

The Mortgage Finance industry which hitherto has been growing at a healthy pace of 26% CAGR over the last 7 years, is expected to continue its growth momentum going ahead on the back of a robust economic growth. On the back of the same, DHFL which has carved a niche for itself in the low cost housing segment, has grown at a healthy CAGR of 36% over the last 5 years boasting an AUM of Rs. 100,000mn as on FY10. With the Housing Finance companies' market share set to increase to 33% by the end of the 11th Five year plan from 29% presently, we expect DHFL's market share to improve to 9% from 7% presently. With an experienced CEO running the business, good asset quality & comparable Return ratios, we find DHFL a compelling story to invest in.

Key Investment Highlights

- Robust Business Model (Direct play on the low cost housing theme) and Strong Asset book growth of 36% CAGR over the last 5 years to continue going ahead
- Professional CEO managing the business
- Strong Asset Quality – Healthy Capital Adequacy Ratio + NPA's trending down over the years
- Higher Fee income (driven by mortgage insurance sold as a coupled product) to offset higher operating costs
- Historically enjoyed better NIMs compared to peers. Trigger could be the Floating Rate Arbitrage in a rising interest rate scenario

Valuation

- At the CMP of Rs.232, the stock is trading at 1.68x its FY11 Adj BV and 1.46x its FY12 Adj. BV. We value the stock at 1.6x its FY12 Adj BV and thus give a 1 year price target of Rs.255. We recommend a **“BUY”** on correction.

Financial summary Rs. Mn

| Year | Nil | Adj PAT | Adj BV | ROE (%) | ROA | Net NPA (%) | P/B (x) |
|-------|-------|---------|--------|---------|------|-------------|---------|
| FY10 | 2,346 | 1,548 | 108 | 22.7% | 1.8% | 0.73% | 2.1 |
| FY11E | 3,486 | 1,969 | 138 | 16.3% | 1.6% | 0.73% | 1.7 |
| FY12E | 4,943 | 2,842 | 159 | 17.2% | 1.7% | 0.72% | 1.5 |

| Market data | |
|--|----------------|
| BSE code/NSE code | 511072 |
| NSE code | DEWANHOUS |
| Bloomberg code | DEWH IN EQUITY |
| CMP | Rs. 232 |
| Fully diluted shares o/s | 102mn |
| 52-week High-Low | Rs. 265/102 |
| Market Cap | Rs. 22,950mn |
| 3m Avg.Daily Volume | Rs. 27mn |
| Shareholding as on 31 st March 2010 | |
| Promoters | 45.2% |
| Institutions | 34.97% |
| Public | 19.83% |

| Stock Performance | | | |
|-------------------|------|-------|-------|
| | 1m | 3m | 6m |
| DHFL | 5.8% | 16.7% | 20.7% |
| Sensex | 3.7% | -0.1% | 3.4% |

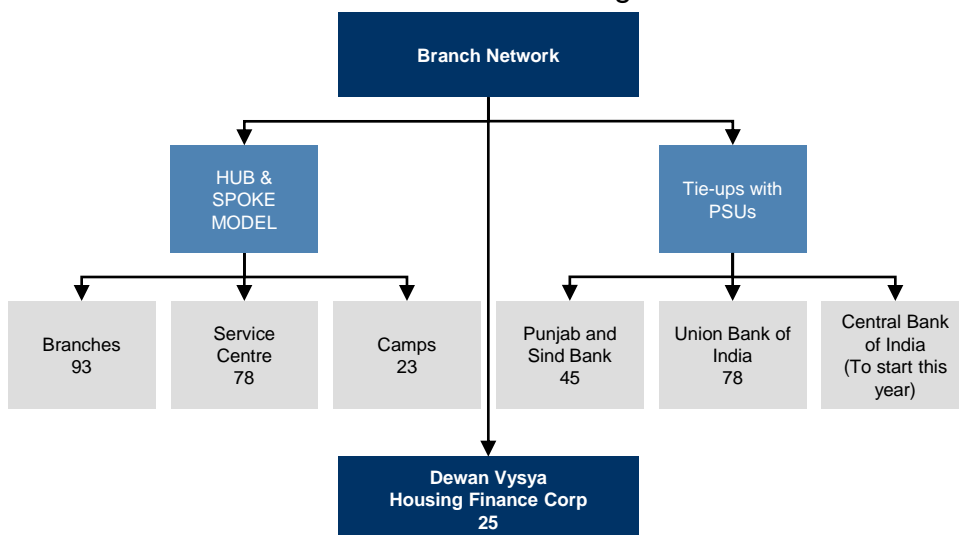
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Robust Business Model

