

Banking

Target price Rs1,449

Target price revision

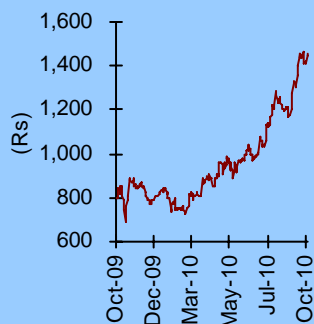
Rs1,449 from Rs1,182

Shareholding pattern

	Mar '10	Jun '10	Sep '10
Promoters	36.5	36.5	36.5
Institutional investors	51.2	50.5	50.9
MFs and UTI	13.0	14.1	5.6
Insurance Cos.	3.8	4.2	3.6
FIs	33.8	32.1	41.7
Others	12.3	13.0	12.6

Source: BSE

Price chart



Reason for report: Q2FY11 results review and recommendation change

LIC Housing Finance (LICHF) reported a robust set of numbers wherein disbursement growth stood at 36% YoY. The key highlight was a sharp jump in developer loans portfolio to 11.3% of total loans. Spreads continued to compress and stood at 2.13%, however, strong volume growth ensured NII growth of 63.3% YoY (I-Sec: 57%). Asset quality improved significantly with GNPA's and NNPA's declining 18bps and 14bps QoQ to 0.74% and 0.21% respectively. Given ~70% of incremental retail business comes from fixed-rate products, spreads will likely remain under pressure and LICHF will bank on volume growth and higher yielding project financing to support profitability. We expect LICHF to sustain +20% RoE trajectory, however, at 13x FY12E EPS and 2.8x FY12E BV the stock is appropriately valued. We downgrade our rating to HOLD on rich valuations.

- ▶ **Volumes pour in but mix changes, spreads compress.** Our expectations of rising share of developer portfolio played out in Q2FY11 with developer portfolio rising to 11.3% of total loans. We expect volume growth to continue with retail still remaining the mainstay, but project loans will likely increase to ~12% in the medium term. Continuing with fixed-rate retail products will continue to compress incremental spreads. To counter this impact, we expect higher-yielding, floating-rate and lower-duration developer/project loans to rise. The borrowing mix has further shifted towards NCDs (Chart 2). With ~85bps increase in incremental costs over H1FY11, LICHF's ability to absorb cost increases will be limited. We maintain that spreads will compress hereon, and sustain at ~1.6-1.7% by FY12E (~1.8% earlier).
- ▶ **Processing fees to remain high, costs to sustain.** Other income was buoyed by Rs220mn dividend income and income from investments in mutual funds. Processing fees, directly a function of disbursements growth will remain high. Expect costs to sustain as branch expansion for FY11 is behind us and salary revisions are factored into the base. We expect cost-to-income to be ~15% through FY12E.
- ▶ **Asset quality to improve, provisioning to rise.** LICHF is incrementally providing 0.1% of the core standard assets and 0.9% of the non-core standard assets as per NHB requirements. We factor in 80% provision coverage ratio through FY12E.
- ▶ **Rich valuations, downgrade to HOLD.** LICHF continues to remain a profitable play on strong growth in mortgage finance space. Taking cognizance of continued volume growth and sustained +20% RoE, we raise our multiple to 2.7x FY12E BV (2.2x earlier). Incorporating Rs17/share for the stake in LIC AMC, our target price stands revised at Rs1,449/share. However, valuations currently are extremely rich at 13x FY12E EPS and 2.8x FY12E BV. Hence we downgrade our rating to Hold. Sharp slowdown in disbursements or a sharp adverse interest rate move is a risk.

