improvement in asset quality with GNPAs down to 1.07% in FY09 from 4.4% in FY05, there has been a spike in NPLs as on December '09 to 1.44%. However, as per the management, NPL spike in Q3FY10 (16bps QoQ) was on account of problem in implementing a web-based application. Hence, loan accounts for which payments were made could not be updated. The flaw is now rectified, implying that most of the incremental NPLs in Q3FY10 are likely to get reversed in our view.

Loan-loss provisions/average loans have come off significantly from 1.24% in FY04 to just 2bps in FY09. We expect GNPAs at ~0.9% levels by FY12E and foresee little scope for improvement from the current levels given the scorching pace at which disbursements have grown in FY10. We are modelling loan-loss provisions at 12bps of average assets for FY11E & FY12E, with provisioning coverage ratio at 65-70%.

## Strong capital position & high internal generation

LICHF's capital position remains strong with tier I capital at 11.5% as on December '09. The company raised Rs6.58bn capital through QIP to fund its aggressive growth plans. We note that given an already high capital adequacy coupled with strong internal generation, LICHF's incremental capital requirement will be minimal at the margin. Despite concerns in the past few years, we note that internal capital generation for LICHF has continued to be healthy – in FY06-09, LICHF's RoE and RoA have averaged 21.2% and 1.8% respectively. Despite a strong loan growth envisaged in FY09-12E and high dividend payout of 21% through FY12E, we estimate tier I capital to be healthy at +9% in FY12E, implying no dilution in the medium term.

**Chart 13: Capital not a constraint for strong growth in the medium term**




Source: Company data, I-Sec Research

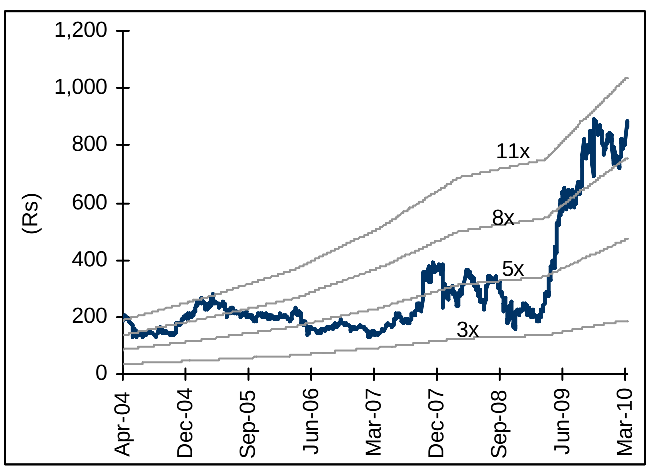
# Financial analysis

We anticipate LICHF to continue to generate robust core RoE of 23% supported by a healthy core RoA of 1.8% over FY10E-12E. While LICHF generates lower spreads vis-à-vis banks as a result of absence of low-cost deposits, it compensates for the same by: i) maintaining an extremely low cost structure with cost-to-assets ratio at ~55-60bps versus banks' 1.7-2% given its wholesale nature and reliance on third-party distribution and ii) favourable loan-loss provisions as a result of stringent internal risk assessment and monitoring systems and a portfolio which is mostly secured. Low loan-loss provisions at 12bps through to FY12E will serve as a key trigger for RoAs – which is higher than the banks' RoA. We have also assumed that Rs1.38bn profit on sale of 17.3% stake in LIC AMC will accrue in FY11E. Hence, there is an exceptional income of Rs1.15bn (on a tax adjusted basis) in our estimates.

We acknowledge that the stock has been structurally rerated from 0.5x FY11E BV to ~2x FY11E BV as on date. However, headwinds faced by the company in terms of threat of large-scale GNPAs and unreasonable increase in wholesale rates are now behind us. LICHF has, since, demonstrated effective spread management and reined in legacy asset quality troubles. It seems adequately capitalised for the foreseeable future to support disbursements CAGR of 23.3% through to FY10E-12E. This should drive a robust earnings CAGR of 25.2% through to FY10E-12E with strong ~23% core RoEs.