- Dewan Housing Finance Limited (DHFL) was formed in the year 1984 by Shri Dewan Kuldeep Singh Wadhwan and Mr. Rajesh Kumar Wadhawan with a vision to provide financing solutions for low cost housing
- Over the last 26 years, the company has established a strong viable business model of financing low cost housing and presently boasts of a Point of Presence (POP) of 342 centers split into branches, service-centers and camps
- DHFL finances low cost flats, plots, self-constructed houses with an average ticket size of Rs. 0.5mn. (Its closest competitor LIC Housing Finance has an average ticket size of Rs. 1.6mn) Incremental ticket size has jumped to Rs. 0.8mn in FY10 purely on account of higher realty prices
- Its customer profile comprises private employees, government employees, self employed et a l. The company's principle to lend money strictly to end-users aids the company in maintaining its asset quality. (Gross NPAs have been less than 1.8% since FY03)
- Average EMI to Income has stood comfortable at ~38% over the last 5 years



Potential Target Segment

| | |
|------------------------|-----------|
| Total Households in Mn | 206 |
| Upper Middle Income | 6 |
| Middle Income | 19 |
| Lower Income | 21 |
| Total | 46 |
| Potential Target | 22.3% |

48% of the LMI segment live in rented apartments

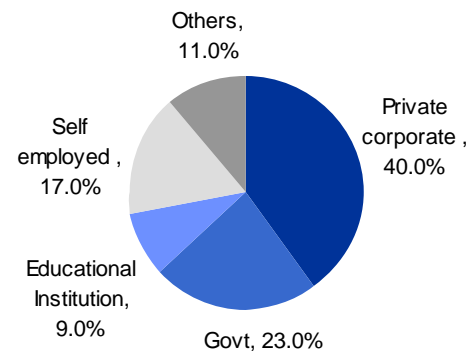
Source: Company

Loan Details

| | |
|----------------------|-------------------------------|
| Average ticket size | Rs 5,06,000 |
| Max. Loan to Cost | 80% (at origination) |
| Average Loan to Cost | 68.80% (at origination) |
| Average Loan Tenor | 12 Years (at origination) |
| Primary security | Mortgage of property financed |
| Repayment type | Amortizing |

