LIC Housing Finance - SELL

CMP Rs1,218, Target Rs1,020

Sector: NBFC	
Sensex:	18,180
CMP (Rs):	1,218
Target price (Rs):	1,020
Downside (%):	16.3
52 Week h/l (Rs):	1311 / 568
Market cap (Rscr) :	11,563
6m Avg vol ('000Nos):	1,041
No of o/s shares (mn):	95
FV (Rs):	10
Bloomberg code:	LICHF IB
Reuters code:	LICH.BO
BSE code:	500253
NSE code:	LICHSGFIN

Prices as on 25 Aug, 2010

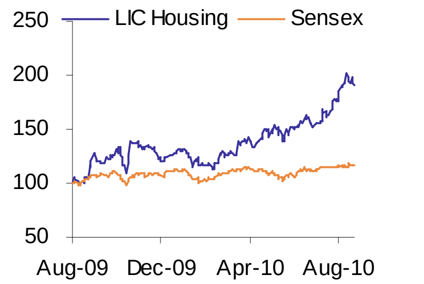
Shareholding pattern

March '10	(%)
Promoters	36.5
Institutions	12.7
Non promoter corp hold	10.0
Public & others	40.8

Performance rel. to sensex

(%)	1m	3m	1yr
LIC Housing	17.2	24.8	76.1
HDFC	3.1	5.9	7.3
Dewan Housing	4.5	13.1	76.3
Gruh Housing	10.8	32.4	81.0

Share price trend



LIC Housing Finance (LICHF), with loan portfolio of ~US$8bn, enjoys a healthy 9%+* market share in mortgage business. Improving economic environment and a pick-up in real estate activities have enabled the company to report 40%+ CAGR in sanctions and ~30% CAGR in loans over FY07-10. However, increasing competition in mortgage space, low loan-to-value ratio and challenging interest environment is likely to drag profitability. The stock currently trades at its peak valuation of 2.8x 1-year forward book (average of 1.2x). Initiate as SELL with a six-month price target of Rs1,020.

Intensifying competition from peers

Historically, HDFC and LICHF had dominated the mortgage space, cumulatively accounting for 55% of the market. However, the secured nature of lending and huge growth potential attracted banks attention to the mortgage space. Further, the soft interest rate regime and Government initiatives towards real estate activities enabled banks to introduce teaser rate schemes. Low cost-of-funds, wide reach and huge customer base enabled banks to capture market share. As a result, banking sector credit to the segment reported 14% CAGR over FY05-10.

NPL and provisions to weigh on profitability

LICHF had been grappling with concerns over its asset quality in early 2000's. However, the restructuring exercise undertaken during FY04-06 had enabled the company to clean its balance-sheet of legacy NPL concerns and also reduce incremental NPL formation. In recent past, the company has started increasing its exposure to high-yielding short term project loans. This increasing exposure, in our view is expected to result in some accretion in NPL given the lumpiness nature of the segment.

Valuations at peak, initiate with a SELL

LICHF, with strong parentage, wide reach, competitive pricing and improvement in asset quality is a play in the housing finance space. Healthy loan CAGR in the past, improvement in market share and returns ratio and exemplary margin maintenance despite volatility in interest rate scenario have all contributed towards significant stock outperformance. The stock currently trades at its peak valuation of 2.8x 1-year forward. We initiate with a sell and assign a multiple of 2x to FY12 book value to arrive at price of Rs1,020.

Financial summary

Y/e 31 Mar (Rs m)	FY09	FY10A	FY11E	FY12E
Total operating income	8,867	10,740	14,007	17,707
yoy growth (%)	28.4	21.1	30.4	26.4
Operating profit (pre-provisions)	7,326	8,820	11,810	15,106
Net profit	5,316	6,622	8,277	10,413
yoy growth (%)	37.3	24.6	25.0	25.8
EPS (Rs)	62.5	69.7	87.1	109.6
BVPS (Rs)	256.0	351.8	420.4	510.0
P/E (x)	19.7	17.6	14.1	11.2
P/BV (x)	4.8	3.5	2.9	2.4
ROE (%)	26.2	23.6	22.3	23.2
CAR (%)	13.5	14.9	13.5	13.1
Tier I (%)	9.3	11.4	9.8	9.7

Source: Company, India Infoline Research

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Intensifying competition from peers

Lending to individuals have been the key area of business

LIC Housing Finance (LICHF) is primarily engaged in providing loans to individuals towards purchase / construction of housing property. In recent past, the company has extended its product portfolio to include lending short-term project loans to builders (9% of loans).

