

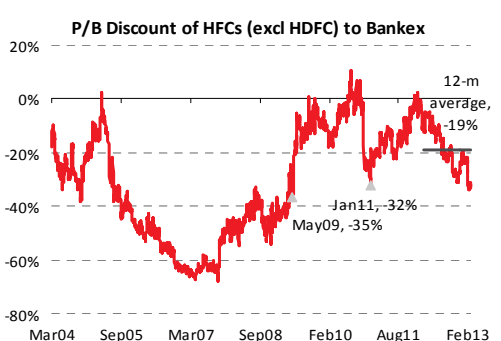
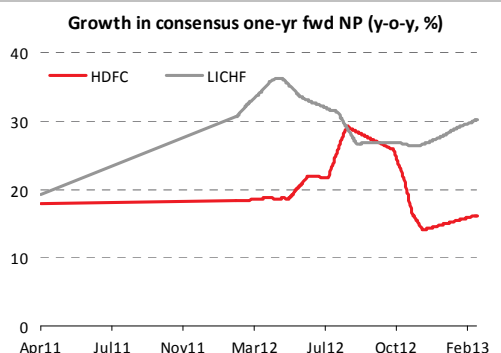
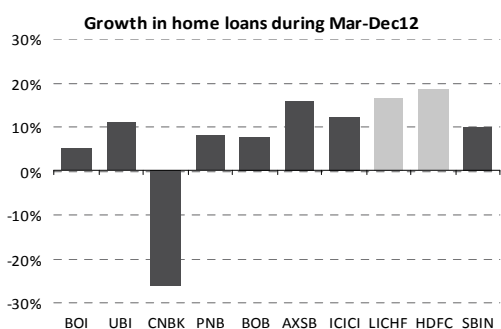
Housing Financials

Earnings downgrade cycle may be nearing an end

Sector Report

Mar 08, 2013		1-m	3-m	6-m
SENSEX Index	19,683	0.1	1.0	13.5
Nifty Index	5,946	-0.2	0.2	13.5
NBFC Index	1,539	-3.3	-4.8	15.9
Housing financials	1,408	-2.5	8.1	-6.3

	Rating Change	TP (INR)	P/B Mar14
HDFC	Add	↑ 911	4.77
LICHF	Buy	↔ 321	1.53



Loan growth for HFCs outpaced the home loan portfolio of banks over the past nine months, amid concerns on rising competition. However, subdued NIMs due to higher funding costs, despite asset re-pricing, has been the key concern, in particular for LICHF. This drove sharp earnings downgrades for LICHF over the past nine months. While incremental yields may be low due to competitive pricing, a likely moderation in funding costs may offset the impact. Thus, a gradual improvement in NIMs may mark an end to the earnings downgrade cycle. We forecast a CAGR of up to 26% in net profit for both leading housing financials over FY13f–FY15f, driven by a CAGR of up to 20% in NII. Retain Buy on LICHF and upgrade HDFC to Add with a revised Mar14 TP of INR321 and INR911, respectively.

Positive signs may support valuations

Growth in loans for HFCs has outpaced growth in the home loan portfolio of banks over the past nine months, amid concerns on rising competition. NIMs for both leading housing financials remained stable q-o-q, as at the end of Dec12, driven by lower yields. Subdued NIMs due to higher funding costs, despite asset re-pricing, has been the key disappointment for LICHF over the past three quarters. However, lower funding costs are likely to offset lower incremental yields, driving a gradual improvement in NIMs for LICHF.

Earnings downgrade cycle may be nearing an end; EPS CAGR up to 26%

LICHF has witnessed sharp earnings downgrades, largely driven by subdued NIMs over the past nine months. Consensus earnings downgrades of up to 26% for FY13f during Mar12–Dec12 led to the growth in the consensus one-year forward NP declining to 26% as at end Aug12 from 37%, as at the end Mar12. However, Dec12 saw it recovering to 30%. With a gradual recovery in NIMs during FY14f aided by lower funding costs, the trend of earnings downgrades may be nearing an end. We lower our net profit estimates by 2%–12% for HFCs, driven by lower spreads. Despite the cut, earnings are likely to increase at a healthy CAGR of 26% for LICHF and 17% for HDFC, supported by a CAGR of 20% for each in NII over FY13f–FY15f.

Valuation gap with banks narrows close to two-year low

The P/B discount of HFCs (excluding HDFC) to the Bankex fell to nearly a two-year low of 32%, as at the end Feb13. The discount has been widening since Mar12, led by concerns on NIMs and asset quality, particularly for LICHF. The rally in May09–Sep10 contracted the P/B discount to banks from a low of 35% during May09 to a premium of 10%, as at the end Aug10. The likelihood of a further fall may be alleviated, as the earnings downgrade cycle nears its end.

Maintain Buy for LICHF and upgrade HDFC to Add

Our final TP is a weighted average, where we assign a weightage of 50% to our DCF/SOTP-based fair values and 25% each to our P/B- and P/E-based fair values. We lower our Mar14 TP for LICHF to INR321 and raise it for HDFC to INR911. We retain a Buy on LICHF and upgrade HDFC to Add. Slower growth in loans and a further decline in NIMs are the key risk factors.