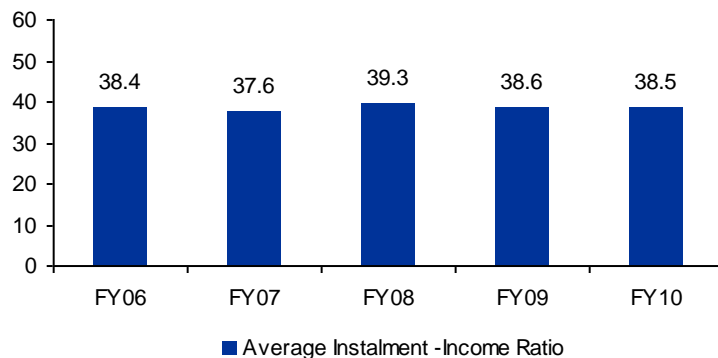
Source: Company

Salaried Individuals form 72% of the borrower profile



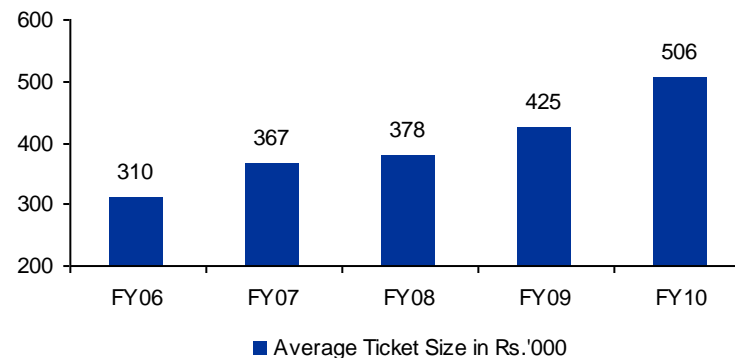
Source: Company

Average Instalment-Income Ratio at 38%



Source: Company

Average Ticket Size of Rs. 0.5mn



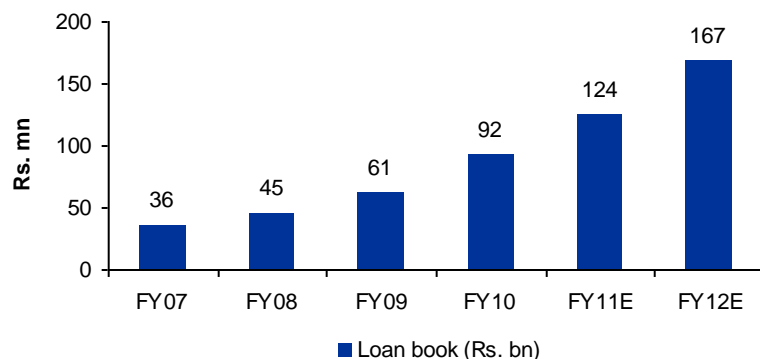
Source: Company

Investment thesis

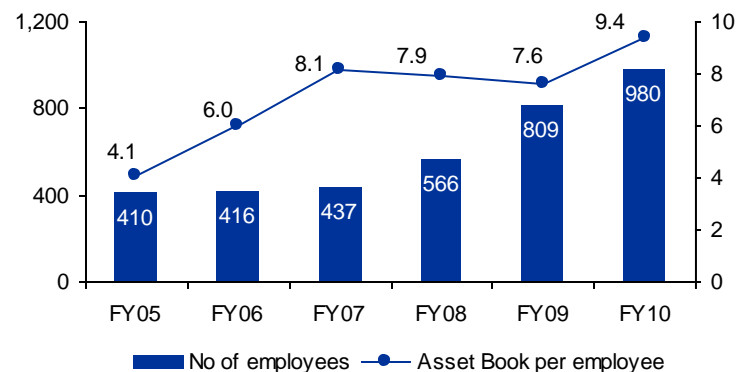
Robust growth in asset book over the last 5 years ... to continue going ahead

- Thanks to its near dominance in the low cost housing segment, the company's asset book and disbursements have grown at a healthy CAGR of 36% & 38% respectively over the past 5 years
- With the housing finance market expected to continue its growth momentum on the back of a buoyant economic growth coupled with the share of HFC's expected to increase to 33% at the end of the 11th Five Year Plan, we expect DHFL's asset book to continue its growth momentum over the coming years
- The recent QIP of Rs. 3,750mn (May 2010) will fuel the next leg of asset growth for the company and will help it achieve its target of becoming a Rs.250,000mn asset book by 2013

Loan Book growing at a CAGR of 36%



Loan Assets per employee on a rise



Source: Company/SPARK Capital

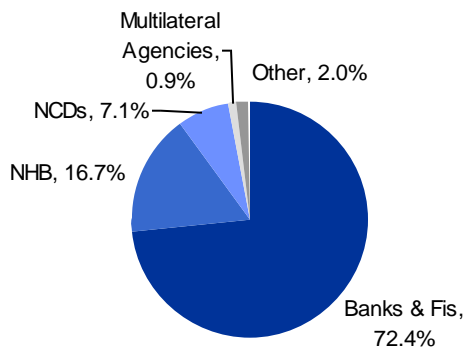
Source: Company/SPARK Capital

Investment thesis (Cont'd)