The secured nature of business enabled the banks to increase space in the mortgage space

A host of teaser rate schemes were introduced with a view to augment real estate activities

Tepid credit demand during H1FY09, increasing real estate activities particularly in the affordable housing segment post the global downturn and soft interest rate regime had attracted banks' attention to mortgage business. Further, with rising NPL levels witnessed across other segments of credit, the secured nature of lending enabled them to expand into this business segment. With Government initiatives towards supporting real estate activities, banks launched various schemes under teaser rates, thereby capturing market share. With a view to remain competitive, LICHF too introduced housing schemes - floating rate (RoI at 8.75%) and 3-year fix-o-floaty scheme (RoI at 8.9%).

Low cost of funds, wide reach and huge customer base allowed banks to mark presence

Access to low cost of funds, wide reach, adequate ALM and huge customer profile enabled banks to capitalise on huge growth opportunity. For instance, banking sector exposure to housing segment witnessed 8% CAGR in loans over FY08-10. Housing loan portfolio for SBI grew 32% yoy during FY10.

Single revenue stream and intense competition is likely to hinder further growth

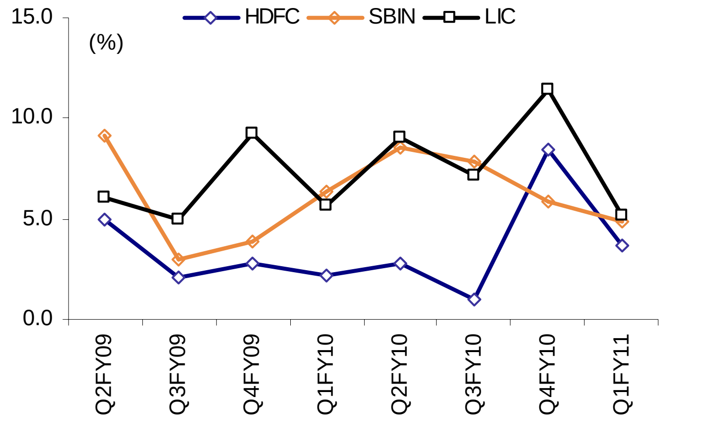
While LICHF reported a healthy 38% yoy growth in loans and robust 66% yoy and 70% yoy growth in sanctions and disbursements respectively during FY10, in our view, a single revenue stream and the intense competition is likely to hinder further growth.

Teaser rate schemes announced by banks and HFCs

Period	Measures / Initiatives taken
Dec 08	**PSU Banks take a first step - *Reduces rate* -** Loans up to Rs2m will now be available at 8.5-9.25 per cent a year for tenures up to 20 years.
February 09 - Effective 2nd Feb 09	**SBI, the largest bank in India,** *announced for a fixed rate of interest on home loan for the first year at 8%. After the first year, the loan shall be reset as per the original arrangement. The scheme was initially launched for period up to April 30, 2009.*
February 09 - Effective 1st March 09	**Union Bank, PNB to join the race -** *Reduce the rates on housing loans by 25-200bps effective from 1st March 09 for different maturities and loan values*
March 09	**Canara Bank rolls out fixed-floating home loan** - *The bank has decided to fix loan rates for 20 years by applying different rates to varying slabs. For home loans up to Rs3m, the country's second largest PSU bank proposes to charge a fixed rate of 8.25% in*
March 09	**ICICI Bank too follow its peers -** *ICICI Bank has reduced its interest rates on new home loans by 0.25-0.50 per cent with immediate effect. For priority sector home loans below Rs2mn, the new interest rate will 9.75% as against the earlier 10%. For loans*
July 09	**HDFC enters the pricing war -** *Reduced its rates to 8.75% for loans up to Rs1.5mn and 9% for loans between Rs1.5mn and Rs3mn.*
August 09	**LIC Housing Finance too reduces its interest rates for new loans by 0.5% -** *effective from August 1st, 2009. With this, for customers opting for floating rate loans between Rs3mn and Rs7.5mn, the new rates will be 8.75 per cent against 9.25 per cent. For t*

Source: Companies, India Infoline Research

Trend in sequential loan growth



Source: Companies, India Infoline Research

Low LTV ratio a concern given elevated property prices

Property prices across all major cities and Tier II cities are currently at their peak levels. With low loan-to-value ratio (near 50%) in case of LICHF, an individual borrower is required to leverage himself for the balance amount. In addition, higher stamp duty and registration charges eventually results in higher outflow. With ~72% of loans being lent to salaried individuals, this low loan-to-value ratio is likely to act as a caveat. Banks, on other hand, offer higher LTV at 80-85%.