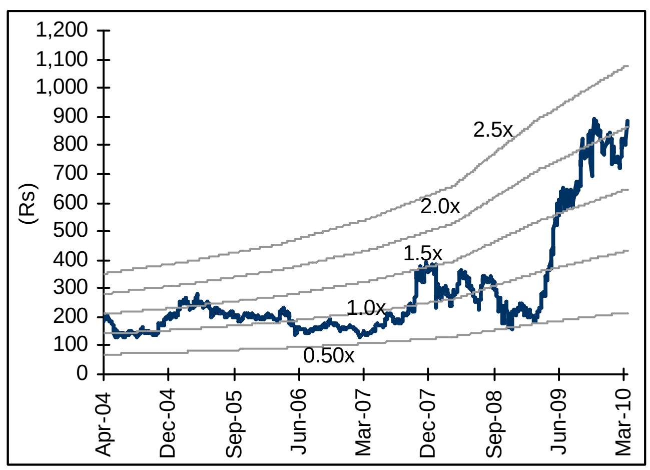
Hence, we peg our fair value for LICHF at 2.25x FY11E BV (Rs977/share) and after adding Rs17/share for its 20% stake in LIC AMC, we arrive at Rs994/share target price, with 15.2% upside from the current levels. We initiate coverage on LICHF with BUY.

**Chart 14: P/E bands**



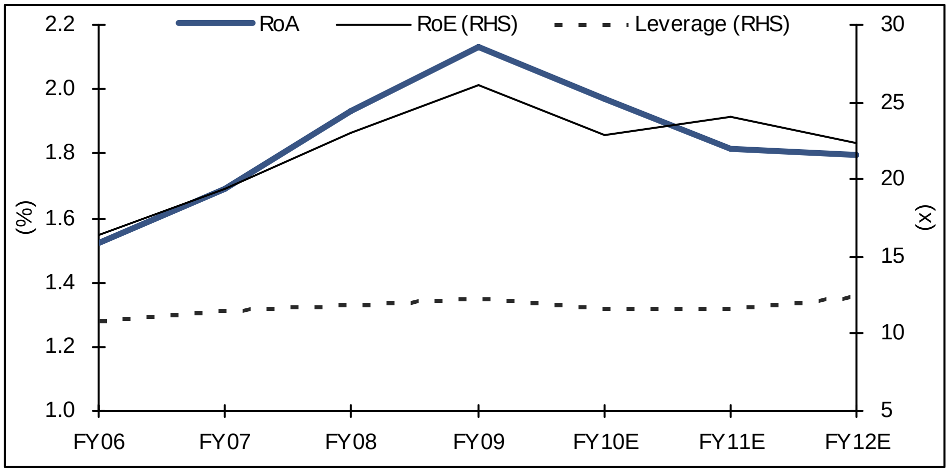

Source: BSE India, I-Sec Research

**Chart 15: P/BV bands**




Source: BSE India, I-Sec Research

**Chart 16: Leverage to rise on strong growth, pumping up RoEs**




Source: Company data, I-Sec Research

# Key risks

## Slowdown in disbursements growth

A key performance parameter for LICHF is its higher-than-industry disbursements growth on the back of which it is gaining market share rapidly. Fortunately, this has also coincided with a key competitor staying low in the market. However, LICHF remains a price-taker in the market and its lending rates remain susceptible to the rates set by larger competitive forces in the market such as HDFC, State Bank of India and other large private lenders. If LICHF is forced to increase rates owing to rise in costs as against competitors continuing with lower rates, the firm might suffer a slowdown in disbursements (assuming it does not compromise on spreads).

## Asset-liability mismatch & rise in wholesale rates

Assets of LICHF are primarily floating-rate in nature (85%) while they are funded by liabilities, 50% of which are fixed. Further, LICHF historically maintains a negative gap in the one month-one year duration bucket – probably expecting prepayments to make up for the same. Both these factors put the company at risk in case interest rates move adversely or the actual experience of prepayments deviates from the expected.

LICHF remains primarily wholesale funded and with the regulator looking to exit the accommodative monetary policy, wholesale interest rates across the economy will rise. This could increase the cost of funds and without commensurate pass-through to the consumer, might pressurise spreads.