Well Funded by Banks and NHB

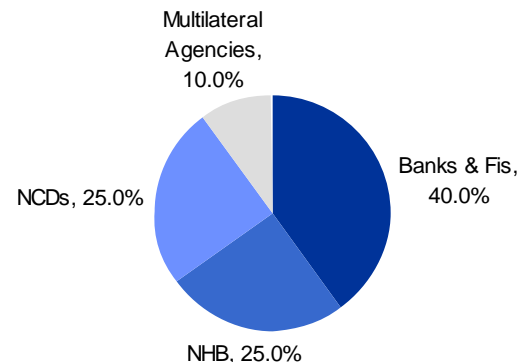
- DHFL over the years have established excellent relationship with banks and NHB which ensures it continuous availability of funds. Banks and NHB put together contributed 89.1% of its borrowed funds in FY10
- DHFL enjoys strong credit rating for both its short term and long term funds from Crisil and CARE. For short term funds, it enjoys the highest rating of P1+ whereas it has a rating of AA+ for its long term debt
- Compared to its peers namely LIC housing finance and HDFC Limited, DHFL historically has had higher costs of funds on account of its high dependence on banks as source of funds. With the company's target to diversify its funding profile across NCDs and finance from multilateral agencies, we would expect rate gap to narrow down over a period of time

Present Funding Profile



Source: SPARK Capital

Targeted Funding Profile by 2013



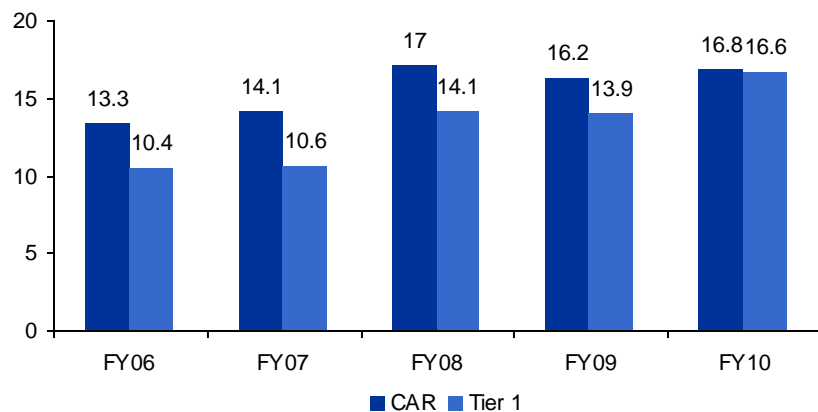
Source: SPARK Capital

Investment thesis (Cont'd)

**Strong Asset Quality.
NPA's trending down ...**

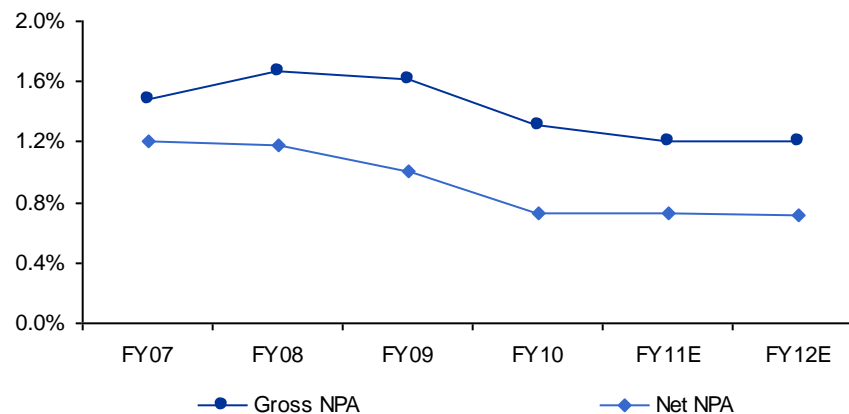
- Capital Adequacy Ratio has remained strong at 16-17% over the last 3 years as against the RBI mandate of 12%
- NPAs have been trending down over the years. Gross NPAs have remained below 1.8% since FY03 and have reduced to 1.3% in FY10 from 1.66% in FY08
- Net NPAs have reduced at a higher pace from 1.2% in FY08 to 0.73% in FY10 thanks to the higher level of provisioning which has increased from 27.1% to 37%

Healthy Capital Adequacy at 17%



Source: SPARK Capital

NPAs trending down



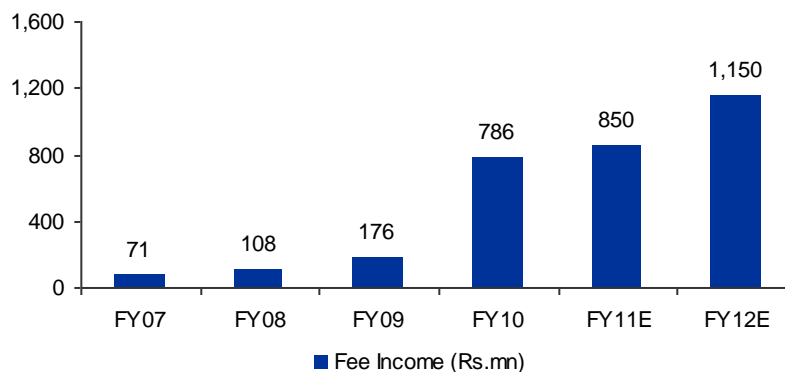
Source: SPARK Capital

Investment thesis (Cont'd)