We have compared a scenario whereby a salaried individual plans to buy a housing property in Mumbai for a value of Rs5mn. Assuming a LTV at 50% in case of LICHF, the monthly outflow for 15year tenure with RoI at 8.9% is at Rs25,023. On other hand, with LTV at 75% in case of banks, the monthly outflow for 20year tenure with RoI at 8.5% is at Rs32,314. In case an individual borrows from LICHF, the PV of savings due to borrowings from LICHF is at Rs0.73mn. Further the PV of savings due to lower tenure comes to Rs0.42mn, taking cumulative savings to Rs1.15mn. This, however, is lower by Rs0.1mn due to differential borrowing from banks.

Scenario analysis: Borrowings from LICHF vs. Banks

EMI chart	LIC HF	Banks
Tenure (years)	**15**	**20**
No of EMI's	180	240
Notional Amount (Rs)	5,000,000	5,000,000
Loan to value ratio (%)	50%	75%
Loan amount (Rs)	2,500,000	3,750,000
Rate of Interest (%)	8.90%	8.50%
Monthly Interest	0.74%	0.71%
EMI	**(25,023)**	**(32,314)**
Savings in case user borrowers from LICHF with 15year tenure		7,292
PV of savings **(A)**		**728,532**
PV of savings if borrowed from LIC instead of banks due to lower tenure **(B)**		**415,705**
PV of total savings if borrowed from LIC **C = (A+B)**		**1,144,237**
Incremental loan received in case borrowed from banks **(D)**		1,250,000
PV of higher outflow in case borrowed from LICHF		**(105,763)**

Source: India Infoline Research

~82% of the total borrowings are in the form of term loans and non-convertible debentures

RBI approval to raise public deposits

Rising interest rates to impact margin

LICHF is primarily a wholesale borrower with borrowing from term loans (32%) and non-convertible debentures (50%) constituting 82% of total borrowings. While strong parentage of LIC had been a key source of borrowings in the past; in recent times, the company has resorted to raising funds via debentures, term loans from banks and public deposits. The company has received RBI approval to raise funds via public deposits (up 100% yoy during FY10).

~60% of borrowings are of floating in nature

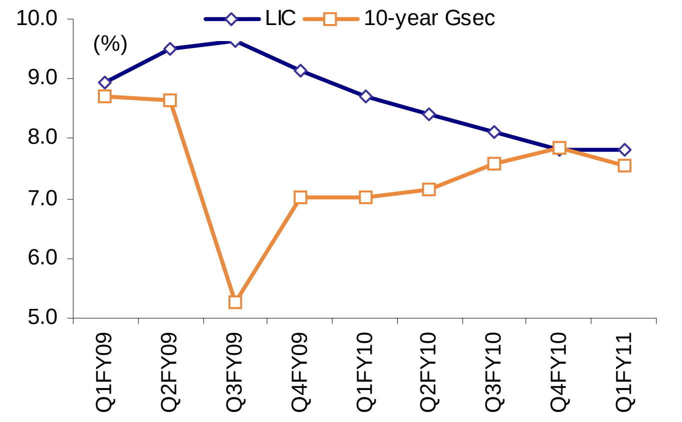
... 96% of assets are floating in nature

~60% of borrowings are floating in nature. Given the rising interest rate scenario, we believe that the cost of funds is likely to increase in coming period. On the other hand, while ~96% of assets are floating in nature, we do not expect LICHF to be in a position to pass on the burden of higher interest cost to its existing customer with immediate effect. The soft interest rate regime and easy availability of funds had enabled LICHF to lower its interest cost. CoF declined by sharp 90bps during past four quarters.