## Regulatory changes

LICHF is a Section 36(i)(viii) company, whereby 20% of its long-term profits are tax exempt. This is responsible for an effective tax rate of 27% as on date. Earlier, however, 40% of long-term profits were exempt, under which its effective tax rate was closer to 22%. Any such regulatory change whereby a lesser percentage of long-term profits (than 20% currently) are tax exempt is a risk to LICHF’s healthy return ratios.

The Government has incentivised housing demand by subjecting ~Rs0.25mn paid towards principal and interest payments exempt from taxation. Removal of tax exemptions might cause some slowdown in housing demand.

## Resurgence of NPAs

LICHF has painstakingly cleaned-up its balance sheet and installed specific processes for centralised approval of loan applications, day-to-day monitoring of credit risk and resolution and recovery of non-performing assets. As a result, GNPAs have declined to 1.07% in FY09 from 4.4% in FY05. Any worsening of economic conditions or sharper-than-expected rise in borrowing costs passed-through to the borrowers might aggravate non-performing assets.

# HFCs well placed – LICHF to gain market share

Planning Commission report on urban housing demand (XI Five Year Plan) pegs the total housing requirement at 26.5mn as on FY12. Despite the huge potential, penetration of mortgage in India remains among the lowest in Asia at 6% of GDP as of FY09. This represents a huge opportunity for banks and HFCs alike, with both in keen competition for market share. We believe HFCs are at an advantage vis-à-vis banks in this space.

### Table 4: Housing requirement during XI FYP as on FY12

*(mn)*

| | |
|---|---|
| **Housing shortage as on '07** | **24.71** |
| Households | 75.01 |
| *Pucca* Houses | 53.49 |
| Semi *Pucca* Houses | 10.05 |
| *Katcha* Houses | 2.56 |
| Addition to households | 8.71 |
| Addition to housing stock | 7.27 |
| Upgradation of *Katcha* Houses | 0.38 |
| Additional requirement | 1.82 |
| **Total requirement** | **26.53** |

Source: Planning Commission

Firstly, with pick-up in loan disbursements, incremental focus of banks on housing finance is likely to be diluted with lesser resources focused towards loan origination and disbursal. To add to this, a large private sector bank's home loan subsidiary, which had rapidly gained market share earlier in the decade, remains in consolidation mode, allowing HFCs to claw back market share. HFCs' market share in total disbursements, which had eroded to 32% in FY06, stood at 50% as of FY09.

Secondly, loan processing and asset valuation competencies are far more developed for pure HFCs vis-à-vis public banks. Anecdotal evidence suggests that the turnaround time of a home loan sanction at LICHF is 10-12 days versus close to six weeks for public banks.

Thirdly, HFCs make up for the lack of access to low-cost deposits by utilising debentures for most of their funding. Debentures are tradable, have wider investor participation, cost less as compared with bank loans and offer a quick avenue of raising capital, thereby providing funding flexibility. Both HDFC and LICHF are AAA-rated companies, which further help reduce the cost of debentures.

LICHF is likely to be a key beneficiary of the absence of large private banks in the home loan segment. Its strong disbursements growth is extremely timely and this has helped it improve its market share to 7.6% as on Q3FY10 versus 5.8% in FY06. With the overall interest rates set to rise, LICHF will no longer face extreme competitive pressure on lending yields from teaser rates as the latter are withdrawn. Hence, with above-industry disbursements growth driving a sharp increase in assets, we believe its market share is set to rise hereon.

# Company profile

LICHF was incorporated in 1989 as an HFC, with LIC as its major shareholder. Its primarily business is mortgage lending, wherein it provides loans to individuals, corporates and developers for purchase, construction and repair of residential and commercial real estate. Apart from its primary lending business, it has a wholly-owned subsidiary LICHFL FS engaged in selling third-party products, holds a 20% stake in LIC AMC and has floated LICHFL Care Homes which operates assisted living community centres for senior citizens. Currently, LICHF is present across 450 locations and utilises 11,538 agents for its business.