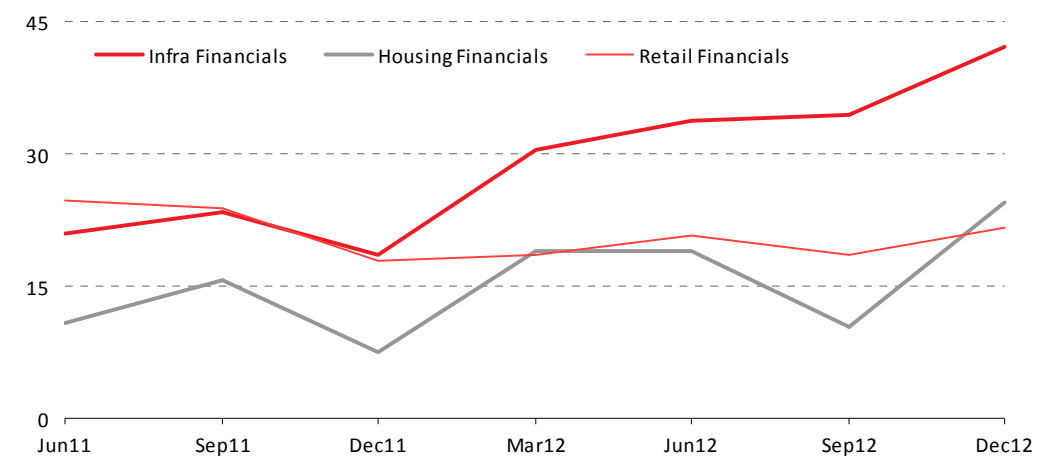
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Concerns likely factored in, positive signs may support valuations

NII growth rebounds after nearly five quarters

The net interest income (NII) growth for HFCs increased to 24% y-o-y for the Dec12 quarter after having declined to 10% during the Sep12 quarter. The rebound in the NII may be linked to stable NIMs during the quarter and strong growth in the outstanding loans, despite loss of NII related to higher slippages for LICHF. HDFC had the strongest growth at 28% y-o-y, on a lower base last year. Growth in NII for LICHF rebounded to 13% y-o-y, from a negative to single-digit growth over the past four quarters, despite the loss of NII on higher slippages from the developer book.

Exhibit 1: Y-o-y growth in NII (%)

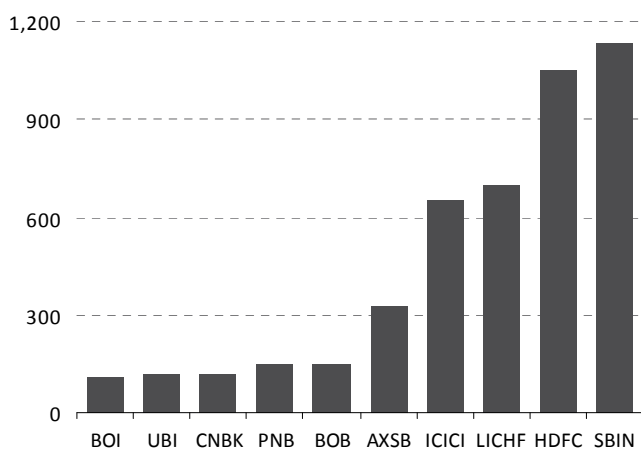


Source: Company, Avendus Research

Growth in mortgages outpaces home loans of banks for first nine months

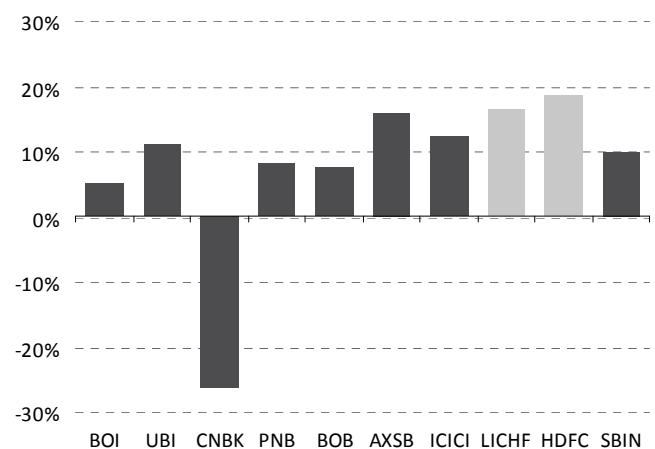
Growth in home loans for HFCs over the past nine months has outpaced that of banks even amid concerns on rising competition led by aggressive pricing. Outstanding loans grew 17% and 19%, respectively, during the first nine months of the fiscal year for LICHF and HDFC Ltd. Growth of home loans for select new banks such as ICICIBC and AXSB appeared strong at 12% and 16%, respectively, though lagged behind that for HFCs. On the other hand, PSU banks barely managed to grow their mortgage portfolio in their early teens with the exception of Canara Bank.

