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INDIA - HOUSING FINANCE

Undeterred by rough seas

January, 2012

- Nascent mortgage penetration; stronger growth in tier II cities with stringent regulations to ensure steady and smooth growth
- Better risk management systems and standards than global has mitigated the severe NPA risks on the Indian mortgage industry
- Prefer housing finance companies given growth visibility, comfortable asset quality, capital and return ratios

INDUSTRY REPORT

Table of Contents

India - Housing Finance

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The Indian housing mortgage industry is on a strong footing, given the immense growth potential and its ability to weather flip flops in the real estate sector. Our confidence stems from the resilience exhibited during the global downturn of 2007-09. Through enhanced risk management systems and effective standards, the regulator has mitigated the risk of any severe impact on the housing finance sector. While the mortgage industry witnessed slower growth during the crisis period, (11% CAGR during FY08-10), its asset quality remained largely intact. Mortgage/GDP in India is a meager 10%* and with improving demographics and economies of scale, we believe there is room for growth.

We are positive on the mortgage industry from a medium to long term perspective and prefer housing finance companies over banks in this space. The recent NHB regulation on withdrawal of pre-payment penalty and uniformity in interest rates on floating loan is unlikely to have any material impact on growth and profitability. Also, interest rates and property prices, albeit a detriment, have had minimal impact on growth.

We initiate coverage on Dewan Housing Finance (BUY) and HDFC (HOLD). Maintain BUY rating on LICHF. Dewan Housing, through both organic and inorganic growth, is well placed to cater to mortgage needs of customer across different income levels and geographies. We expect the conso. entity to report healthy 33% CAGR in loan portfolio over FY11-13E. HDFC, the mortgage giant, with healthy loan mix, adequate borrowing profile and stable spread is set to clock 18%/15% CAGR in loan/balance sheet. LICHF, through relentless efforts towards loan growth, NPA management and further penetration into smaller cities is set to witness 26% CAGR in loan portfolio.

Conducive growth environment given strong demand drivers

Indian mortgage industry is characterized by its a) customer's profile and his mortgage needs b) his behavior to interest rate regime and property prices c) asset quality and d) timely government and regulatory intervention. Increasing income levels with improved affordability, urbanization including emergence of tier-II and tier-III cities, availability of finance and tax incentives have all attributed for rise in housing mortgage in the past.

Improving demographics + stringent regulations to ensure steady growth

Mortgage penetration in India is at a nascent stage and given favorable demographics with improving economies of scale, we believe there is enough room for penetration. Further, timely intervention by the regulator towards capital requirement, provisioning and risk weights has ensured stable balance sheet growth with comfortable asset quality. The recent move towards removal of pre-payment penalty clause and uniformity in interest rates, in our view will have minimal impact on HFC's profitability and growth.

HFCs better placed than its peers – Banks & NBFCs

The dominance of HFCs'/Banks' in the mortgage space has been a debatable topic in the past. In our view, HFCs stand at gain given the resilience exhibited on both growth and profitability front. Mono-line business with domain expertise, lower operational cost and ALM portfolio remain key +ves. Even when compared on asset quality front, HFCs GNPA at ~1% has remained far too superior to its peers - SBI Q2FY12 housing GNPA at 2.4%. When compared to other NBFC's, housing finance companies have outpaced its peers on their ability to deliver balance sheet growth with healthy return ratios.

Valuation and view

HFCs have outperformed its peers on expectations of a) stable balance sheet growth b) adequate capital c) comfortable asset quality and d) superior return ratios. Mortgage penetration in India is at a nascent stage and given strong demand drivers with favorable demographics, we believe there is immense potential for penetration and growth. We expect the mortgage industry to witness steady 15% CAGR over FY11-15E and the ratio of mortgage/GDP to inch towards 13% (+300bps) by end-FY15E.

Investment rationale:

A) Conducive growth environment given strong demand drivers

Indian housing mortgage industry is on a strong footing, given the immense growth potential and its ability to weather flip flops in the real estate sector. The mortgage industry in India has been characterized by its a) customer's profile and his mortgage needs b) his behavior to interest rates and property prices c) asset quality and d) government participation (via affordable housing scheme, interest rate subvention etc). We have tried to evaluate each of these factors below and believe that the mortgage industry is on a strong and safe footing.

Mortgage industry is characterized by first-time borrower…

… risk averse nature of borrower has ensured stable asset quality

1) Customer profile and his mortgage needs: Mortgage industry in India is characterized by the first-time home borrower primarily in working class group (average age of ~30-35years) and with limited liability. Resultant, the mortgage need is towards end-use and not speculative in nature. Also, being risk averse by nature, the borrower is unlikely to default on loan repayments linked to the apartments, in which they are residing. Further, lower age of the borrower with stability in his income provides comfort to the lender towards timely repayment of loan (even after factoring any increased tenure due to interest rate and vice-versa) and limited risk of default. Also, comfortable loan-to-value and installment/ income ratio with adequate credit appraisal has ensured growth with stable asset quality to the lender. In India, it has been observed that against the maximum loan tenure limit of 20/25years, the repayment has been far too early. This has been due to conservative nature of the borrower and his mind-set towards the liability.

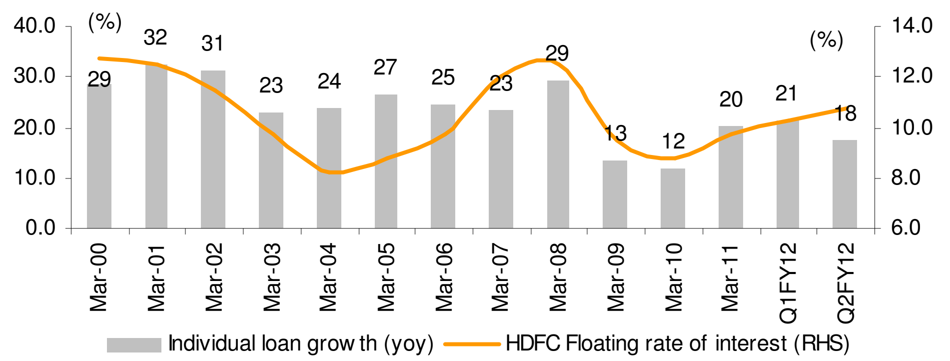
While fears over volatile interest rates and uncertainties over property prices prevail, historical evidence suggests that interest rates have had minimal impact on growth.

Historical evidence suggests minimal impact of interest rates on the mortgage needs…

… any rise in interest rate has been passed in form of increased repayment tenure / EMI

2) a) Interest rates: In order to gauge the impact of interest rate on housing loan growth, we have plotted the trend on yoy growth in individual loan portfolio and floating rate loan of HDFC. Our analysis depicts that interest rates have minimal impact on mortgage demand in the past. This is clearly evident from the fact that over the last decade, despite volatile interest rate regime (8.25%-12.75%), HDFC has witnessed healthy 24% CAGR in its loan book. Also, in India, interest rates have not remained at elevated levels for a prolonged period of time, thereby reducing any material risk of default. Further, any rise in rates has been passed through in the form of increased repayment tenure or higher EMI. The average loan tenure however, has remained comfortable with stable asset quality.