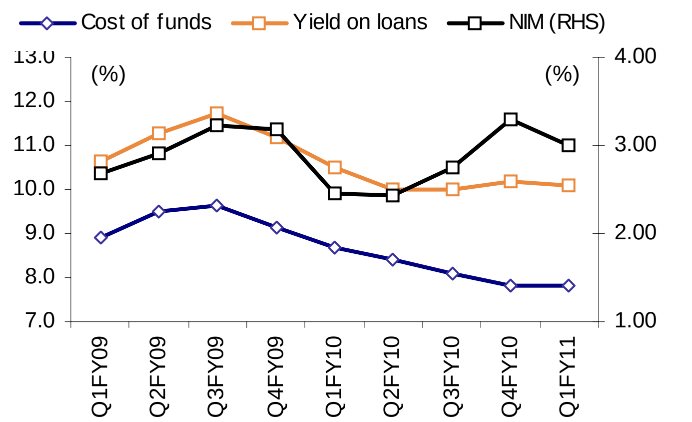
LICHF can raise funds from banks under the priority sector window

The recent hike in key policy rates by the central bank and tepid deposit growth, had urged banks to raise their lending and deposit rates. While LICHF is eligible to borrow from banks under Priority sector lending (PSL) window, the increase in lending rate is only expected to result in higher interest cost for the company.

Cost of funds higher vis-à-vis 10-yr G-sec



Trend in YoA, CoF and NIM



Source: Bloomberg, Company, India Infoline Research

Restructuring exercise undertaken during FY04-06 have resulted in significant improvement in asset quality

NPL and provisions to weigh on profitability

While LICHF was primarily engaged in providing loans to individuals, in recent past it has started increasing its exposure towards high-yielding short term loans to builders and co-operative societies. Disbursements to this segment grew 46% yoy in FY10. Asset quality has remained comfortable with GNPL and NNPL at 0.69% and 0.12% respectively, with provision coverage ratio high at 82%. However, increasing exposure to the segment can result in some accretion given the lumpiness nature of the segment.

The restructuring exercise undertaken during FY04-06 enabled it clean its balance-sheet of legacy NPL concerns and has also reduced incremental NPL formation. The restructuring exercise involved a) separation of origination, underwriting and recovery functions, b) focus on lower-risk salaried individuals, c) introduction of credit scoring mechanisms, and d) improved technology and recovery processes.

Head to head with HDFC

HDFC and LIC enjoyed a dominant 55% market share in housing finance segment

Prior to FY 2002, the housing finance space was dominated by HDFC and LICHF, cumulatively enjoying over 55% of the market share. However, since then, banks, primarily private banks had started capturing market share. The stringent provisioning policy and adequate credit appraisal norms have enabled HFC's maintain check on asset quality. GNPL for HDFC and LICHF remain comfortable at 0.89% and 0.92% respectively.

Loan mix and distribution channel

HDFC exposure to individual loans is at 60-65%.

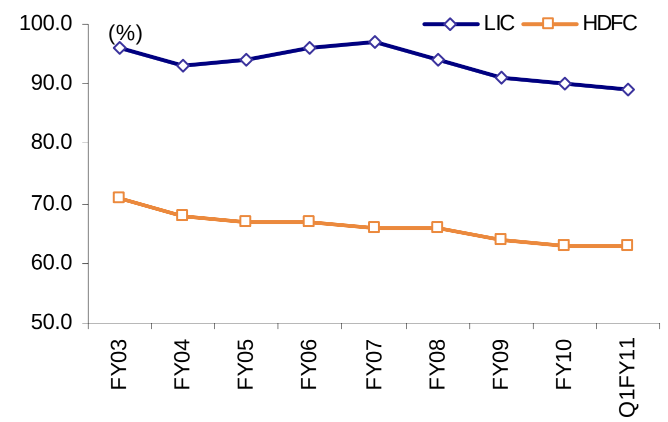
~92% of business in case of HDFC is originated via in-house sources

HDFC witnessed a moderate 15% yoy growth in loans during FY10. While, LICHFs exposure to individual loans has remained high at ~85-90% of total loans, in case of HDFC, this exposure is limited at 60-65%. The balance exposure in case of HDFC is towards corporate bodies. Further with 277 outlets, HDFC originates ~92% of loans via in-house sources. (HDFC Bank – 31%, HDFC sales – 46% and 15%-direct walk-ins). LICHF on other hand generates business through 1,480 DSAs, 7,850 LIC agents and 785 individual agents.