Exhibit 2: Outstanding home loans as at the end of Dec12



Source: RBI, Company, Avendus Research

Exhibit 3: Growth in home loans during Mar-Dec12



Source: RBI, Company, Avendus Research

Competitive pricing may continue to aid growth in disbursements

Growth in the outstanding loans for HFCs remained strong and outpaced that of banks during the first nine months of the fiscal, despite concerns on rising competitive pressure. This is likely to have been led by competitive pricing at par with those offered by select banks which may aid growth in disbursements in the near term.

Exhibit 4: Interest rates for home loans across categories as at the end of Feb13

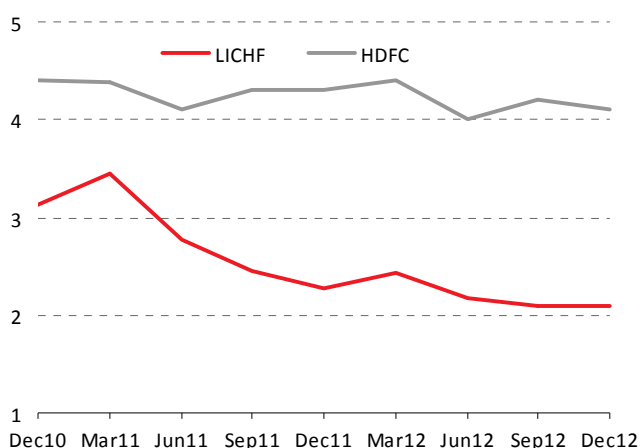
	INR0–INR30 lacs	INR30–INR70 lacs	> INR70 lacs
SBIN	9.95%	10.10%	10.10%
AXSB	10.75%	11.00%	11.25%
ICICIBC	10.25%	10.50%	11.00%
HDFC	10.15%	10.40%	10.40%
LICHF (Bhagyalaxmi)	10.00%	10.25%	10.25%

Source: Company, Avendus Research

Recovery in NIMs may be gradual

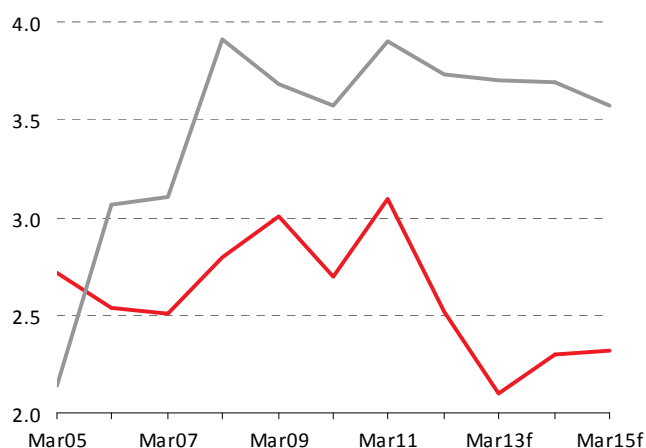
NIMs for both housing financials remained stable q-o-q, as at the end of Dec12, driven by lower incremental yields. Subdued NIMs due to higher funding costs, despite asset re-pricing, have been the key disappointment for LICHF over the past three quarters. Incremental yields may be low given the competitive pricing undertaken by HFCs. However, a likely moderation in funding costs may offset the impact. We lower our NIM estimates during FY13f from 2.3% to 2.1% and subsequently forecast a two-year mean of 2.3% over FY14f–FY15f from 2.5% earlier. We also lower our NIM estimates for HDFC Ltd from a three-year mean of 3.8% to a three-year mean of 3.7%.

Exhibit 5: NIM (%) at quarterly intervals



Source: Company, Avendus Research

Exhibit 6: NIM (%) at annual intervals and forecasts



Source: Company, Avendus Research

Lower earnings, though structural outlook remains unchanged

We cut our net profit estimates by 7%–12% for LICHF and 2%–5% for HDFC over FY13f–FY15f, driven by lower spreads. Despite the cut, earnings are likely to rise at a healthy CAGR of 26% for LICHF and 17% for HDFC over FY13f–FY15f. Strong NII, led by healthy growth in the outstanding loans, is likely to be the key profitability driver.

Exhibit 7: Earnings revision summary for LICHF

(INRbn)	FY13f			FY14f			FY15f		
	Old	New	Var (%)	Old	New	Var (%)	Old	New	Var (%)
Net interest income	16.4	14.7	-10.4	22.0	19.9	-9.4	26.7	24.8	-7.1
Operating income	20.5	18.6	-9.1	27.0	24.7	-8.4	32.8	30.7	-6.5
Operating profit	17.8	15.9	-10.5	23.9	21.6	-9.5	29.3	27.2	-7.2
Net profit	12.0	10.6	-11.3	16.9	15.2	-9.8	20.7	19.1	-7.5