Interest rates and loan growth – Interest rates have had minimal impact in past



Source: Company, Emkay Research

12/15 cities surveyed by National housing Board have witnessed steep increase in property prices

2) b) Property prices: After a lull in 2008-09, real estate prices are back to their peak levels of 2007. Thanks to improved income levels (relative to 2008 levels) and job security, developers are now able to cash-on the increasing mortgage demand in India. According to City-wise housing price index released by National Housing Board, property prices in 12/15 cities surveyed are above their 2007 levels (see chart below).

Housing Price Index – Property prices still remain comfortable in cities of Surat, Pune, Bengaluru, Hyderabad and Jaipur.

Cities	2007	Jan-Jun '08	Jul- Dec '08	Jan-Jun '09	Jul-Dec '09	Jan-Mar '10	Apr-Jun '10	Jul-Sep '10	Oct-Dec '10	Jan-Mar '11	Apr-Jun '11	Jul-Sept' 11
Chennai	100	104	95	120	143	164	183	210	214	218	248	271
Bhopal	100	139	151	139	162	158	153	166	173	167	224	208
Faridabad	100	100	121	139	145	154	152	170	176	165	220	206
Mumbai	100	112	117	124	126	134	160	167	173	175	181	194
Kolkata	100	114	140	162	185	165	176	191	213	211	194	191
Pune	100	101	97	103	117	124	135	140	141	148	150	169
Ahmedabad	100	106	100	127	128	113	131	141	164	165	169	163
Lucknow	100	103	102	104	119	112	133	148	152	157	160	154
Delhi	100	124	130	121	113	106	110	115	123	126	147	154
Patna	100	103	100	107	119	127	124	148	146	146	146	141
Surat	100	101	98	111	123	109	136	128	133	128	149	139
Kochi	100	106	95	90	83	79	83	97	101	86	107	97
Bengaluru	100	73	76	58	59	64	68	74	101	88	92	93
Hyderabad	100	96	92	65	81	81	82	87	87	83	91	84
Jaipur	100	119	115	71	63	66	61	63	69	67	64	65

Source: National Housing Board, City-wise housing price index, Emkay Research

Significant traction in tier II and tier III cities

While demand for mortgage persists, higher interest rates have restricted growth in tier-I cities. Finance companies too, are reluctant to increase their exposure (cities of Mumbai, Delhi etc) given irrational behavior in those real estate markets. However, our interactions with the management of mortgage finance companies suggest that they have been witnessing increasing demand from tier-II and tier-III cities. HDFC, the largest mortgage finance company with key foothold in tier-I cities have started witnessing huge traction in cities of Indore, Baroda, Surat, Pune, Jaipur, Bangalore etc. Dewan Housing too, through its pan-India presence is now geared to serve customers across different income levels and in under-penetrated regions of Bihar, UP, Jharkand, Uttaranchal. In case of LICHF, top 10-cities contribute 70% of total loan portfolio.

… aided by a) employment opportunities b) relatively lower property prices and c) easy finance

In India, a) employment opportunities b) affordable property prices and c) availability of easy finance have resulted in increasing number of people migrating from smaller towns to tier-II and tier-III cities. Also, measures in the form of interest rate subvention, affordable housing and higher income via sixth pay commission etc by Government of India and teaser rate loan schemes by mortgage financing companies has encouraged mortgage demand in smaller cities.

In order to gauge the volume / increase in credit flow by banking sector to housing industry, we tried to analyze the data for 19-districts spread across India and in two-different time frames ie FY04-06 and FY06-10. The analysis revealed that over the longer run (ie FY04-10) bank credit to mortgage industry has remained at healthy 27% CAGR. This growth has been well-supported by ~25%+ CAGR each in both Tier-I / Tier-II and smaller cities.

Until FY06, growth in mortgage industry was centric around tier-I and larger cities. This is clearly evident as credit flow to mortgage industry for top 5-cities accounted for 74% of total credit. However, over the years, this ratio has tilted in favor of non-metro and tier-II cities which now account for 33% of total bank credit to housing sector (up from 26% in FY06). Increasing employment opportunities with easy availability of finance and affordable prices have resulted in migration of people from smaller cities and in-turn increasing mortgage needs in these regions. Bank credit to tier-II and smaller cities at 18% CAGR have outpaced far too higher than the overall credit flow to sector at 13% CAGR and tier-I cities of mere 9% CAGR. While the growth may seem higher for tier-II and smaller cities given its low base effect, it is interesting to note that cities like Thane, Ahmedabad, Surat, Baroda, Bangalore and Hyderabad have actually witnessed higher credit demand during this time-frame. 12 / 19 cities or 63% of cities analyzed have reported either improvement in their ranking or remained constant vis-à-vis FY06.

Bank credit outstanding across 19-districts and in various time-frames

		Loan portfolio (Rs bn)			Loan CAGR (%)			Rank		
District	**Change over FY06**	**FY04**	**FY06**	**FY10**	**FY04-10**	**FY04-06**	**FY06-10**	**FY04**	**FY06**	**FY10**
Mumbai	↔	100	237	320	21.4	24.1	7.7	1	1	1
Thane	↑	9	20	57	36.8	23.7	29.3	10	9	8
Pune	↔	25	52	110	27.6	19.4	20.8	5	6	6
Chennai	↓	8	103	141	62.3	91.2	8.1	11	4	5
Coimbatore	↓	6	19	33	32.3	31.9	15.4	12	10	11
Ahmedabad	↑	10	13	44	28.1	7.8	34.4	8	12	10
Baroda	↑	4	7	19	27.7	10.6	30.4	15	17	16
Surat	↑	3	9	26	41.9	29.6	30.4	18	15	12
Lucknow	↓	10	16	24	15.4	12.4	10.2	7	11	14
Varanasi	↔	2	3	5	21.9	17.7	14.3	19	19	19
Bhopal	↓	5	10	24	27.6	16.5	23.6	14	14	15
Indore	↔	6	13	25	26.2	20.6	17.5	13	13	13
Amritsar	↔	3	5	9	18.1	13.3	13.3	17	18	18
Kolkatta	↔	21	48	97	28.7	22.4	19.3	6	7	7
Delhi	↓	71	162	231	21.7	22.8	9.3	2	2	3
Jaipur	↓	10	26	44	28.2	27.7	13.7	9	8	9
Bangalore	↑	54	142	239	28.1	27.4	13.8	3	3	2
Mysore	↓	4	9	14	22.2	19.0	13.5	16	16	17
Hyderabad	↑	30	73	143	29.8	25.0	18.3	4	5	4
Total		**383**	**968**	**1,603**	**27.0**	**59.0**	**13.4**			
Tier I *		**200**	**550**	**789**	**25.7**	**65.8**	**9.4**			
Tier II and smaller cities		**182**	**417**	**814**	**28.3**	**51.3**	**18.2**			
Top-5 cities**		**281**	**718**	**1,074**	**25.1**	**60.0**	**10.6**			
Others		**102**	**250**	**529**	**31.6**	**56.4**	**20.7**			