Market Cap	Rs138.6bn/US\$3.1bn	Year to Mar	2009	2010E	2011E	2012E
Reuters/ Bloomberg	LICH.BO/LICHF IN	NII (Rs mn)	7,417	8,926	12,185	15,199
Shares Outstanding (mn)	95.0	Net Profit (Rsmn) *	5,317	6,621	8,568	10,677
52-week Range (Rs)	1,469/693	EPS (Rs) *	62.6	69.7	90.2	112.4
Free Float (%)	63.5	% Chg YoY	37.3	11.4	29.4	24.6
FII (%)	41.7	P/E (x)	23.3	20.9	16.2	13.0
Daily Volume (US\$/'000)	27,300	P/BV (x)	5.6	4.1	3.3	2.8
Absolute Return 3m (%)	35.9	Net NPA (%)	0.21	0.12	0.12	0.11
Absolute Return 12m (%)	83.3	Dividend Yield (%)	0.9	1.0	1.3	1.5
Sensex Return 3m (%)	14.5	RoA (%)	2.13	2.01	1.92	1.81
Sensex Return 12m (%)	19.2	RoE (%) *	26.2	23.6	22.6	23.2

*Net profit, EPS & RoE does not include exceptional income of Rs1150mn from profit on sale of 17.3% stake in LIC AMC assumed to accrue in FY11E

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Table 1: Q2FY11 results review*(Rs mn, year ending March 31)*

	Q2FY11	Q2FY10	% YoY	Q1FY11	% QoQ	YTD FY11	YTD FY10	% YoY
Interest income	10,429	7,847	32.9	9,716	7.3	20,145	15,297	31.7
Interest expense	7,378	5,979	23.4	6,772	8.9	14,151	11,687	21.1
Net interest income	3,051	1,868	63.3	2,943	3.7	5,994	3,610	66.0
Non-interest income	645	544	18.5	434	48.7	1,079	913	18.2
Total income	3,696	2,413	53.2	3,377	9.5	7,073	4,523	56.4
Operating expenses	505	552	(8.4)	394	28.2	900	882	2.0
Pre-provisioning profit	3,191	1,861	71.5	2,983	7.0	6,174	3,641	69.5
Total provisions	3	(417)	(100.7)	89	(96.9)	92	(317)	(129.1)
Prior period items	(2)	(1)		(0)		(2)	(9)	
PBT	3,190	2,279	40.0	2,893	10.3	6,084	3,967	53.3
Tax	848	566	50.0	773	9.7	1,622	1,015	59.7
PAT	2,342	1,714	36.6	2,120	10.5	4,462	2,952	51.1
Loan sanctions	76,668	53,648	42.9	53,483	43.4	76,668	53,648	42.9
Individual sanctions	56,930	44,267	28.6	36,543	55.8	56,930	44,267	28.6
Project sanctions	19,738	9,382	110.4	16,940	16.5	19,738	9,382	110.4
Loan disbursements	51,012	37,570	35.8	33,918	50.4	51,012	37,570	35.8
Individual disbursements	38,180	33,879	12.7	30,183	26.5	38,180	33,879	12.7
Project disbursements	12,832	3,692	247.6	3,735	243.6	12,832	3,692	247.6
Outstanding mortgage portfolio	433,849	318,900	36.0	400,296	8.4	433,849	318,900	36.0
Individual	384,884	292,110	31.8	358,458	7.4	384,884	292,110	31.8
Project/developer	48,965	26,790	82.8	41,838	17.0	48,965	26,790	82.8
Cost of funds (%)	7.91	8.38		7.81		7.91	8.38	
Yield on funds (%)	10.04	10.03		10.05		10.04	10.03	
Spread (%)	2.13	1.65		2.24		2.13	1.65	
NIM (%)	2.93	2.44		3.01		2.93	2.44	
GNPAs (Rs mn)	3,195.9	4,085.5		3,669.2		3,195.9	4,085.5	
NNPAs (Rs mn)	901.6	1,982.5		1,398.4		902	1,983	
GNPAs (%)	0.7	1.3		0.9		0.7	1.3	
NNPAs (%)	0.2	0.6		0.4		0.2	0.6	
Provision coverage (%)	71.8	51.5		61.9		71.8	51.5	