Source: Company, Avendus Research

Exhibit 8: Earnings revision summary for HDFC

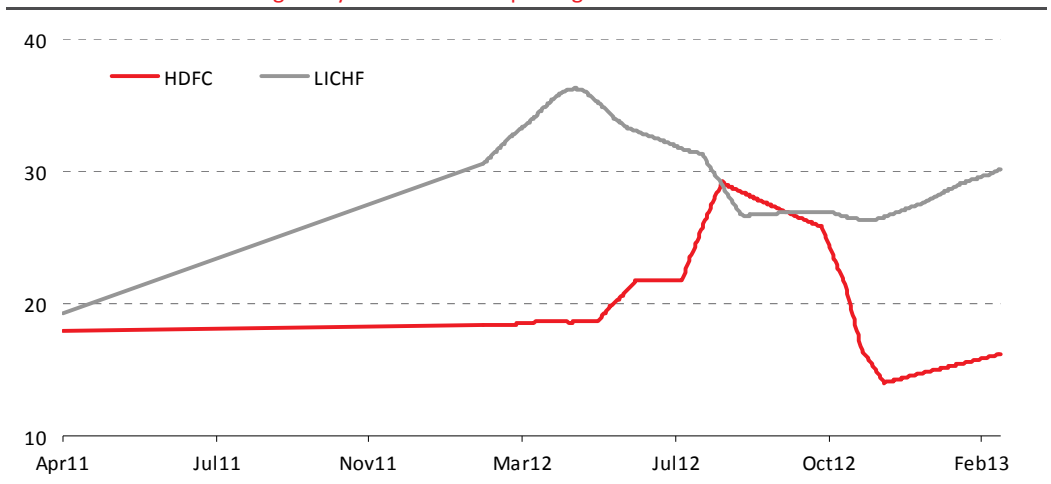
(INRbn)	FY13f			FY14f			FY15f		
	Old	New	Var (%)	Old	New	Var (%)	Old	New	Var (%)
Net interest income	60.2	58.4	-3.0	75.0	71.4	-4.9	89.8	85.2	-5.1
Operating income	71.3	69.5	-2.5	86.9	83.2	-4.2	102.8	98.1	-4.5
Operating profit	66.7	64.9	-2.7	82.1	78.4	-4.5	97.7	93.1	-4.7
Net profit	47.0	45.7	-2.8	57.9	55.2	-4.6	68.8	65.4	-4.9

Source: Company, Avendus Research

Earnings downgrade cycle may be nearing an end

LICHF has witnessed sharp earnings downgrades largely driven by subdued NIMs over the past nine months. Consensus earnings downgrades of up to 26% for FY13f during Mar12–Dec12 led to the growth in the consensus one-year forward NP declining to 26% from 37%, as at the end of Mar12. However, Dec12 saw it recovering to 30%. With a gradual recovery in NIMs during FY14f aided by lower funding costs, the trend of earnings downgrades may be nearing an end.

Exhibit 9: Consensus rolling one-year forward net profit growth



Source: Bloomberg, Avendus Research

Valuation gap with banks narrows close to two-year low

Exhibit 10: P/B discount of HFCs (excluding HDFC) to Bankex



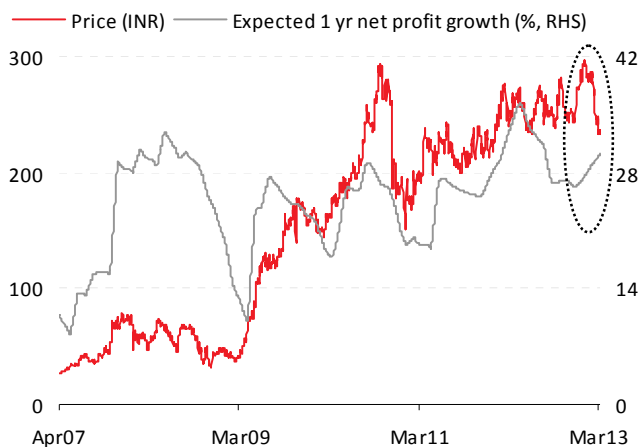
Source: Bloomberg, Avendus Research

The P/B discount of HFCs (excluding HDFC) to the Bankex fell to nearly a two-year low of 32%, as at the end of Feb13. The discount has been widening since Mar12, driven by concerns on NIMs and asset quality, particularly for LICHF. Subdued NIMs despite an asset re-pricing at a higher rate for LICHF have weighed on the stock performance over the past nine months. However, a gradual improvement in NIMs and sound asset quality, despite concerns, are likely to drive strong NII growth. With likely lower funding costs aiding NIMs over the coming quarters, consensus earnings downgrades may be nearing an end. The rally during May09–Sep10 contracted the P/B discount to banks from a low of 35% during May09 to a premium of 10%, as at the end of Aug10. However, the premium has since lowered to a discount of 32%, as at the end of Feb13. The likelihood of a further fall may be alleviated, as the earnings downgrade cycle nears its end.