Strong fee income to drive profits going ahead... offset higher operating costs

- The fee income has seen a strong traction in the last financial year thanks to the initiatives taken by the CEO, Mr. Anil Sachidanand. His strong focus on the concept of mortgage insurance being sold as an attached product has helped the fee income jump to Rs. 786mn in FY10 vis a vis Rs. 176mn in FY09
- Through an innovative tie-up, DHFL has formed an alliance with Prudential ICICI Life Insurance whereby DHFL has committed an assured business to the former and the latter agreeing to upfront the commission of 1.2%. The company expects to tap 60% and 75% of its incremental disbursements by FY11 & FY12 respectively, 25% of its existing loan book and expects a commission of 1.2% on the same. We have factored a fee income of Rs. 850mn and Rs. 1,150mn for FY11 and FY12 respectively
- The company's Operating costs have been historically high compared to LIC Housing Finance substantiated by the fact that average opex/NII has hovered at 38% for DHFL for the last 5 years compared to ~20% for LIC Housing Finance. The higher fee income will offset the higher operating costs thus improving the profitability for the company

Fee Income gaining traction



Source: Company

Investment thesis (Cont'd)

Tie –up with PSB and Union Banks to augment loan book

To drive its asset book further, the company has tied up with Punjab Sind Bank and Union Bank of India to use their client base to disburse housing finance loans.

The nature of the tie-up is as follows: An official/executive of will be present in the branch to tap the clients and originate loans. The credit appraisal will be done by the banks whereas the processing will be taken care of by DHFL. The loan book will be shared in the ratio 50:50 and HFL will get a processing charge of 1% for the transaction

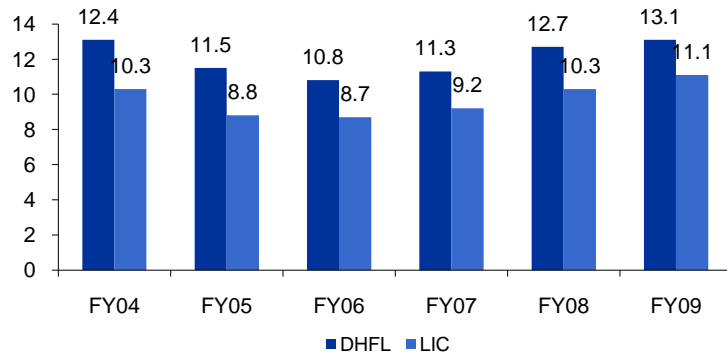
We believe this initiative to be strategically positive for the company as it serves three goals in one go namely:

- Higher penetration to the northern markets where presence is low at present
- Savings on operational costs
- Potential customer base for cross selling of insurance products

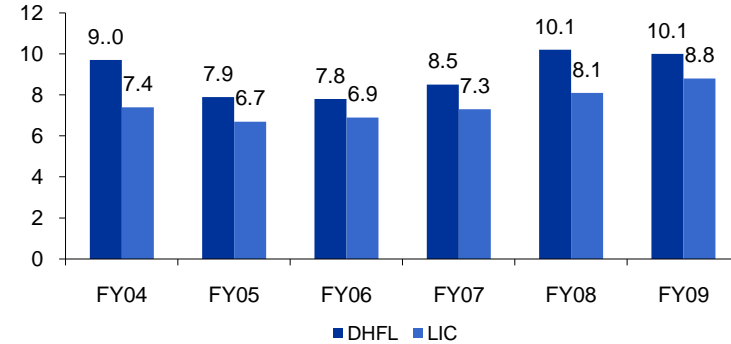
NIMs better than peers.. could be a play on the floating rate arbitrage

- DHFL has historically enjoyed higher yield on advances compared to its peers (higher by 150-200 bps on an average) thanks to the combination factors namely riskiness of the loan portfolio and higher pricing power it enjoys in the low cost financing segment
- The higher yield on advances has more than compensated the higher funding costs of DHFL (which has on an average been higher by 100-150 bps compared to its peers) ,thus resulting in higher NIMs (excluding investment income) at an average of 3% for last 5 years
- We expect Net interest margins to gradually improve to 3.3% by FY12 as against 3% in FY10
- Trigger could be the floating rate arbitrage in an increasing rate cycle thanks to the fact that 85% of its assets are on floating rate

Higher Yield on Advances...