Source: Company data, I-Sec Research

Table 2: Contours of 'Advantage 5' – Management retains flexibility

Product features	Lending rates are fixed at 9.25% for five years and thereafter on floating basis
Rationale	<ul style="list-style-type: none"> To fill gap in the market – consumers looking for fixed rates for a longer term Over five years, the interest rates are expected to remain cyclical and hence, will not hurt long-term product profitability
Concerns	In a rising interest rate scenario, a fixed rate of 9.25% will hurt incremental spreads significantly
Validation of concerns	Management admitted that LICHF recently borrowed five-year money at 8.28%
Management, however, has retained flexibility over the product	
Funding strategy	Partly through back-to-back arrangements and partially through roll-over of liabilities
Continuity	LICHF will also extend the product by a month at a time. It can technically discontinue the product if rates increase significantly
Our view	<ul style="list-style-type: none"> Incremental spreads (from this product) will definitely compress in the short term Current funding is expected mostly through roll-over of borrowings as cost of five-year money is high vis-à-vis 9.25% lending rate Product IRR may not suffer significantly given cyclicity in interest

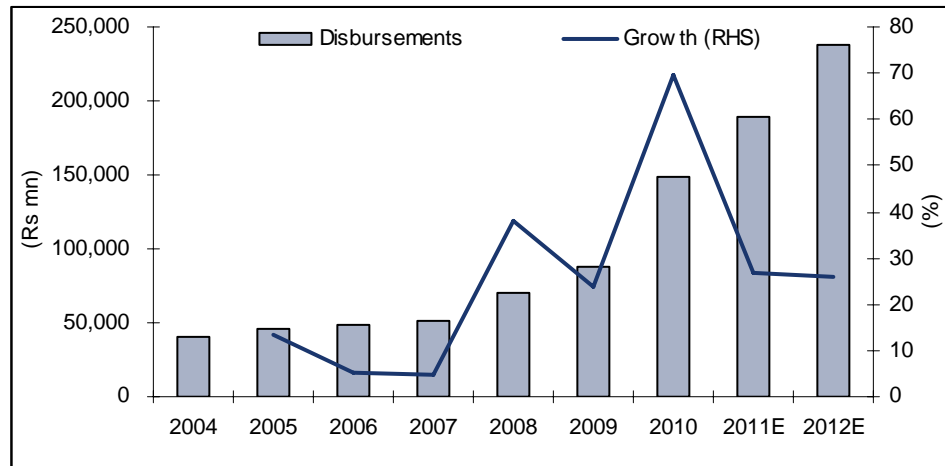
Source: Company data, I-Sec Research

Table 3: Asset liability profile – increasing proportion of fixed rate assets

	Assets	Liabilities
Q1FY11		
Fixed rate (%)	25-30	60
Floating rate (%)	70-75	40
Q2FY11		
Fixed rate (%)	35	58
Floating rate (%)	65	42

Source: Company data, I-Sec Research

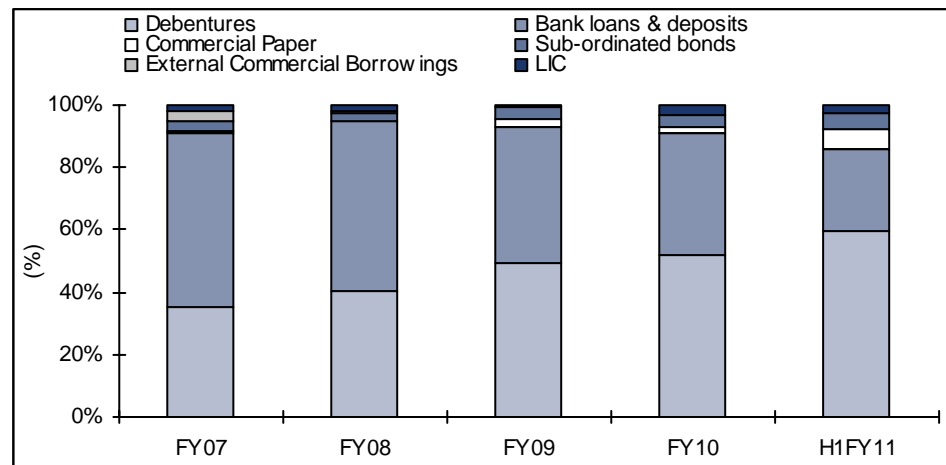
Chart 1: Disbursements to grow at a brisk pace hereon