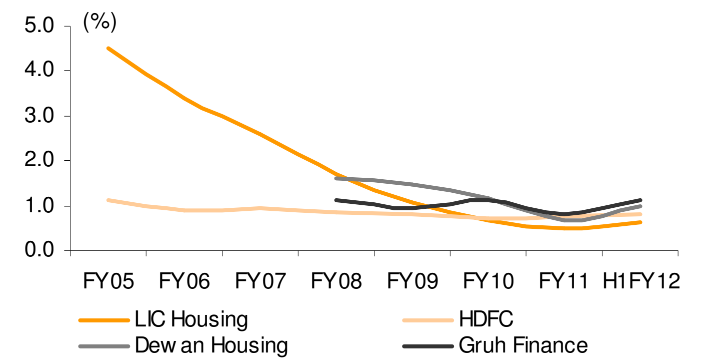
*Source: RBI, Emkay Research * tier I cities include Mumbai, Delhi, Chennai and Kolkatta ** denotes top-5 cities based on their ranking*

Asset quality remains upbeat given customer profile and risk-averse behavior…

… asset quality for HFC remained comfortable even during the crisis period

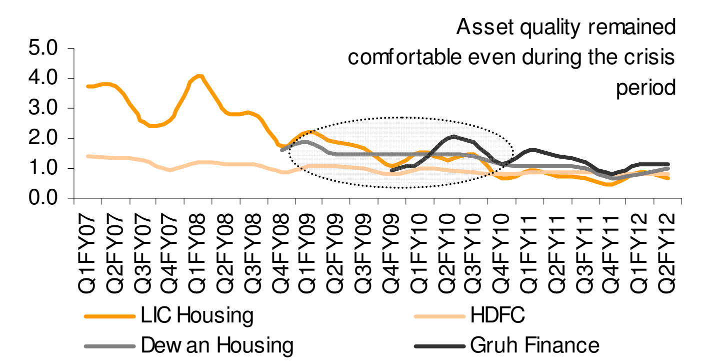
3) Asset quality remains upbeat: In India, the mortgage market has remained upbeat given the nature of borrower (being end-user) and their risk-averse behavior. The mortgage demand is primarily dominated by first time home buyers and is not much speculative in nature. Also, being risk averse by nature, the borrower is unlikely to default on loan repayments linked to the apartments, in which they are residing. This is clearly evident from the fact that even during the crisis period of 2008-09, GNPA for HFCs remained well within their comfort zone. Over the years, asset quality has shown material improvement driven by adequate appraisal systems and effective recovery mechanism. Also, through stringent provisioning norms, the regulator has ensured adequate cover.

Material improvement in asset quality – annualized basis



Source: Companies, Emkay Research

…. and on sequential basis



Source: Companies, Emkay Research

4) Government participation: The global financial crisis and its follow through impact on real estate had urged the need for Government participation. Accordingly, the finance ministry had announced interest subvention scheme. Further, to stimulate housing demand, particularly in lower and middle income groups, an amount of Rs10bn was allocated as interest subsidy for a period of one year beginning Oct'2009 to Sep'2010. The scheme was further extended till March, 2011. It also stressed the need for affordable housing and made efforts towards the same. These measures in turn, supported mortgage demand, even during the crisis period. Also, steps in form of Sixth-pay commission and rural housing scheme attributed for increasing mortgage demand (primarily in tier-II and smaller cities).

Quotes from recent Union Budgets:

Interim Budget Speech: 2009-10

Given the importance accorded to housing for the weaker sections in rural areas, 60 lakh houses were to be constructed under the Indira Awaas Yojana by 2008-09. In the period between 2005-06 and December 2008, 60.12 lakh houses have already been constructed.

Budget Speech: 2010-11

While presenting the Union Budget for the year 2009-10, I had announced a Scheme of one per cent interest subvention on housing loans up to Rs.10 lakhs where the cost of the house does not exceed Rs.20 lakhs. I propose to extend this Scheme up to March 31, 2011. Accordingly, I propose to provide a sum of Rs.700 crore for this Scheme for the year 10-11

Budget Speech: 2011-12

To further stimulate growth in housing sector, I am liberalising the existing scheme of interest subvention of 1 per cent on housing loans by extending it to housing loan upto Rs15 lakh where the cost of the house does not exceed Rs25 lakh from the present limit of Rs10 lakh and Rs20 lakh respectively.

On account of increase in prices of residential properties in urban areas, I propose to enhance the existing housing loan limit from Rs20 lakh to Rs25 lakh for dwelling units under priority sector lending.

To provide housing finance to targeted groups in rural areas at competitive rates, I propose to enhance the provision under Rural Housing Fund to Rs3,000 crore from the existing Rs2,000crore.

Lower mortgage penetration with adequate regulations will ensure steady growth…

… expect industry to witness healthy 15% CAGR over FY11-15E

B) Improving demographics + Stringent regulations to ensure growth

Mortgage penetration in India is at a nascent stage and given improving demographics and economies of scale, we believe there is enough room for penetration. Also, with timely intervention by the regulatory authorities in form of cap on loan-to-value ratio, higher provisioning requirement and risk-weights (see page 9), we expect industry to expand manifold and witness healthy 15% CAGR over FY11-15E (see page 12).

1) Low mortgage/GDP, improving demographics to aid higher penetration

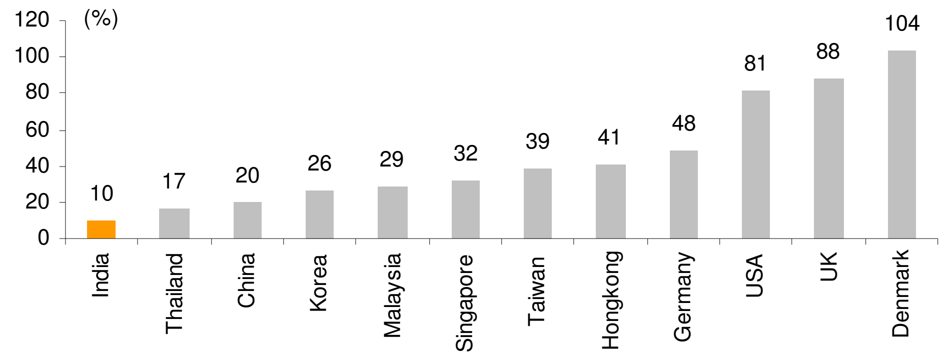
Mortgage/GDP at 10% is low when compared to its peer economies*

Traditionally, people in India have resorted to buying property through their savings or borrowings from friends and relatives. Financing through the organized sector has accounted for less than 30% of the total housing investment in India. Consequently, mortgage/GDP ratio in India has remained at a low 10%, against its Asian peers like - China (20%), Singapore (32%) and developed economies of USA (81%) and UK (88%).