Maintain Buy on LICHF and upgrade HDFC to Add

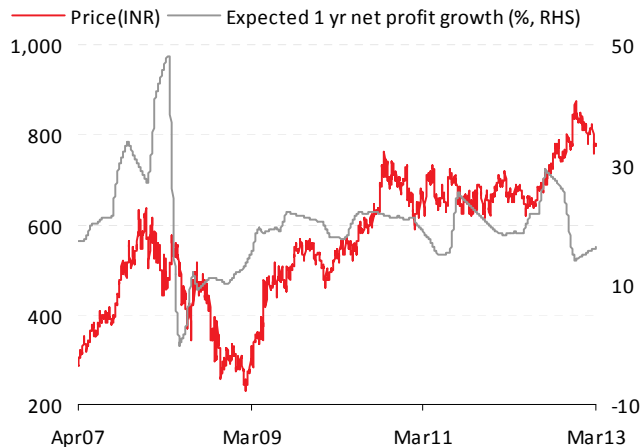
We apply the mean P/B and P/E for the 12-month period to our one-year forward EPS and book value for Mar14 to arrive at P/E- and P/B-based fair values. Our final TP is a weighted average, where we assign a weightage of 50% to our DCF/SOTP-based fair value and 25% each to our P/B- and P/E-based fair values. We lower our Mar14 TP for LICHF to INR321 and raise it for HDFC to INR911. We retain our Buy on LICHF and upgrade HDFC to Add.

Exhibit 11: Price relative to rolling one-yr fwd NP growth – LICHF



Source: Bloomberg, Avendus Research

Exhibit 12: Price relative to rolling one-yr fwd NP growth – HDFC



Source: Bloomberg, Avendus Research

LIC Housing Finance

Subdued NIMs and increase in slippages in the developer book during Dec12 are the key reasons for the underperformance of the stock since the past nine months. However, a gradual improvement in NIMs, driven by lower funding costs, may lead to the earnings downgrade cycle nearing an end. Slippages in the legacy developer book during the quarter ended Dec12 are likely to be recovered over the coming quarters. Retail asset quality continues to be impeccable. We lower our earnings estimates by 7%–12% over FY13f–FY15f, driven by lower spreads. We maintain a Buy rating on the stock, even as we lower our Mar14 TP to INR321. A higher-than-estimated rise in slippages and decline in spreads are the key risk factors.

Exhibit 13: 12-month average P/E and P/B

	1-month	3-month	6-month	12-month
P/E	9.4	10.4	10.4	10.9
P/Adj. B	1.6	1.8	1.8	1.9

Source: Bloomberg, Company, Avendus Research

Exhibit 14: Weighted average TP based on P/E, P/B and DCF/SOTP methods

	P/E	P/B	DCF	Target Price
Weights	25%	25%	50%	
Fair value (INR)	379	338	284	321

Source: Company, Avendus Research

HDFC Ltd.

Strong growth in outstanding loans in the individual segment along with stable asset quality continues to stay the key positive. Individual loan book growth of 31%, inclusive of loans sold to HDFCB, continues to drive loan growth, despite concerns on rising competition in the retail segment. Stable spreads during the Dec12 quarter were driven by a decline of 43-bp q-o-q in funding costs. A shift in the liability mix towards bonds aided the fall in funding costs. We tweak our estimates and lower them marginally by 1%–5% over FY13f–FY15f, driven by lower spreads. We upgrade the rating to Add after the underperformance over the past three months with a revised Mar14 TP of INR911. A slowdown in loans and decline in spreads due to rising competition remain the key risk factors.

Exhibit 15: SOTP-based fair value

	Stake (%)	Value of the firm (INRbn)	Value of HDFCs stake (INRbn)	Value/share (INR)	Contr. to total (%)	Rationale
Standalone	100.0%	700.0	700.0	475	55.9	Based on DCF method
HDFC Bank	23.4%	1,483.5	347.1	235	27.6	Market cap
HDFC Life	72.4%	108.1	78.0	53	6.3	Based on FY13f EV and 9x NBAP multiple
HDFC ERGO	74.0%	4.5	3.3	2	0.3	1x FY13f book value
HDFC AMC	60.0%	55.8	33.5	23	2.7	6% of AUMs
GRUH Finance	60.7%	38.1	23.1	16	1.8	Market cap
Unrealised gains		341.2	68.2	46	5.4	20% of total unrealised gains
Total		2,731.1	553.3	850		

Source: Company, Avendus Research

Exhibit 16: Weighted average TP based on P/E, P/B and DCF/SOTP methods

	P/E	P/B	DCF/SOTP	Target price
Weights	25%	25%	50%	
Fair value (INR)	962	979	850	911