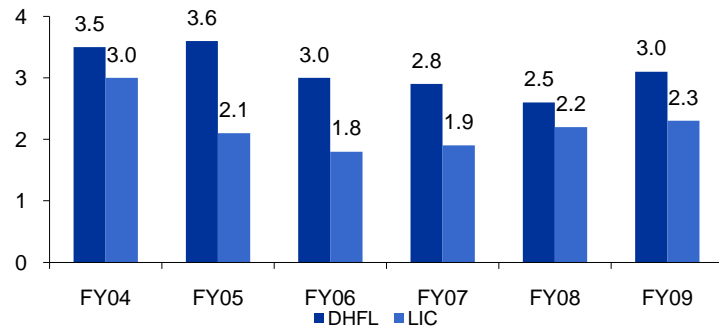
...albeit at a higher Cost



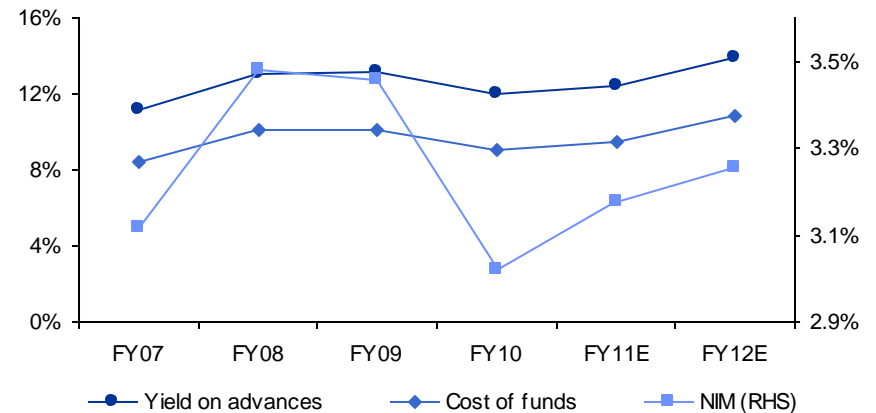
Source: SPARK Capital

Source: SPARK Capital

Superior Spreads...



...Leading to Higher NIMs



Source: SPARK Capital

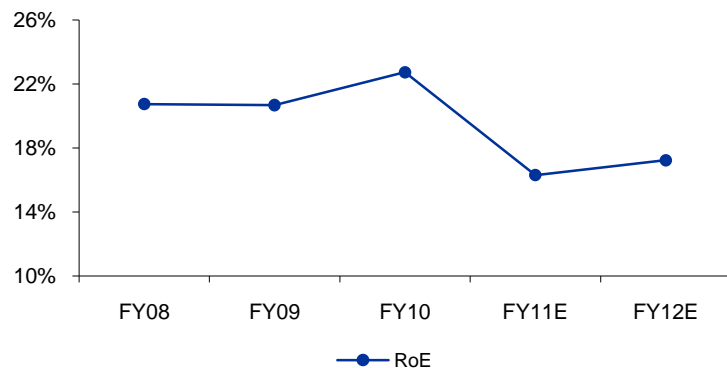
Source: SPARK Capital

Investment thesis (Cont'd)

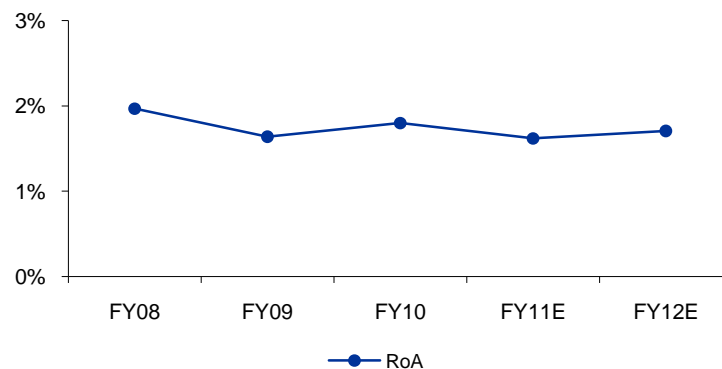
Return Ratios to be depressed for the next couple of years...though structurally to improve.