## Key subsidiaries – Profile

**LICHFL Financial Services Company** was established in October ’07 to undertake non-fund based activities such as marketing of insurance, mutual funds, home loans, credit cards, etc. It currently has 33 branches (14 branches as on March 31, ’09) and +800 sales agents. Of its total product suite, it exclusively sells life insurance and originates home loans for LIC and LICHF respectively. It is a multi-brand retailer for other products including mutual funds. We expect LICHFL FS to increase its contribution towards home loan origination, which will be an added positive for LICHF.

**LIC Asset Management Company** manages Rs464.6bn as of February ’10 with LICHF’s stake at 20% post dilution and subsequent stake sale. LICHF had taken a 39.3% stake in LIC AMC for Rs39.3mn in 1994. It pared its holding recently to 20% post a 10% dilution and subsequent sale of 17.3% for Rs1.38bn. The AMC also aims to manage, advice and administer venture funds in India by beginning of FY11E.

**LICHFL Care Homes**, promoted by LICHF, manages assisted community living centres for senior citizens. The wholly-owned subsidiary of LICHF commenced an eco-friendly pilot project in Bangalore and is looking to open similar community centres in Bhubaneswar and Jaipur.

# Annexure 1: Financials

## Table 5: Profit & Loss statement

*(Rs mn, year ending March 31)*

| | FY08 | FY09 | FY10E | FY11E | FY12E |
|---|---|---|---|---|---|
| Interest earned | 20,584 | 27,583 | 33,436 | 44,606 | 58,037 |
| Interest expended | 14,829 | 20,166 | 24,536 | 33,252 | 43,511 |
| **Net interest income** | **5,756** | **7,417** | **8,900** | **11,354** | **14,527** |
| Other income | 1,044 | 1,343 | 1,849 | 2,262 | 2,763 |
| Processing Fees | 526 | 682 | 1,072 | 1,307 | 1,607 |
| Miscellaneous Income | 518 | 661 | 777 | 955 | 1,156 |
| Operating expenses | 1,339 | 1,551 | 1,888 | 2,263 | 2,756 |
| Employee costs | 347 | 449 | 547 | 668 | 821 |
| **Pre-provisioning profit** | **5,461** | **7,209** | **8,861** | **11,353** | **14,534** |
| Loan and investment loss provisions | 243 | 53 | 10 | 517 | 667 |
| Profit before tax | 5,218 | 7,157 | 8,851 | 10,836 | 13,866 |
| Income taxes | 1,451 | 1,948 | 2,390 | 2,926 | 3,744 |
| **Net profit** | **3,767** | **5,209** | **6,462** | **7,910** | **10,122** |
| Exceptional items | - | - | - | 1,150 | - |
| **Net profit (adjusted for exceptional items)** | **3,767** | **5,209** | **6,462** | **9,060** | **10,122** |

Source: Company data, I-Sec Research

## Table 6: Balance sheet

*(Rs mn, year ending March 31)*

| | FY08 | FY09 | FY10E | FY11E | FY12E |
|---|---|---|---|---|---|
| Share Capital | 850 | 850 | 950 | 950 | 950 |
| Reserves and surplus | 17,467 | 21,491 | 33,140 | 40,298 | 48,295 |
| Loans | 110,939 | 110,890 | 150,810 | 187,005 | 226,275 |
| Bonds, CPs, Debentures, Deposits | 86,852 | 142,033 | 192,865 | 264,183 | 355,688 |
| ECB | 2,345 | - | - | - | - |
| LIC | 3,308 | 1,294 | 1,294 | 1,294 | 1,294 |
| **Total liabilities & stockholders' equity** | **221,761** | **276,558** | **379,060** | **493,729** | **632,503** |
| Housing Loans | 219,364 | 276,793 | 373,579 | 488,032 | 624,243 |
| Net Investments | 7,746 | 11,292 | 10,671 | 10,870 | 13,412 |
| Net Fixed Assets | 300 | 345 | 362 | 381 | 400 |
| Net Current Assets | (6,578) | (12,819) | (6,500) | (6,500) | (6,500) |
| Deferred Tax | 929 | 948 | 948 | 948 | 948 |
| **Total assets** | **221,761** | **276,558** | **379,060** | **493,729** | **632,503** |