…expect the ratio to improve by 300bps over FY11-15E

While mortgage / GDP ratio at 10%* appears on the lower end as compared to its peers, it has reported a remarkable 400bps improvement in the last six-years (6% in FY05 – 10% in FY11). Given a) increasing income levels and improved affordability, b) urbanization including emergence of tier-II and tier-III cities and evolution of nuclear family concept c) easy availability of finance and d) tax incentives under the Income Tax Act, the need for housing mortgage is on the rise. With improving demographics and economies of scale, we expect the mortgage/GDP ratio to move to 13% (+300bps) by end-FY15 (see page 12).

Mortgage/GDP in India vis-à-vis Asian peers and other developed economies



Source: Emkay Research, HDFC

2) Regulatory intervention to help tide over tough times…

Housing crisis has urged for tighter regulatory requirement….

…. resultant, measures were introduced by regulators

The housing crisis in developed countries and its follow through impact on world economy had urged the need for tighter regulatory requirements. Accordingly, since then, measures have been introduced across the globe to cap any leakages. Measures in the form of reduced amortization period, new subsidies to middle-income housing sectors, lower tax-incentives including criteria for land-development projects, mortgage-interest tax relief, lower LTV ratio have been introduced, which will act as crisis management (see page 9).

Despite mortgage penetration being at a nascent stage and unlikely to cause a major meltdown, the regulatory authority in India has learnt from the pitfalls of the developed mortgage financing companies and accordingly put in place several checks and measures.

In India, NHB tightened screws towards
a) LTV
b)Provisioning requirement and
c) Risk weights

National Housing Board (NHB), the regulatory authority for housing finance companies (HFCs'), has been constantly tightening the screws to plug any leakages towards - a) exposure limits, b) asset quality and c) capital requirement. With a view to avoid any concerns on asset quality owing to real estate market and volatile interest rate regime, the regulator issued guidelines pertaining to LTV ratio, provisioning norms on both individiual and non-individual loan portfolio, including capital requirement in FY11. These measures have been introduced to ensure quality growth while maintaining profitability.

HFC well placed for growth given improving demographics and increasing income levels…

… GoI participation augmented growth

Measures introduced in FY11 and thereafter :-

- Loan-to-value ratio (LTV) for individual loans upto Rs2mn was capped at 90% of the value and at 80% for individual loans above Rs2mn.
- Risk weights on loan portfolio were raised by 50-125bps based on loan-to-value ratio.
- In addition to provisions towards non-performing assets, NHB also stated for general provision at 0.4% on outstanding standard non-housing loan portfolio and a 2% standard asset provisioning on standard assets under dual (teaser) rate home loan scheme.

Raised general provisioning requirement to 0.4% on standard housing loan…

… higher provisioning on sub-standard / doubtful assets

In September'2011, NHB made it mandatory for HFC to make a) general provisions at 0.4% on outstanding standard housing loans and b) higher provisioning on sub-standard and doubtful assets (table below).

NHB introduced measures towards LTV, risk-weights and provisioning requirement

Risk weights - a move to ensure adequate capital buffer

Loan value	LTV	Risk-weight (%)
Above Rs3mn and less than Rs7.5mn	Less than or equal to 75%	75
Upto Rs7.5mn	More than 75%	100
Above Rs7.5mn	No LTV	125
Corporate loans	Irrespective of ticket size	100

Provisioning norms: Tightened belts to avoid any leakages

(Fig in %)	Now	Before
Standard Assets	0.4	Nil
Standard assets on non-housing loan		
by March 2011	0.2	Nil
by Sept 2011	0.4	Nil
Standard assets on retail loan portfolio	0.4	0.1
Standard asset provisioning on dual rate scheme portfolio	2.0	Nil
Sub-standard Assets	15.0	10.0
Doubtful assets		
Upto 1 year	25.0	20.0
1-3 Years	40.0	20.0
Over 3 Years	100.0	50.0

Source: NHB, Emkay Research

… and in October' 2011, NHB directed housing finance companies:

No pre-payment penalty on foreclosure of loan, subject to condition…

…uniformity in interest rate on floating rate portfolio for both old and new customers

- Not to charge any pre-payment penalty on pre-closure of housing loans (both floating and fixed rate loan, subject to condition) and
- Charge uniform rates on floating loan portfolio to both old and new customers with the same credit or risk profile, irrespective of the time of entry of the borrower.

No major impact on withdrawal of pre-payment penalty clause

NHB regulation towards removal of pre-payment penalty clause is likely to aid borrowers to replace their high-cost borrowing with a relatively lower rate or pre-pay their loan amount thereby saving on interest out-flow. Even on HFCs front, share of fees from pre-payment penalty is at sub-2% of total profit, thereby having minimal impact on their profitability.

As far as uniformity on interest rates for floating loan portfolio is concerned, HFCs management suggested that they are in interaction with the regulatory authority and await further clarity over the same. In our view, following points need to be looked upon before driving to any conclusions:

Re-alignment of rates would call for either increase in lending rates for new borrowers (hurt growth with up-tick in margin) or reduce the lending rates of old customers by marking them in sync with new rates (healthy loan growth but at cost of margins). However, HFC in the past, have been providing this facility to their existing borrowers to shift their loan portfolio to current rates if they find that their rates are higher, albeit at some cost. Also, with competitive market, it is practically impossible for the borrower to replace his debt to relatively lower cost (see table below). Further, while RBI is silent over the said issue, any notification towards implementation of the same by banks would make the environment more competitive.

Regulator should strive to derive the floor rate for HFC, in line with banks…

… we believe the floor rate could be a sum of 10-yr corporate bond + provision cost + any other opex cost

NHB has argued the need for uniformity in floating rates on the grounds of lack of transparency and fairness in rates charged by the housing finance companies. Unlike bank base rate which is determined by "Cost of deposit + negative carry cost of CRR etc, it is practically impossible to gauge any minimum floor rate for HFCs. In our view, any mechanism towards calculation of minimum floor rate for HFC would help implement uniformity in floating interest rates to the borrowers based on their risk / credit profile. *(For instance: HFC floor rate may be determined as = 10-yr Gsec / 10-yr AAA corporate bond + provisioning cost towards the loan portfolio + any other cost viz opex etc).* While the implementation of uniform lending rates will aid benefit over the longer run, we do not expect any material shift in loan portfolio. We expect HFC to stand tall in this stiff competition and gain market share over FY11-15E given its expertise and ability to maintain stable asset quality.