- ROE has improved over the years from 17.2% in FY06 to 22.7% in FY10 on the back of decreasing operating costs and higher leverage ratio. (increased from 9.7x in FY06 to 13.2x in FY10. ROAs have been hovering around 1.7% over the last 5 years comparable to that of LIC Housing Finance
- Going ahead the ROAs should improve on the back of higher fee income
- ROE's will be depressed for the next couple of years purely on the back of the lower leverage factor as it typically takes 1.5 to 2 years for leverage factor to resume its pre-capital raise level
- But structurally Return Ratios will trend upwards on the back of higher scale, higher fee income and higher leverage ratio

ROE on the rise. Will be depressed for the next couple of years



ROA to be maintained..



Source: SPARK Capital

Source: SPARK Capital

| As on March 2010 | HDFC Limited | LICHF | DHFL |
|----------------------|--------------|---------|--------|
| Asset Book in Rs. mn | 979,670 | 380,000 | 91,813 |
| Yield on Advances | 10.9% | 10.0% | 12.0% |
| Cost of funds | 7.8% | 8.0% | 9.1% |
| NIM | 3.3% | 2.7% | 2.8% |
| Opex/Income | 11.10% | 17.9% | 34.0% |
| Net NPA | 0.2% | 0.1% | 0.7% |
| ROE | 20% | 23.6% | 22.7% |
| ROA | 2.6% | 2.0% | 1.8% |

Stock trading at 1.5x its FY12 Adj BV of Rs. 159. Recommend a BUY on correction.

- At the CMP of Rs. 232, the stock is trading at 1.68x its FY11 Adj BV and 1.46x its FY12 Adj. BV. We value the stock at 1.6x its FY12 Adj BV and thus give a 1 year price target of Rs. 255. We recommend a **BUY** on correction

Financial Summary

| Particulars (Rs. mn) | FY08 | FY09 | FY10 | FY11E | FY12E |
|----------------------------------|-----------------|-----------------|------------------|------------------|------------------|
| Interest Income | 5,333.7 | 7,115.3 | 9,352.0 | 13,680.2 | 21,020.6 |
| Interest Expense | 3,907.2 | 5,249.0 | 7,006.0 | 10,193.9 | 16,078.0 |
| Net Interest Income | 1,426.5 | 1,866.3 | 2,346.0 | 3,486.3 | 4,942.6 |
| Fee Income | 108.1 | 176.1 | 786.0 | 850.0 | 1,150.0 |
| Other Income | 126.4 | 65.2 | 294.0 | 100.0 | 100.0 |
| Total Income | 1,661.0 | 2,107.6 | 3,426.0 | 4,436.3 | 6,192.6 |
| Operating Expenditure | 469.7 | 673.2 | 1,196.6 | 1,428.8 | 1,874.2 |
| Loan Loss Provisions | 75.1 | 114.9 | 96.6 | 249.7 | 349.6 |
| PBT | 1,116.2 | 1,319.5 | 2,132.9 | 2,757.8 | 3,968.7 |
| Tax | 249.6 | 349.0 | 549.1 | 744.6 | 1,071.6 |
| PAT | 866.6 | 970.5 | 1,583.8 | 2,013.2 | 2,897.2 |
| Minority Interest | 10.7 | 16.5 | 35.8 | 44.2 | 55.2 |
| Adjusted PAT | 855.9 | 954.0 | 1,548.0 | 1,969.0 | 2,841.9 |
| Sources of Funds | FY08 | FY09 | FY10 | FY11E | FY12E |
| Equity Share Capital | 605.2 | 605.2 | 820.3 | 1,039.3 | 1,039.3 |
| Preference Capital | 70.0 | 30.0 | 30.0 | - | - |
| Reserves & Surplus | 3,868.6 | 4,056.3 | 8,078.2 | 14,180.1 | 16,719.1 |
| Loan Funds | 42,587.2 | 61,760.7 | 93,055.0 | 122,358.0 | 173,554.0 |
| Current Liabilities & Provisions | 732.4 | 1,758.9 | 1,391.0 | 1,647.7 | 1,960.5 |
| Deferred Tax | 42.5 | 43.7 | 38.7 | 38.7 | 38.7 |
| Minority Interest | 186.7 | 203.2 | 274.3 | 318.5 | 373.8 |
| Total | 48,092.6 | 68,458.0 | 103,687.5 | 139,582.3 | 193,685.4 |
| Application of Funds | | | | | |
| Net Block | 418.6 | 462.2 | 2,222.7 | 2,392.0 | 2,458.3 |
| Loans Advanced | 44,690.0 | 61,359.0 | 91,813.0 | 124,865.7 | 174,812.0 |
| Investments | 885.0 | 945.9 | 1,148.5 | 1,608.0 | 2,251.1 |
| Current Assets | 2,053.6 | 5,646.4 | 8,502.8 | 10,716.7 | 14,163.9 |
| Total | 48,047.2 | 68,413.5 | 103,687.1 | 139,582.3 | 193,685.4 |