Average loan size in case of HDFC is at Rs1.5mn as against near Rs1.4mn in case of LICHF

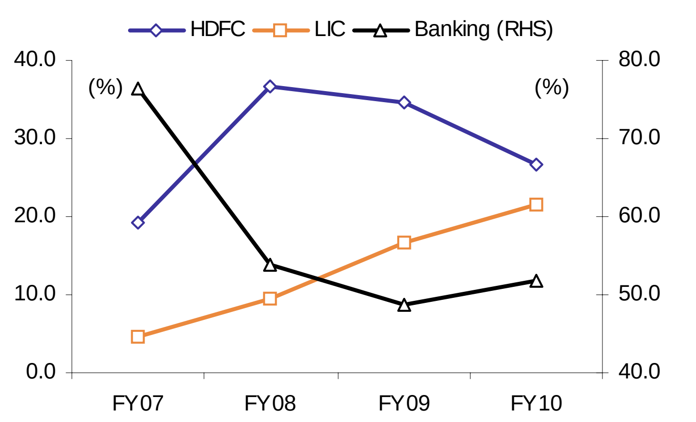
The average loan size in case of HDFC stands marginally higher at Rs1.5mn as against Rs1.4mn in case of LICHF. Also LTV for HDFC is higher at 67% as against 50% in case of LICHF.

Individual loan exposure by LICHF & HDFC



Source: Companies, India Infoline Research

LIC share has seen significant traction*



Source: Companies, RBI, India Infoline Research
*Incremental market share

Funding mix – HDFC in a better position

Strong parentage had acted as a major source of finance for LICHF. Over the years, the company has resorted to raising funds via issue of non-convertible debentures and term loans from banks. While term loans from banks can be availed under the Priority sector window, interest cost attached to these instruments remains high. In case of LICHF, borrowings from debentures and term loans constitute ~82% of total borrowings. This is relatively less at 76% in case of HDFC.

Borrowing mix

	LICHF		HDFC	
(%) of total borrowings	FY09	FY10	FY09	FY10
Term loan	47.4	43.5	30.0	33.0
Bonds, Deb and FCCB	49.6	48.5	47.0	43.0
Deposits	3.0	8.0	23.0	24.0

Source: Companies, India Infoline Research

Industry primer

Huge demand-supply mismatch in the housing

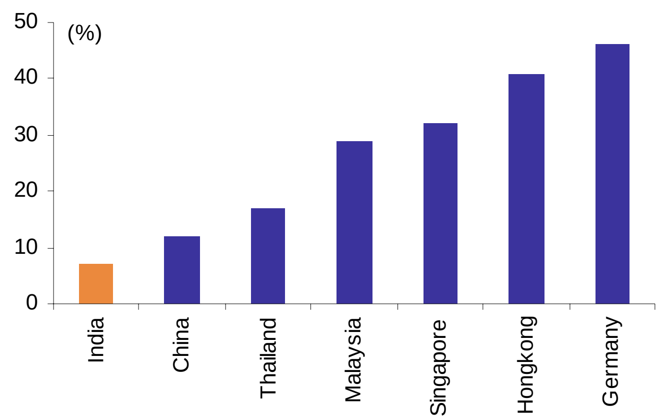
Demand for housing sector has gained significant traction since the beginning of second-half of FY10. Real estate prices had corrected sharply during the recent global downturn (2008-09). However, with improvement in economic environment and stability over income levels, real estate activities have picked up across major cities including Tier II cities. While affordable housing had been a key theme during the H1FY10, real estate players have now shifted their focus to premium segment houses. Real estate prices are currently at their peak levels owing to a) rising levels of income and higher affordability, b) easy availability of finance, c) urbanization and evolution of nuclear family concept, d) soft interest rate regime and e) tax incentives under the Income Tax Act. While the demand for housing sector continues to remain strong, the shortage in the housing industry is pegged at 24.7mn units, depicting a huge demand-supply mismatch.

Low Mortgage/GDP ratio

Traditionally, people in India had resorted to buying property through their savings or borrowings from friends and relatives. Also, with lower real estate prices, average cost of property had remained low. Urbanization and emergences of nuclear family concepts in addition to easy availability of finance have resulted in emergence of mortgage business. Mortgage / GDP ratio in India, however, has remained low at 7%. This is relatively lower as compared to its Asian peers – China (12%), Thailand (17%), Singapore (32%), and Hongkong (41%).