Lending rates across various ticket size - HFC vis-à-vis peers

Ticket size (Rs mn)	LICHF	HDFC	ICICI Bank	Axis Bank	SBI
Base rate / RPLR (%)	14.40	16.50	10.00	10.00	10.00
Upto Rs2.5-3mn	10.65	10.75	10.50	10.75	10.75
> Rs2.5mn and upto Rs7.5mn	11.00	11.00	11.00	11.00	11.00
> Rs7.5mn	11.50	11.50	11.50	11.25	11.25

Source: Companies, Emkay Research. Note (*): Axis Bank - Offering 11.75% fixed rate loans for life, HDFC offering fixed rate loans between 10.75-11.75%, LICHF offers fixed rates product in the range of 10.75-11.75% of various maturities.

… and will thereby, ensure stable balance sheet growth and asset quality

The regulatory measures towards higher provisioning norms, cap on LTV ratio, higher risk-weights, removal of pre-payment penalty clause and uniformity in interest rates will aid stable balance sheet growth over the longer run.

Annexure: Crisis management system implemented across the globe by the respective regulatory authority

Economy	Year	Crisis measures	Main lenders	Interest rate type	LTV on new loans (%)
Canada	Mid-2008 to April 2011	Reduced maximum amortization periods (30 years from 35 years) for new government-backed insured mortgages with loan-to-value (LT V) more than 80 percent), increase in minimum down-payment (with insurance) from 0 to 5 percent. Tightened mortgage insurance rules in 2008, 2010, and 2011, requiring, among other things, all borrowers, regardless of choice of mortgage product, to qualify for a standard five-year fixed-rate mortgage, and reducing the maximum LT V ratio to 85 percent when refinancing. Require borrowers with variable rate loans or fixed for less than five years to be qualified at the average major lender posted five-year rate. Withdraw government insurance backing on lines of credit secured by homes, such as home equity lines of credit.	Banks and specialized non depository and mortgage brokers (31 percent)	Mixed	80 (95)
China	Late 2009 to end-2010	Reduce tax incentives; tightening eligibility criteria for land-development projects; requiring state-owned enterprises to exit land and property development business if not already core; banning banks from extending loans to speculators; increasing down-payment requirements; and increasing interest rates.	Banks	Mixed	avg 60
India	Nov'2010	LTV limited to 80 percent for residential loans; increase in risk-weights of housing loans (above 7.5 million rupees) to 125 percent; increase loan-provisioning for housing with "teaser rates" to 2 percent.	Banks and housing finance companies	Mixed	80/90
Hong Kong SAR	September 2009 to end-2010	Lowering maximum LT V to 60–70 percent (depending on property value); LT V limit of 50 percent for non-owner occupied; standardizing debt-service-to-income (DTI) limits to 50 percent; insurance denied for LT Vs>90 percent (from 95 percent).	-	-	-
Singapore	February 2010 to January 2011	Seller's stamp duty on property sold within a year introduced; LT V limit reduced from 90 to 80 percent (60 percent for second and subsequent mortgages granted by FIs regulated by the MAS); increasing housing grants to lower-income households; lengthening the minimum occupancy period for nonsubsidized flats; raising the seller's stamp duty rates to 16 percent if sold within a year, 4 percent if sold in the 4th year.	-	-	80
South Korea	July 2009 to August 2010	Lower LT V limits on non-speculative (in addition to the previous speculative) mortgages; tightened DTI limits. In 2010, temporary suspension of the DTI ratio cap for people who own at most one home; waiver period on transaction taxes for owners of multiple properties; and support for low-income homeowners, renters and the construction sector.	-	-	60-70
United Kingdom	2009 to January 2011	Contemplating tightened mortgage regulations, laying out a number of proposals in its 2009 Mortgage Market Review Discussion Paper, followed by two 2010 consultation papers on responsible lending, focusing on enhancing borrower affordability assessment, and improving the distribution and disclosure process, respectively. The UK government announced a package of measures to enhance consumer protection in the mortgage market. Notably, the FSA is given responsibility for the whole residential mortgage market, transferring some regulatory responsibilities from the office of fair trading.	Banks and building societies and mortgage brokers (60 percent)	Variable	110
United State	2008–10	From a supervisory perspective, tightened real estate evaluation and appraisal guidelines, enhanced disclosures for home mortgage transactions, and implemented registration requirements for mortgage loan originators; adopted policy supporting prudent commercial real estate loan workouts; and created an independent Consumer Financial Protection Bureau. From a housing support perspective, expanded scope of Community Reinvestment Act regulation to support communities affected by high foreclosure levels; and introduced programs to promote sustainable loan modifications. The Federal Reserve also purchased $1.25 trillion of agency MBS to reduce the cost and increase the availability of mortgage credit. From a financial stability perspective, injected capital and placed Fannie Mae and Freddie Mac in conservatorship.	Banks and mortgage brokers (68 percent 2004; 10 percent 2010)	Fixed	100+

Source: IMF report on Housing Finance and Financial stability – Back to Basics?, April 2011

Mortgage industry to witness steady 15% CAGR over FY11-15E…

Loan portfolio (Rs mn)	FY06	FY11	FY12E	FY13E	FY15E	CAGR (FY01-11)	CAGR (FY06-11)	CAGR (FY08-11)	CAGR (FY11-13E)	CAGR (FY11-15E)
Banks (from RBI)	**1,851,810**	**3,461,100**	**3,807,210**	**4,264,075**	**5,444,798**		13.3	10.3	11.0	12.0
growth (%)	*38.3*	*15.0*	***10.0***	***12.0***	***13.0***					
HFC's (individual loans)										
HDFC	302,618	736,493	873,111	1,037,031		22.6	19.5	15.0	18.7	
LICHF	133,805	467,307	594,501	751,392		25.7	28.4	33.3	26.8	
Dewan	19,104	134,855	188,630	249,380		36.2	47.8	53.7	36.0	
Gruh Finance	10,691	31,769	38,122	44,984		21.5	24.3	21.5	19.0	
GIC Housing	16,900	33,102	38,729	45,313		18.2	14.4	11.4	17.0	
Total	**483,119**	**1,403,525**	**1,733,093**	**2,128,101**	**3,115,752**	24.3	23.8	22.7	23.1	22.1
growth (%)	*23.8*	*28.9*	*23.5*	*22.8*	***21.0***					
Total (Banks + HFC)	**2,334,929**	**4,864,625**	**5,540,303**	**6,392,176**	**8,560,550**		**15.8**	**13.4**	**14.6**	**15.2**
growth (%)	*35.0*	*18.7*	*13.9*	*15.4*						
Market share % in total										
Banks	**79.3**	**71.1**	**68.7**	**66.7**	**63.6**					
HFC	**20.7**	**28.9**	**31.3**	**33.3**	**36.4**					
HDFC	*13.0*	*15.1*	*15.8*	*16.2*	-					
LIC	*5.7*	*9.6*	*10.7*	*11.8*	-					
Dewan	*0.8*	*2.8*	*3.4*	*3.9*	-					
GDP (Rs mn)	*32,542,160*	*48,778,420*	*52,192,909*	*56,107,378*	*65,443,645*		**8.4**	**7.8**	**7.2**	**7.6**
Growth (%)	*9.5*	*8.5*	***7.0***	***7.5***	***8.0***					
Mortgage % of GDP	***7.2***	**10.0**	**10.6**	**11.4**	**13.1**					