Source: Company, Avendus Research

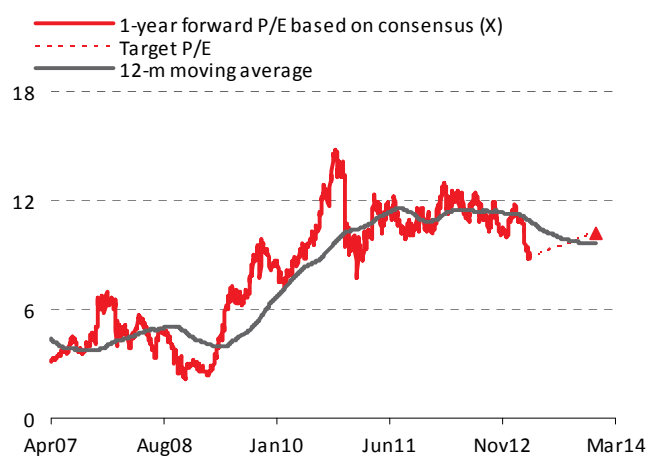
LIC Housing Finance

Exhibit 17: One-yr fwd, average and target P/B



Source: Bloomberg, Avendus Research

Exhibit 18: One-yr fwd, average and target P/E



Source: Bloomberg, Avendus Research

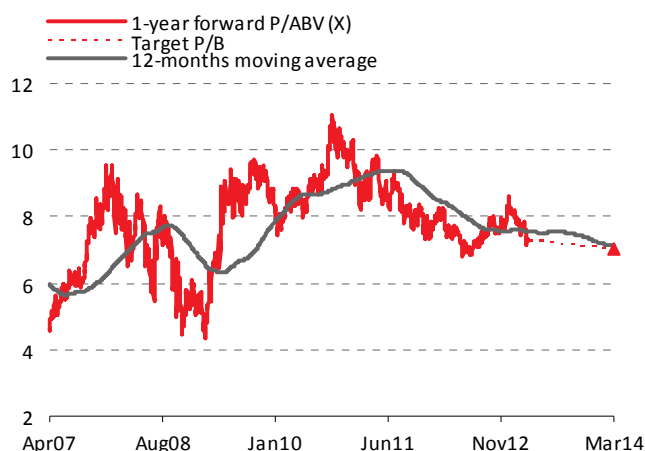
Exhibit 19: Summary financials for LICHF

Income statement (INRbn)					Balance sheet (INRbn)				
Fiscal year ending	03/12	03/13f	03/14f	03/15f	Fiscal year ending	03/12	03/13f	03/14f	03/15f
Net interest income	14.3	14.7	19.9	24.8	Equity capital	1.0	1.0	1.1	1.1
Fee income	1.3	2.4	2.9	3.6	Net worth	56.8	64.9	88.1	103.0
Trading profit	0.0	0.0	0.0	0.0	Total borrowings	560.9	687.4	841.8	1,029.6
Other income	0.9	1.5	1.9	2.3	Total liabilities	617.7	752.2	930.0	1,132.5
Total operating income	16.6	18.6	24.7	30.7	Current Assets	10.1	11.0	12.3	13.8
Total operating expense	2.4	2.8	3.2	3.6	Less: Current Liabilities	40.0	49.3	60.7	72.9
Operating profit	14.2	15.9	21.5	27.1	Investments	13.8	12.5	13.6	14.8
Provision for bad debt	1.6	1.4	0.9	1.1	Advances	630.8	774.5	961.0	1,172.7
Other provision	0.0	0.0	0.0	0.0	Fixed, other assets	2.4	2.5	2.6	2.6
PBT (reported)	12.6	14.4	20.7	26.0	Total assets	617.8	752.2	930.0	1,132.5
Total taxes	3.2	3.9	5.6	7.0	Business Ratios (%)				
PAT (reported)	9.4	10.5	15.1	19.0	Loan / Deposit	112.5	112.7	114.2	113.9
(+) Share in assoc. earnings	0.0	0.0	0.0	0.0	Investment/Deposit	1.7	1.8	1.7	1.6
Less: Minority interest	0.0	0.0	0.0	0.0	SLR Investment / Deposit	-	-	-	-
Net income (reported)	9.5	10.6	15.2	19.1	SLR Investment / NDTL	-	-	-	-
Avendus net income	9.5	10.6	15.2	19.1	Debenture/Investment	-	-	-	-
Avendus EPS (INR)	18.7	21.1	27.6	34.7	Key Ratios				
Decomposition of RoA (%)					P/E (on Avendus EPS)	14.6	13.0	9.9	7.9
Net interest income	2.4	2.0	2.2	2.3	P/Adjusted BV	2.5	2.2	1.7	1.5
Fee income	0.4	0.5	0.5	0.5	Dividend yield (%)	2.3	2.8	3.7	4.7
Other income	0.0	0.0	0.0	0.0	Yield on advances	10.5	10.6	10.6	10.5
Operating income	2.8	2.6	2.8	2.8	Yield on investments	9.2	9.6	9.4	9.3
Operating expenses	0.4	0.4	0.3	0.3	Cost of deposits	1.3	1.0	1.2	1.2
Operating profit	2.4	2.2	2.4	2.5	Net interest margin	2.5	2.1	2.3	2.3
Loan loss provisions	0.3	0.2	0.1	0.1	Internal capital growth	18.3	15.0	18.8	17.4
Other provisions	-	-	-	-	Capital adequacy	14.1	13.6	14.6	14.0
Depreciation	-	-	-	-	Gross NPL ratio	0.4	0.4	0.5	0.5
Tax	-	-	-	-	Net NPL ratio	0.1	0.1	0.2	0.2
Net profit	0.5	0.5	0.6	0.6	Net NPL / networth	1.5	1.5	2.1	2.8
Assets / Equity	12.1	12.0	11.7	11.5	Loan-loss reserve / Gross NPL	67.9	70.7	58.9	50.7
RoE	19.2	17.5	19.9	20.0					