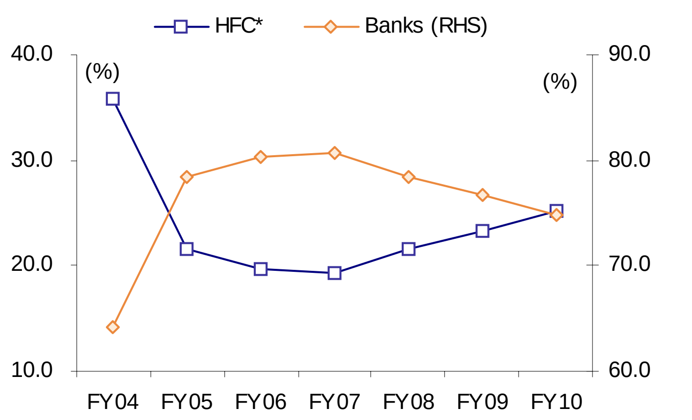
Until FY2002, HFCs (primarily HDFC and LICHF) had dominated the mortgage space with ~55% market share. Given the enormous growth potential, bank's entered this space in FY2003, thereby capturing market share. Lower cost-of-funds, wide reach and healthy customer base provided banks an opportunity to increase their market share from 45% as at end FY02 to 71% as at end FY07. The soft interest regime during FY09 enabled HFCs to pass on the benefits of lower interest cost to its customers. Also, with teaser rate loan schemes announced by banks, HFCs, too introduced various competitive schemes.

Mortgage / GDP ratio remains low at 7%



Source: HDFC, India Infoline Research

Trend in market share in mortgage business



Source: Companies, RBI, India Infoline Research
* HFC includes only HDFC and LIC Housing Finance

LIC Housing – Stupendous growth in the past

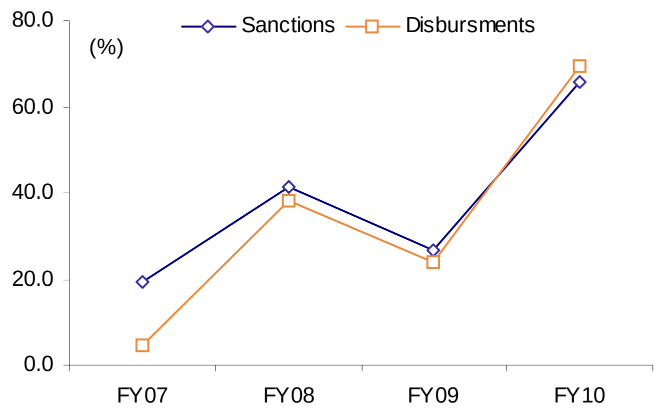
LIC Housing Finance (LICHF), with loan portfolio of US$8bn, enjoys a healthy 9%+ market share in mortgage business. The company operates through 6 regional offices, 13 back offices, and 158 marketing offices over 450 locations catering to over 1mn home loan borrowers.

With lending portfolio confined primarily to individuals, in recent past, the company has started increasing its exposure towards high yielding segments of project loans and loan to builders and co-operative societies, which are short term in nature. The loan portfolio, however, remains skewed towards individual loans, which constituted ~90% of the total loans as at end FY10. The share of lending to salaried individual remains high at 80%+. Strong parentage, superior credit rating, benign interest rate regime and permission from RBI to raise public deposits have enabled the company to borrow at competitive rates.

While stringent credit appraisal norms have enabled LICHF to maintain check on asset quality, large exposure in urban cities (60% of total loans) has increased the average loan size. Also, with lower loan-to-value ratio (near 50%) and income-to-installment ratio (~40%) the risk of NPL has remained negligible.

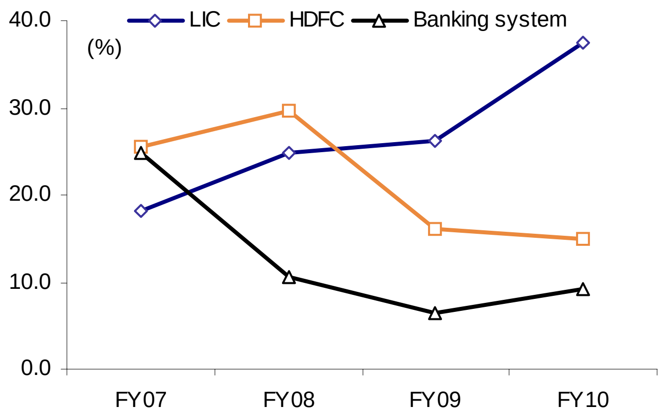
During FY10, LICHF reported healthy 66% growth in sanction. Disbursements too grew at robust 70% yoy leading to 38% growth in loans. Asset quality too remained comfortable with GNPL at 0.69% and NNPL at 0.12%. In the wake of teaser rate schemes announced by various banks (both private and PSU banks) during FY09, LICHF too launched competitive schemes – floating rate (RoI at 8.75%) and 3-year fix-o-floaty scheme (RoI at 8.9%).