Source: RBI, Companies, Emkay Research. Note: cells marked in orange colour denotes assumed growth rate

Floating rate loans

then…. (August - September, 2009)

LIC: Floating rate loans & 3-year Fix-O-floaty Loans	
Loan value	RoInterest (%)
Floating rate:	
Upto Rs7.5mn	8.75
Fix-O-floaty rate:	
Upto Rs7.5mn	8.90

HDFC: Dual rate loan scheme - Fixed upto March, 2012	
Loan value	**RoInterest (%)**
Upto Rs3mn	8.25
Rs3mn to Rs5mn	8.25
Rs5mn and above	8.25

State Bank of India :	
Loan value	**RoInterest (%)**
SBI Hi-Five	
Upto Rs0.5mn for 5-years	8.00
SBI Easy Home loan (Loans <Rs5mn)	
1st year	8.00
2nd year	8.50
3rd year	8.50
SBI Advantage Home loan (Loans >Rs5mn)	
1st year	8.00
2nd year	8.50
3rd year	8.50

and now….

LIC: New Advantage 5 Scheme Fixed for 5-years	
Loan value	**RoI (%)**
Upto Rs3mn	11.15
Rs3mn to Rs7.5mn	11.40
Rs7.5mn and above	11.65

HDFC: Fixed interest for 3-yrs & 5-years	
3-year option	
Loan value	**RoI (%)**
Upto Rs3mn	10.75
Rs3mn to Rs7.5mn	11.25
Rs7.5mn and above	11.75
5-year option	
Loan value	**RoI (%)**
Upto Rs3mn	11.25
Rs3mn to Rs7.5mn	11.50
Rs7.5mn and above	11.75

State Bank of India – festive Season (valid till 31st Dec)	
Loan value	**RoI (%)**
Upto Rs3mn	10.50
Rs3mn to Rs7.5mn	10.75
Rs7.5mn and above	11.00

HFCs better placed to its counter peers - Banks…

It has been long argued about key dominance of HFCs/Banks in the mortgage business. In our view, while banks have an edge over HFCs owing to its reach and customer base, concerns over ALM mismatch, limited target audience based on creditability, longer processing time, limited expertise and higher operational cost have remained the key constraints for banks. On the other hand, housing finance companies with mono-line business model stand to gain owing to domain expertise, lower opex and adequate ALM portfolio.

Indian mortgage industry was dominated by HFC in early 2000. However, with enormous growth potential, banks entered the mortgage space. Lower cost-of-funds, wide reach and healthy customer base provided banks' an opportunity to penetrate and increase their market share considerably over the years. Consequently, their market share in total mortgage industry increased substantially and stood at 79% as at FY06.

Following slump in real estate market in early 2009 and sluggish credit growth, banks introduced teaser rate home loan schemes for individual borrowers. Under the scheme, loans were offered at a pre-determined fixed rate for certain period of time after which they were to be linked to the bank's PLR. SBI, the largest bank in India was the front-runner to introduce such scheme in February, 2009. Following the move, ICICI Bank and other banks too, introduced teaser rate loan schemes. With a view to remain competitive, HDFC and LICHF too, introduced teaser rate schemes. However, despite aggressive stance by banks, credit to mortgage industry witnessed miniscule 10% CAGR over FY08-11 against 22% CAGR by HFC's and 13% CAGR for the overall mortgage industry. Consequently, its market share has declined by over 800bps to 71% by end-FY11 (see page 11).

During FY11, with a view to tide over concerns on steep rise in property prices and increasing interest rates, RBI and National Housing Board had made it mandatory for mortgage financing companies to make provisions towards a) teaser rate loans b) general provision on standard non-housing loans c) cap on LTV in addition to higher risk weights. In a recent move, NHB has made if mandatory for HFC to charge uniform interest on its floating loan portfolio and also proposed for withdrawal of pre-payment penalty charges. However, despite higher provisioning norms and stiff competition, we expect HFC to continue its growth with stable asset quality and superior return ratios.

… and now well placed over other NBFCs

On the other hand, asset financing companies (AFC) historically have operated on a relatively higher RoA's vis-à-vis housing finance companies. Niche target audience with limited competition from its peers had enabled AFC's to command premium spreads. Also, with lower operating expenses and minimal provisioning requirements, return ratios remained attractive in the past. However, in the backdrop of higher interest rates and material slowdown in corporate capex and infrastructure activities, growth rate has moderated. Further, with fears over deterioration in asset quality, provisioning norms have been strengthened. As a result, profitability is on a decline resulting in lower RoA's and steep underperformance vis-à-vis peers (see table below).

Price performance – HFC vis-à-vis NBFC

Company	Chg_1month	Chg_3month	Chg_6month	Chg_YTD
HDFC	1.2	7.3	(5.7)	2.8
Dewan Hsg	(1.1)	(12.3)	(14.7)	3.9
LICHF	(2.3)	7.1	1.6	2.8
GIC	(1.8)	(18.0)	(36.5)	4.0
Gruh Fin	2.7	7.0	27.4	(2.1)
IDFC	(13.7)	(8.8)	(26.4)	9.7
REC	(19.2)	4.6	(20.0)	5.9
PFC	(15.9)	11.7	(24.3)	8.0
Shriram Trans.	(14.2)	(17.9)	(28.4)	16.3
M&M Fin.	(10.7)	(1.4)	(9.1)	0.2
Sensex Index	(5.6)	0.4	(15.3)	2.6
Bankex Index	(8.2)	(2.7)	(25.0)	5.8

Source: Bloomberg, Emkay Research

Valuation and view:

Housing Finance companies have outperformed the broader index and its peers on expectations of a) stable balance sheet growth b) adequate capital c) comfortable asset quality, d) superior return ratios and e) attractive valuations. Mortgage penetration in India is at a nascent stage and we believe with increasing demand-supply mismatch, customer profile and the risk-averse behavior, there is immense potential for penetration. While fears over moderation remain due to higher interest rates and property prices, a material slowdown seems unlikely. ***In our view, the mortgage space is poised for a healthy 15% CAGR over FY11-15E and we expect the share of mortgage/GDP to inch to 13% (up 300bps) by end-FY15. We initiate coverage on Dewan Housing Finance (BUY) and HDFC (HOLD)). We continue to maintain BUY on LICHF.***

Valuation matrix – HFC vis-à-vis other NBFCs

FY12	RoA (%)	RoE (%)	Book value	P/B(x)
HDFC	2.6	21.2	131	5.1
Dewan Hsg (Standalone)	1.5	18.5	171	1.1
LICHF	1.8	24.1	104	2.2
GIC*	3.2	21.1	87	0.8
Gruh Finance*	2.8	26.0	90	6.1
IDFC (Conso)	2.9	13.1	82	1.2
REC	3.8	20.3	147	1.1
Power Finance	2.5	15.8	156	1.0
Shriram Trans.	4.0	25.0	266	1.8
M&M Fin.	3.8	21.5	284	2.2