Source: Company data, I-Sec Research

### Table 7: Key ratios

*(Year ending March 31)*

| | FY07 | FY08 | FY09 | FY10E | FY11E | FY12E |
|---|---|---|---|---|---|---|
| **Per share data (Rs)** | | | | | | |
| Period end shares outstanding (mn) | 85.0 | 85.0 | 85.0 | 95.0 | 95.0 | 95.0 |
| Basic EPS | 32.8 | 45.6 | 62.5 | 68.0 | 95.4 | 106.6 |
| Diluted EPS | 32.8 | 45.6 | 62.5 | 68.0 | 95.4 | 106.6 |
| Book value per share | 181.6 | 215.5 | 262.8 | 358.9 | 434.2 | 518.4 |
| Adjusted book value per share | 155.6 | 198.9 | 256.2 | 343.0 | 421.4 | 500.4 |
| | | | | | | |
| **Growth ratios (%)** | | | | | | |
| Total assets | 18.2 | 24.1 | 24.7 | 37.1 | 30.3 | 28.1 |
| Housing Loans | 18.1 | 24.9 | 26.2 | 35.0 | 30.6 | 27.9 |
| Borrowings (Secured + Unsecured) | 18.5 | 24.6 | 25.0 | 35.7 | 31.2 | 28.9 |
| Book value | 14.7 | 18.6 | 22.0 | 36.5 | 21.0 | 19.4 |
| EPS | 33.8 | 38.7 | 37.3 | 8.8 | 40.2 | 11.7 |
| | | | | | | |
| **Valuation ratios (x)** | | | | | | |
| P/PPP (pre-provisioning profit) | 20.0 | 13.4 | 10.2 | 9.2 | 7.2 | 5.6 |
| P/E | 26.3 | 18.9 | 13.8 | 12.7 | 9.0 | 8.1 |
| P/BV | 4.7 | 4.0 | 3.3 | 2.4 | 2.0 | 1.7 |
| P/ABV | 5.5 | 4.3 | 3.4 | 2.5 | 2.0 | 1.7 |
| Dividend yield (%) | 0.9 | 1.2 | 1.5 | 1.7 | 2.3 | 2.6 |
| | | | | | | |
| **Operating ratios (%)** | | | | | | |
| Operating cost to income | 23.4 | 19.7 | 17.7 | 17.6 | 16.6 | 15.9 |
| Operating expenses/ Avg. assets | 0.7 | 0.7 | 0.6 | 0.6 | 0.5 | 0.5 |
| Op. expense/ non-interest income | 191.1 | 128.3 | 115.5 | 102.1 | 100.0 | 99.7 |
| | | | | | | |
| **Profitability ratios (%)** | | | | | | |
| Average yield on funds | 9.3 | 10.3 | 11.1 | 10.2 | 10.2 | 10.3 |
| Average cost of funds | 7.4 | 8.1 | 8.8 | 8.2 | 8.3 | 8.4 |
| Spread | 1.9 | 2.1 | 1.9 | 1.8 | 1.8 | 1.8 |
| Net interest margin | 2.6 | 2.8 | 2.9 | 2.6 | 2.6 | 2.6 |
| Return on avg. assets | 1.7 | 1.9 | 2.1 | 2.0 | 1.8 | 1.8 |
| Return on avg. net worth | 19.3 | 22.9 | 26.2 | 22.9 | 24.1 | 22.4 |
| | | | | | | |
| **Asset quality and capital (%)** | | | | | | |
| Gross NPA | 2.58 | 1.70 | 1.07 | 1.05 | 0.85 | 0.85 |
| Net NPA | 1.26 | 0.64 | 0.21 | 0.40 | 0.25 | 0.27 |
| Total CAR | 12.94 | 13.34 | 13.50 | 14.69 | 13.31 | 12.54 |

Source: Company data, I-Sec Research

# Annexure 2: Index of Tables and Charts

## Tables



## Charts

*I-Sec investment ratings (all ratings relative to Sensex over next 12 months)*
**BUY**: +10% outperformance; **HOLD**: -10% to +10% relative performance; **SELL**: +10% underperformance

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