Source: Company data, I-Sec Research

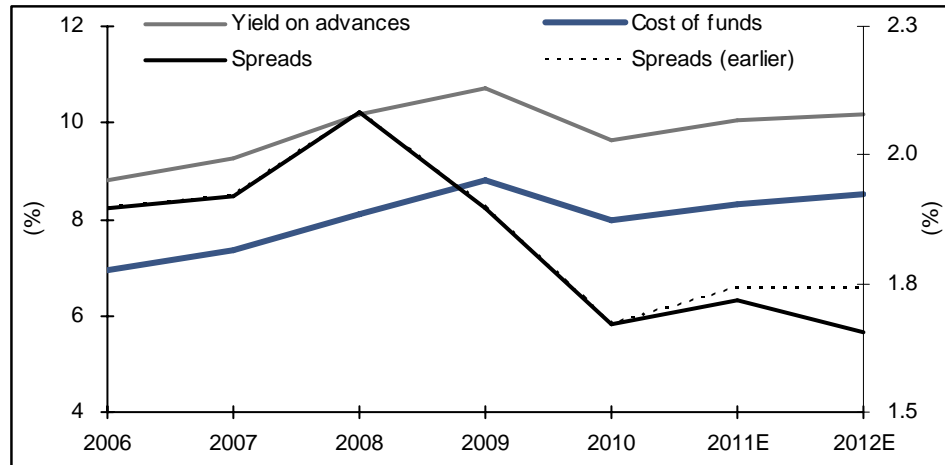
Chart 2: Significantly lower dependence on bank loans will help spreads

Increasing share of borrowings from NCDs and away from bank loans as interest rates rise



Source: Company data, I-Sec Research

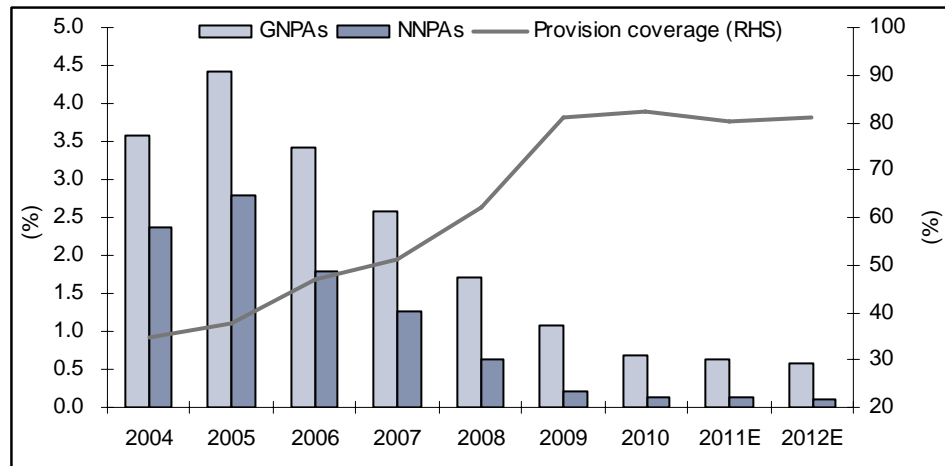
Chart 3: Spreads to decline to ~1.7% through FY12E



Source: Company data, I-Sec Research

Chart 4: Asset quality to remain benign with a high provision coverage ratio

Low loan-to-value, increasing average ticket size (ATS) and high collateral (>2x) in the developer portfolio are effective checks against meaningful asset quality deterioration



Source: Company data, I-Sec Research

Financial Summary

Table 4: Profit and Loss statement
(Rs mn, year ending March 31)