Trend in loan sanctions and disbursed



Source: Company, India Infoline Research

Loan growth – LIC has outpaced banking and HDFC in near past



Source: Companies, RBI, India Infoline Research

Healthy loan CAGR in the past; margins remained intact

LICHF has witnessed a healthy 30% CAGR in loans and over 43% CAGR in sanctions over FY07-10. This increase in loan book has in-turn resulted in significant improvement in market share. Incremental market share for the company has increased from 4.5% to 21.6% during FY07-10. This growth is commendable given the competitive business environment. Despite being wholesale funded, margins have improved by 11bps yoy during FY09-10.

We expect LICHF to report healthy 23% CAGR in loans over FY10-12E. Given the challenging interest environment, margins are expected to remain under pressure. However, lending to high-yielding segment of project loans is likely to act as a safeguard.

Stringent provisioning norms

The restructuring exercise undertaken by the management during FY04-06 has resulted in significant improvement in asset quality. GNPL for the company declined from a peak of 4.4% in FY05 to mere 0.7% as at end FY10.

The major balance sheet clean up steps involved a) Shift in focus to relatively higher income group, b) defined collection mechanism, c) implementation of credit-scoring model and risk-based pricing framework, d) quicker turnaround and early rejection of doubtful applications and e) effective utilization of distribution set-up.

The stringent credit appraisals norms have enabled the company to maintain adequate check on asset quality. As against statutory requirement of zero provisions towards standard retail and project loans, LICHF has been conservatively provided provisions @0.1% and @0.5% for standard retail and project loans respectively.

Stringent provisioning norms

Asset classification (% to be provided)	NHB requirement	Policy followed by LICHF
Standard asset (Retail loans)	0.0	0.1
Standard asset (Project)	0.0	0.5
Standard (non-housing individual & projects)	0.4	0.4
Sub-standard asset	10	15
Doubtful asset	25-65	25-65
Loss asset	100	100

Source: Company, India Infoline Research

No clarity on bank license yet

The finance ministry in its Union budget for 2010-11 had proposed banking licenses to private sector players including NBFC. Further, in the recent past, RBI had issued a discussion paper pertaining to new banking license and regulatory requirements. While LICHF has been keen to acquire the banking license, in our view, it would still take some time before RBI starts issuing the licenses.

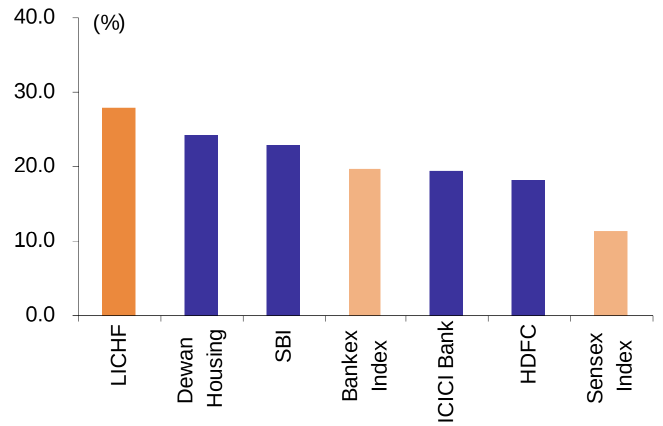
Story intact but too expensive, initiate with SELL

Healthy loan CAGR in the past, significant improvement in market share and returns ratio and exemplary margin maintenance despite volatility in interest rate scenario have all attributed towards decent stock outperformance. The stock currently trades at its peak valuation of 2.8x 1-year forward as against its average levels of 1.5x-2x.

We initiate with a sell and assign a multiple of 2x to FY12 book value to arrive at target price of Rs1,020. While LICHF enjoys minimal regulatory interference in respect to SLR requirement (currently at 12.5%) and provisioning norms, banks due their diversified loan portfolio, healthy liability franchise, wide reach, huge customer base and resilience in asset quality attract higher multiples.