Source: Company, Avendus Research

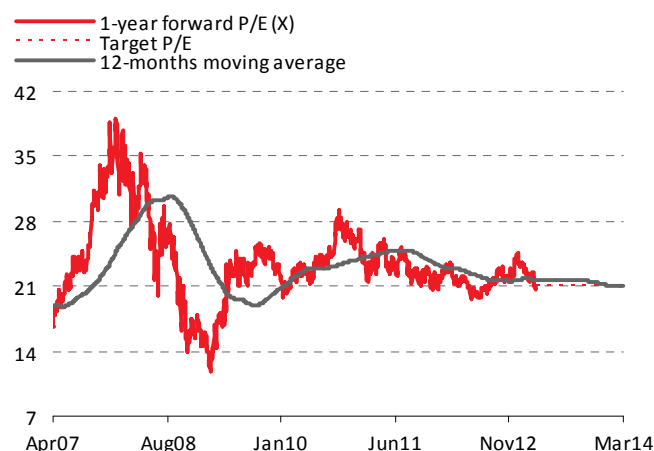
HDFC Ltd.

Exhibit 20: One-yr fwd, average and target P/B



Source: Bloomberg, Avendus Research

Exhibit 21: One-yr fwd, average and target P/E



Source: Bloomberg, Avendus Research

Exhibit 22: Summary Financials for HDFC

Income statement (INRbn)					Balance sheet (INRbn)				
Fiscal year ending	03/12	03/13f	03/14f	03/15f	Fiscal year ending	03/12	03/13f	03/14f	03/15f
Net interest income	48.9	58.4	71.4	85.2	Equity capital	3.0	3.0	3.0	3.0
Fee income	2.7	3.2	4.0	4.9	Net worth	190.2	214.2	243.1	277.2
Trading profit	0.0	0.0	0.0	0.0	Total borrowings	1,391.5	1,643.7	2,022.4	2,475.6
Other income	10.4	7.8	7.9	8.0	Total liabilities	1,581.7	1,857.9	2,265.5	2,752.8
Total operating income	62.0	69.5	83.2	98.1	Current Assets	140.3	102.0	112.0	123.0
Total operating expense	4.5	4.7	5.0	5.2	Less: Current Liabilities	94.1	84.1	101.8	123.2
Operating profit	57.5	64.8	78.3	92.9	Investments	122.7	129.0	136.0	143.9
Provision for bad debt	0.8	1.9	2.4	2.9	Advances	1,404.2	1,701.7	2,109.3	2,598.2
Other provision	0.0	0.0	0.0	0.0	Fixed, other assets	2.4	2.5	2.6	2.6
PBT (reported)	56.6	62.9	75.9	90.0	Total assets	1,581.7	1,857.9	2,265.5	2,752.8
Total taxes	15.4	17.2	20.7	24.6	Business Ratios (%)				
PAT (reported)	41.2	45.7	55.2	65.4	Loan / Deposit	100.9	103.5	104.3	105.0
(+) Share in assoc. earnings	0.0	0.0	0.0	0.0	Investment/Deposit	7.7	7.7	7.5	7.3
Less: Minority interest	0.0	0.0	0.0	0.0	SLR Investment / Deposit	-	-	-	-
Net income (reported)	41.2	45.7	55.2	65.4	SLR Investment / NDTL	-	-	-	-
Avendus net income	41.2	45.7	55.2	65.4	Debenture/Investment	-	-	-	-
Avendus EPS (INR)	27.9	30.9	37.4	44.3					
Decomposition of RoA (%)					Key Ratios				
Net interest income	3.2	3.2	3.3	3.3	P/E (on Avendus EPS)	30.3	27.3	22.6	19.1
Fee income	0.2	0.2	0.2	0.2	P/Adjusted BV	6.6	5.8	5.1	4.5
Other income	0.7	0.4	0.4	0.3	Dividend yield (%)	1.3	1.4	1.7	2.1
Operating income	4.0	3.8	3.9	3.7	Yield on advances	11.8	12.0	11.9	11.9
Operating expenses	0.3	0.3	0.2	0.2	Yield on investments	8.5	9.0	8.9	9.0
Operating profit	3.8	3.6	3.6	3.6	Cost of deposits	3.4	3.1	3.0	2.9
Loan loss provisions	0.1	0.1	0.1	0.1	Net interest margin	3.7	3.7	3.7	3.6
Other provisions	-	-	-	-	Internal capital growth	14.4	14.6	15.6	16.3
Depreciation	0.0	0.0	0.0	0.0	Capital adequacy	11.1	8.6	8.5	8.4
Tax	1.0	0.9	1.0	0.9	Gross NPL ratio	0.8	0.7	0.7	0.6
Net profit	2.7	2.5	2.6	2.5	Net NPL ratio	0.0	0.0	0.0	0.0
Assets / Equity	8.5	8.9	9.4	10.1	Net NPL / networth	0.0	-0.2	-0.3	-0.3
RoE	22.7	22.6	24.1	25.2	Loan-loss reserve / Gross NPL	100.0	103.7	104.6	105.5

Source: Company, Avendus Research

Analyst Certification

The following analyst(s) is(are) primarily responsible for this report and, certifies(y) that the opinion(s) on the subject company(ies) and its security(ies) and any other views or forecasts expressed herein accurately reflect their personal view(s). They further certify that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Jaynee Shah.