*Source: Bloomberg, Companies, Emkay Research. Note: *denotes FY11*

Provisioning requirements – Bank, HFC and NBFC

(%)	Bank	HFC	NBFC*
Standard asset provisioning			
- Teaser rate home loan	2.0	2.0	NA
- General provisions	0.4	0.4	NA
Sub-standard assets	**10.0**	**15.0**	**10.0**
Doubtful assets			
- upto 1year	20.0	25.0	20.0
- 1year to 3-years	30.0	40.0	30.0
- More than 3-years	100.0	100.0	50.0
Loss assets	**100.0**	**100.0**	**100.0**

Source: RBI, NHB, Emkay Research

Valuation matrix & recommendation:

HFC	Target price (Rs)	RECO		Net Inc.	Net profit	EPS (Rs)	ABV (Rs)	RoA (%)	RoE (%)	P/E (x)	P/ABV (x)
Dewan Hsg (Conso)	275	BUY	**FY11**	5,566	3,574	29.8	138.2	1.9	25.5	6.2	1.3
			FY12E	6,759	4,075	35.4	191.8	1.4	19.9	5.2	1.0
			FY13E	9,273	5,497	46.1	215.2	1.6	22.1	4.0	0.9
HDFC	700	HOLD	**FY11**	42,471	32,283	22.0	118.1	2.5	19.9	29.3	5.5
			FY12E	49,480	39,078	26.6	131.3	2.6	21.2	24.2	4.9
			FY13E	54,058	43,008	29.3	147.3	2.5	20.8	22.0	4.4
LICHF	250	BUY	**FY11**	13,770	10,406	21.9	87.5	2.2	27.5	10.0	2.5
			FY12E	16,177	10,969	23.1	103.7	1.8	24.1	9.5	2.1
			FY13E	21,741	15,062	31.7	131.0	2.0	26.9	6.9	1.7

Source: Companies, Emkay Research

Key Financials

	HDFC			LIC Housing			Dewan Hsg (Consolidated)		
	FY11	FY12E	FY13E	FY11	FY12E	FY13E	FY11	FY12E	FY13E
Borrowings	**1,154,105**	**1,356,073**	**1,566,264**	**451,628**	**578,095**	**735,976**	**206,897**	**266,839**	**341,480**
- Term loans from banks /FI's	424,487	473,269	523,132	164,968	254,415	319,612	163,029	172,133	218,140
- Bonds	482,239	569,551	681,325	284,202	310,646	399,989	32,881	47,398	65,703
- Deposits / others	245,951	311,897	360,241	2,458	13,034	16,374	10,987	47,308	57,637
% of borrowing									
- Term loans from banks / FI's	*36.8*	*34.9*	*33.4*	*36.5*	*44.0*	*43.4*	*78.8*	*64.5*	*63.9*
- Bonds	*41.8*	*42.0*	*43.5*	*62.9*	*53.7*	*54.3*	*15.9*	*17.8*	*19.2*
- Deposits / FI's	*21.3*	*23.0*	*23.0*	*0.5*	*2.3*	*2.2*	*5.3*	*17.7*	*16.9*
Investment	**118,324**	**123,327**	**128,292**	**14,032**	**14,032**	**14,032**	**6,877**	**5,520**	**2,573**
- ex investment in Sub	38,973	41,476	43,940	13,844	13,844	13,844	6,575	5,212	2,265
Loans	**1,171,266**	**1,385,891**	**1,620,361**	**510,898**	**646,197**	**816,730**	**199,305**	**271,916**	**355,134**
- Individual	736,493	873,111	1,037,031	449,591	597,732	751,392	192,245	258,320	337,377
- Corporate	421,407	491,991	550,923	61,308	48,465	65,338	7,060	13,596	17,757
- Others	13,366	20,788	32,407	-	-	-	-	-	-
% of loans									
- Individual	*62.9*	*63.0*	*64.0*	*88.0*	*92.5*	*92.0*	*96.5*	*95.0*	*95.0*
- Corporate	*36.0*	*35.5*	*34.0*	*12.0*	*7.5*	*8.0*	*3.5*	*5.0*	*5.0*
- Others	*1.1*	*1.5*	*2.0*	-	-	-	-	-	-
Networth	**173,165**	**194,959**	**218,943**	**41,691**	**49,425**	**62,375**	**15,556**	**21,618**	**26,756**
% of Balance sheet	*12.5*	*12.1*	*11.8*	*7.8*	*7.4*	*7.4*	*6.8*	*7.3*	*7.2*
Balance sheet ratio (%)									
Loans / borrowings	*101.5*	*102.2*	*103.5*	*113.1*	*111.8*	*111.0*	*96.3*	*101.9*	*104.0*
Loans / balance sheet	*84.2*	*85.8*	*87.7*	*95.6*	*96.6*	*97.3*	*87.1*	*92.1*	*95.2*
Borrowings / balance sheet	*83.0*	*84.0*	*84.7*	*84.5*	*86.5*	*87.7*	*90.4*	*90.4*	*91.5*
Key ratio (%)									
Cost/Income	*7.7*	*7.9*	*8.4*	*13.5*	*13.3*	*12.1*	*36.0*	*34.6*	*33.2*
Other Income / Total Income	*14.3*	*14.7*	*15.6*	*14.1*	*13.4*	*12.1*	*22.2*	*28.5*	*25.1*
Operating exp	**3,812**	**4,557**	**5,411**	**2,162**	**2,494**	**2,982**	**2,575**	**3,266**	**4,113**
% of average assets	*0.30*	*0.30*	*0.31*	*0.46*	*0.41*	*0.40*	*1.55*	*1.25*	*1.23*
Employee	1,607	1,671	1,721	1,190	1,250	1,312	1,279	1,407	1,547
Avg loan per employee (Rs mn)	*729*	*829*	*941*	*429*	*517*	*623*	*156*	*193*	*229*
DuPont analysis									
NII	3.3	3.3	3.1	2.9	2.7	2.9	3.3	2.6	2.8
Other Income	0.6	0.6	0.6	0.5	0.4	0.4	1.0	1.0	0.9
Total Income	**3.9**	**3.9**	**3.7**	**3.4**	**3.1**	**3.3**	**4.3**	**3.6**	**3.7**
Operating Exp	0.3	0.3	0.3	0.5	0.4	0.4	1.5	1.2	1.2
Pre-provision profit	**3.6**	**3.6**	**3.4**	**3.0**	**2.7**	**2.9**	**2.8**	**2.4**	**2.5**
Provisions	0.1	0.1	0.1	0.0	0.2	0.2	0.1	0.2	0.2
APBT	3.5	3.5	3.3	3.0	2.5	2.7	2.6	2.2	2.3
APAT	**2.5**	**2.6**	**2.5**	**2.2**	**1.8**	**2.0**	**1.9**	**1.4**	**1.6**
Leverage (x)	8.0	8.3	8.4	12.8	13.5	13.5	14.7	13.7	13.9
RoE (%) (calculated)	**20.3**	**21.5**	**21.0**	**28.5**	**24.7**	**26.9**	**27.5**	**19.3**	**22.3**