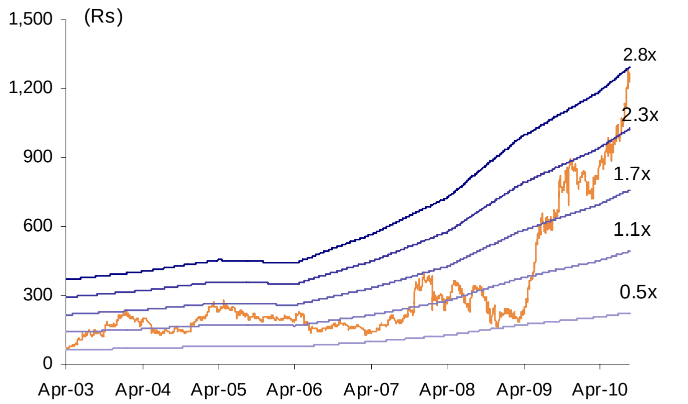
We expect LICHF to witness 23% CAGR in loans and 22% CAGR in balance sheet over FY10-12. This would translate into a net profit CAGR of 25% and average RoE of 23%.

Price performance – LIC vis-à-vis peers



Source: Companies, India Infoline Research

LICHF - 1-yr forward PB – Significant run-up in recent past



Source: Bloomberg, India Infoline Research

Financials

Income statement

Y/e 31 Mar (Rs m)	FY09	FY10	FY11E	FY12E
Interest income	27,476	32,827	44,182	56,352
Interest expense	(20,166)	(23,957)	(32,403)	(41,434)
Net interest income	**7,310**	**8,869**	**11,779**	**14,918**
Non-interest income	1,557	1,871	2,227	2,789
Total op income	**8,867**	**10,740**	**14,007**	**17,707**
Total op expenses	(1,541)	(1,920)	(2,197)	(2,602)
Op profit (pre-prov)	**7,326**	**8,820**	**11,810**	**15,106**
Total provisions	(54)	283	(424)	(782)
Profit before tax	**7,272**	**9,103**	**11,386**	**14,324**
Taxes	(1,956)	(2,481)	(3,108)	(3,910)
Net profit	**5,316**	**6,622**	**8,277**	**10,413**

Balance sheet

Y/e 31 Mar (Rs m)	FY09	FY10	FY11E	FY12E
Total cash & equ.	5,394	7,362	8,479	9,676
Investments	11,292	13,887	15,970	18,366
Advances	276,793	380,814	467,085	575,506
Total int-ear assets	**293,478**	**402,063**	**491,534**	**603,547**
Fixed assets	345	356	423	504
Total assets	**293,823**	**402,419**	**491,958**	**604,051**
Net worth	**22,341**	**33,877**	**40,487**	**49,122**
Secured loans	235,239	310,150	376,238	463,507
Unsecured loans	18,977	37,432	47,675	54,251
Total int-bear liabs	**254,217**	**347,582**	**423,913**	**517,758**
Non-int-bearing liabs	17,265	20,960	27,558	37,171
Total liabilities	**271,482**	**368,542**	**451,471**	**554,929**
Equity + Total liab	**293,823**	**402,419**	**491,958**	**604,051**

Key ratios

Y/e 31 Mar	FY09	FY10	FY11E	FY12E
Growth matrix (%)				
Net interest income	32.0	21.3	32.8	26.6
Total op income	28.4	21.1	30.4	26.4
Op profit (pre-prov)	31.6	20.4	33.9	27.9
Net profit	37.3	24.6	25.0	25.8
Loans	26.2	37.6	22.7	23.2
Borrowings	25.0	36.7	22.0	22.1
Total assets	24.7	37.9	21.7	22.1
Profitability Ratios (%)				
NIM	2.8	2.6	2.7	2.8
Non-int inc/Total inc	17.6	17.4	15.9	15.8
Return on Avg Equity	26.2	23.6	22.3	23.2
Return on Avg Assets	2.1	2.0	2.0	2.0
Per share ratios (Rs)				
EPS	62.5	69.7	87.1	109.6
BVPS	256	352	420	510
DPS	13.0	15.0	15.0	16.0
Other key ratios (%)				
Loans/Borrowings	108.9	109.6	110.2	111.2
Cost/Income	17.4	17.9	15.7	14.7
CAR	13.5	14.9	13.5	13.1
Tier-I capital	9.3	11.4	9.8	9.7
Gross NPLs/Loans	1.1	0.7	0.6	0.6
Total prov/Avg loans	1.0	0.7	0.6	0.6
Net NPLs/Net loans	0.2	0.1	0.1	0.1
Tax rate	26.8	27.3	27.3	27.3
Dividend yield	1.1	1.2	1.2	1.3

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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