	FY09	FY10	FY11E	FY12E
Interest earned	27,583	32,883	46,074	61,698
Interest expended	20,166	23,957	33,889	46,499
Net interest income	7,417	8,926	12,185	15,199
Other income	1,343	1,813	2,124	2,663
Processing Fees	682	1,274	1,434	1,806
Miscellaneous Income	661	540	691	857
Operating expenses	1,549	1,911	2,172	2,647
Employee costs	449	485	562	675
Pre-provisioning profit	7,210	8,828	12,137	15,215
Loan and investment loss provisions	53	(283)	400	589
Profit before tax	7,158	9,112	11,737	14,626
Income taxes	1,948	2,491	3,169	3,949
Net profit	5,210	6,621	8,568	10,677
Exceptional items	-	-	1,150	-
Net profit (adjusted for exceptional items)	5,210	6,621	9,718	10,677

Source: Company data, I-Sec Research

Table 5: Balance sheet
(Rs mn, year ending March 31)

	FY09	FY10	FY11E	FY12E
Share Capital	850	950	950	950
Reserves and surplus	21,491	32,927	40,895	49,437
Loans	110,890	142,878	175,740	217,917
Bonds, CPs, Debentures,				
Deposits	142,033	203,136	289,678	402,790
ECB	-	-	-	-
LIC	1,294	1,568	1,725	1,897
Total liabilities & stockholders' equity	276,558	381,458	508,988	672,991
Housing Loans	276,793	380,814	508,515	669,914
Net Investments	11,292	13,887	14,708	17,793
Net Fixed Assets	345	356	374	393
Net Current Assets	(12,819)	(14,489)	(15,500)	(16,000)
Deferred Tax	948	891	891	891
Total assets	276,558	381,458	508,988	672,991

Source: Company data, I-Sec Research

Table 6: Key ratios
(Year ending March 31)

	FY09	FY10	FY11E	FY12E
Per share data (Rs)				
Period end shares outstanding (mn)	85.0	95.0	95.0	95.0
Basic EPS *	62.6	69.7	90.2	112.4
Diluted EPS *	62.6	69.7	90.2	112.4
Book value per share	262.8	356.6	440.5	530.4
Adjusted book value per share	256.2	351.7	433.8	522.7
Growth ratios (%)				
Total assets	24.7	37.9	33.4	32.2
Housing Loans	26.2	37.6	33.5	31.7
Borrowings (Secured + Unsecured)	25.0	36.7	34.4	33.3
Book value	22.0	35.7	23.5	20.4
EPS	37.3	11.4	29.4	24.6
Valuation ratios (x)				
P/PPP (pre-provisioning profit)	17.2	15.7	11.4	9.1
P/E	23.3	20.9	16.2	13.0
P/BV	5.6	4.1	3.3	2.8
P/ABV	5.7	4.1	3.4	2.8
Dividend yield (%)	0.9	1.0	1.3	1.5
Operating ratios (%)				
Operating cost to income	17.7	17.8	15.2	14.8
Operating expenses/ Avg. assets	0.6	0.6	0.5	0.4
Op. expense/ non-interest income	115.4	105.4	102.2	99.4
Profitability ratios (%)				
Average yield on funds	11.1	10.0	10.3	10.4
Average cost of funds	8.8	8.0	8.3	8.5
Spread	1.9	1.7	1.7	1.7
Net interest margin	2.9	2.6	2.7	2.5
Return on avg. assets	2.1	2.0	1.9	1.8
Return on avg net worth	26.2	23.6	22.6	23.2
Asset quality and capital (%)				
Gross NPA	1.07	0.69	0.63	0.58
Net NPA	0.21	0.12	0.12	0.11
Total CAR	13.50	14.89	13.50	12.88

*EPS does not include exceptional income of Rs1150mn from profit on sale of 17.3% stake in LIC AMC assumed to accrue in FY11E

Source: Company data, I-Sec Research

Table 7: Quarterly trend
(Rs mn, year ending March 31)

	Dec-09	Mar-10	Jun-10	Sep-10
Net interest income	2,280	2,980	2,943	3,051
% growth (YoY)	53.4	40.9	69.0	63.3
Other income	469	489	434	645
Pre-provision profit	2,323	2,856	2,983	3,191
Net profit	1,536	2,135	2,120	2,342
% growth (YoY)	14.3	36.2	71.2	36.7

Source: Company data, I-Sec Research

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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