Disclosures

Meaning of Avendus Securities Private Limited's equity research ratings

The rating represents the expected change in the price of the stock over a horizon of 12 months.

Buy: more than +20% **Add:** +10% to +20% **Hold:** -10% to +10% **Reduce:** -10% to -20% **Sell:** less than -20%

Proportion of ratings in each category and investment banking relationships (%)

At the end of Dec 2012	Buy	Add	Hold	Reduce	Sell	NR	Total
Proportion of ratings in each category	30.3	34.2	18.4	10.5	0.0	6.6	100.0
Proportion of companies to whom material investment banking services were offered during the previous 12 months	16.67	66.67	0.00	0.00	0.00	16.67	100.00

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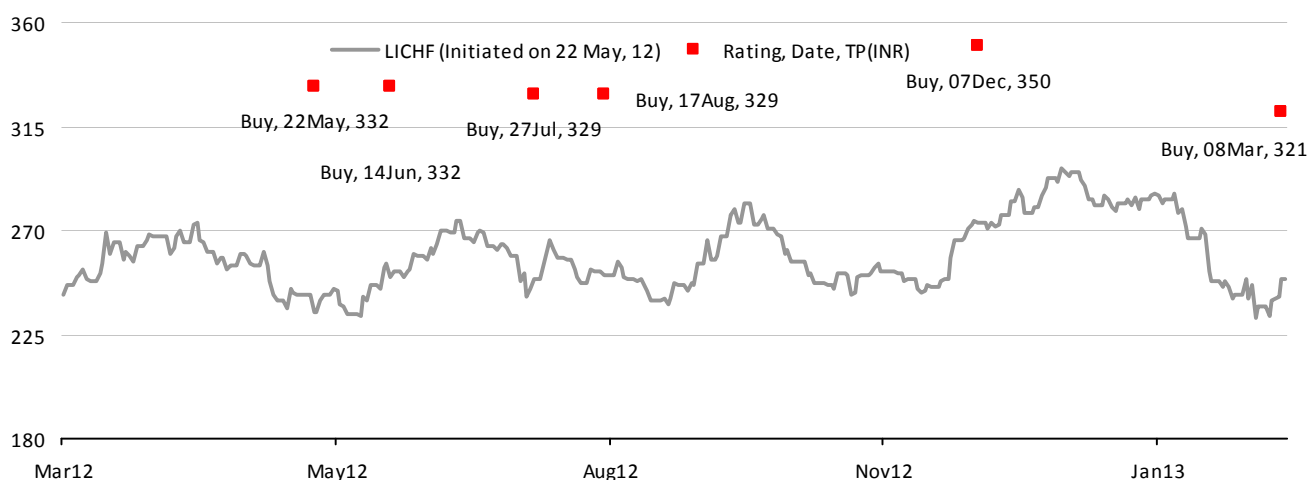
Company: LICHF

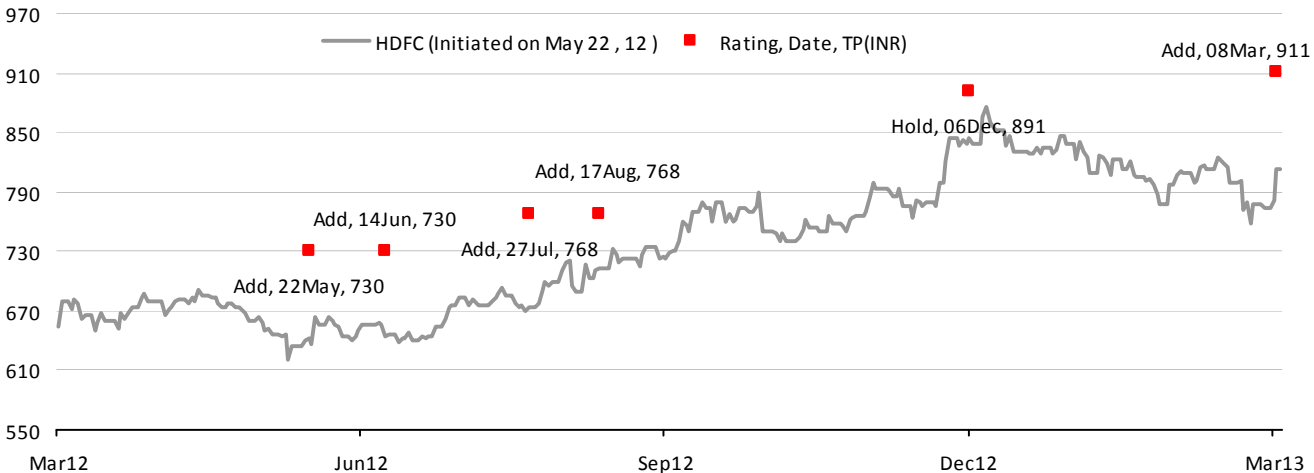
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Share price history and rating changes





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