Key Metrics

| ROA and ROE decomposition | FY08 | FY09 | FY10 | FY11E | FY12E |
|--|--------|--------|--------|--------|--------|
| NII to Average Total Assets | 3.27% | 3.20% | 2.73% | 2.87% | 2.97% |
| Other Income Average Total Assets | 0.54% | 0.41% | 1.25% | 0.78% | 0.75% |
| Total revenues to Average Total Assets | 3.81% | 3.62% | 3.98% | 3.65% | 3.72% |
| Operational expenses to Average Total Assets | 1.02% | 1.11% | 1.35% | 1.15% | 1.04% |
| Provisions to Average Total Assets | 0.80% | 0.84% | 0.79% | 0.84% | 0.93% |
| MI & EO items | 0.02% | 0.03% | 0.04% | 0.04% | 0.03% |
| Total costs to Average Total Assets | 1.85% | 1.98% | 2.18% | 2.03% | 2.01% |
| RoA | 1.97% | 1.64% | 1.80% | 1.62% | 1.71% |
| Average Total Assets/Average Equity | 10.55 | 12.62 | 12.64 | 10.07 | 10.11 |
| RoE | 20.75% | 20.68% | 22.73% | 16.31% | 17.24% |
| Spread Analysis | | | | | |
| Yield on Assets | 13.0% | 13.2% | 12.0% | 12.5% | 13.9% |
| Cost of funds | 10.1% | 10.1% | 9.1% | 9.5% | 10.9% |
| Spread | 2.9% | 3.1% | 3.0% | 3.0% | 3.0% |
| NIM | 3.5% | 3.5% | 3.0% | 3.2% | 3.3% |
| Valuation | | | | | |
| EPS | 14.2 | 15.8 | 18.9 | 18.9 | 27.3 |
| Number of shares - in mn | 60.5 | 60.5 | 82.0 | 103.9 | 103.9 |
| Book Value per share | 73.9 | 77.0 | 108.5 | 146.4 | 170.9 |
| Adj book value per share | 73.9 | 77.0 | 108.5 | 138.2 | 159.3 |
| Share price | 228.0 | 228.0 | 228.0 | 228.0 | 228.0 |
| Market cap | 13,799 | 13,799 | 18,702 | 23,697 | 23,697 |
| P/E | 16.1 | 14.4 | 12.1 | 12.0 | 8.3 |
| Price to book | 3.1 | 3.0 | 2.1 | 1.6 | 1.3 |
| Price to Adj book | 3.1 | 3.0 | 2.1 | 1.7 | 1.4 |

Initiating Coverage

RATING ★★☆☆

Narration
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| Rating Interpretation | |
|-----------------------|--------------------------------|
| ★★★★ | Recommend "BUY" |
| ★★★☆☆ | Recommend "ADD on correction" |
| ★★★☆☆ | Recommend "REDUCE on strength" |
| ★☆☆☆☆ | Recommend "SELL" |

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