Source: Companies, Emkay Research

Companies

- **Dewan Housing Finance**
- **HDFC Ltd**
- **LIC Housing Finance**

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Your success is our success

Dewan Housing Finance

On a strong footing

Initiating Coverage

January 6, 2012

Reco

BUY

CMP	**Target Price**
Rs 185	Rs 275

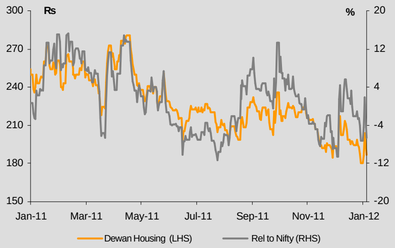
EPS change FY12E/13E (%)	NA
Target Price change (%)	NA
Nifty	4,750
Sensex	15,857

Price Performance

(%)	1M	3M	6M	12M
Absolute	(2)	(13)	(17)	(30)
Rel. to Nifty	7	(11)	3	(8)

Source: Bloomberg

Relative Price Chart



Source: Bloomberg

Stock Details

Sector	Financial Services
Bloomberg	DEWH@IN
Equity Capital (Rs mn)	1049
Face Value(Rs)	10
No of shares o/s (mn)	105
52 Week H/L	288/171
Market Cap (Rs bn/USD mn)	20/378
Daily Avg Volume (No of sh)	195136
Daily Avg Turnover (US$mn)	0.8

Shareholding Pattern (%)

	Sept-11	Jun-11	Mar-11
Promoters	39.3	39.3	39.4
FII/NRI	34.6	34.3	35.0
Institutions	8.6	8.7	8.8
Private Corp	11.7	11.0	10.5
Public	5.7	6.7	6.3

Source: Capitaline

- **Dewan Housing Finance, aided by its recent inorganic growth, is well equipped to cater to the mortgage needs of customers in different income levels and geographies**
- **As integration gains scale, we expect consolidated entity to report 33%/28% CAGR in loans/bal. sheet (FY11-13E). Despite higher Opex + credit cost, expect healthy 24% CAGR in PAT**
- **Branch business model has assured stable asset quality. GNPA at 0.9% remains up-beat and on par with peers. Carries cumul. provisions of Rs1.2bn (0.7% of loans) as on H1FY12**
- **Adequate capital for growth with decent return ratios are key + ves. Strong fundamentals with attractive valuation of 0.9x FY13 conso ABV provide room for decent upside. BUY.**

Consolidated entity to witness healthy 33% loan CAGR over FY11-13E

DHFL, through relentless organic and inorganic growth (over the past decade) has expanded its reach pan-India and is now well placed to cater to the mortgage needs of customers across different income levels and geographies. Improving income levels with higher affordability and emergence of tier-II and tier-III (along with higher demand in tier-I cities) have enabled DHFL enjoy a healthy 4%* market share in the mortgage space. With improving economies of scale and increasing mortgage demand, we expect DHFL with strong brand name and reach to gain share. As integration gains momentum, we expect the consolidated entity to report 33% / 28% CAGR in loans / balance sheet over FY11-13E. PAT growth too, is expected to remain a healthy 24% CAGR despite ~140bps of opex and credit cost over FY12/13E.

Early entry into smaller cities provides it an edge over peers

High interest rates and volatile property prices have remained key detriment for growth, in recent times. With steep rise in property prices in tier-I cities, a large no of HFCs and banks have shifted their focus towards emerging and relatively affordable tier-II and tier-III cities. DHFL, through its early entry and brand name in this region, stands to gain over its peers.

Minimal concerns on asset quality; factoring 18bps of credit cost

The branch business model for credit appraisal with centralized loan processing has ensured stable asset quality with growth. GNPA for H1FY12 at 1% remains well within comfort zone and on par with its peers. Cumulative standalone provisioning on balance sheet stood at Rs1.2bn (0.7% of loans). Given higher provisioning requirement, we have factored 19bps (average assets) of credit cost over FY12-13.

Well-built business model with attractive valuations; Initiate with BUY

We have valued DHFL on SOTP basis and arrived at a target price of Rs275. Strong business model with immense growth potential, stable asset quality and decent return ratios remain key positives. The stock has outperformed its peers and trades at an attractive valuation of 0.9x FY13 consolidated ABV. **Initiate as BUY**

Consolidated Financial Snapshot **(Rs mn)**

Y/E, Mar	Net Income	Net profit	EPS (Rs)	ABV (Rs)	RoA (%)	RoE (%)	P/E (x)	P/ABV (x)
FY10	3,392	1,584	19.1	95.9	1.8	22.3	9.7	1.9
FY11	7,150	3,574	29.8	138.2	1.9	25.5	6.2	1.3
FY12E	9,447	4,075	35.4	191.8	1.4	19.9	5.2	1.0
FY13E	12,374	5,497	46.1	215.2	1.6	22.1	4.0	0.9

Source: Company, Emkay Research

Company Description

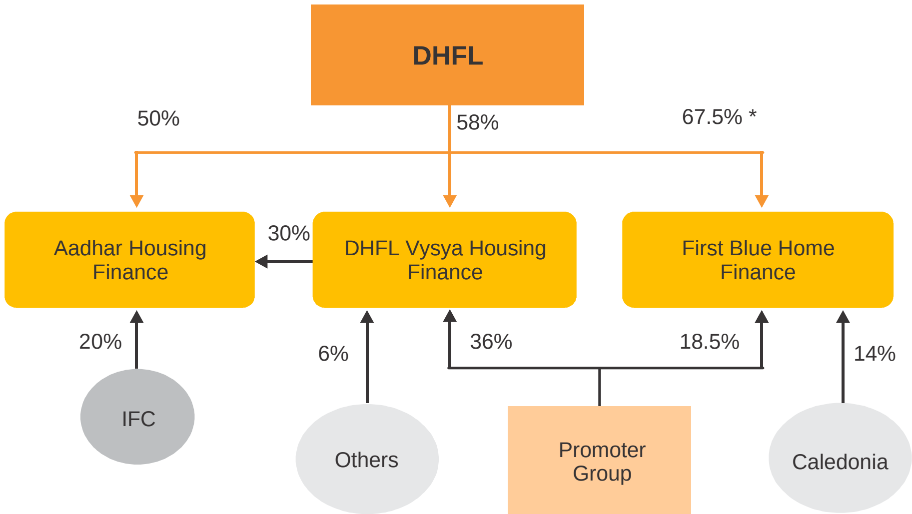
4% market share in Indian individual mortgage industry*

… Operates through 289 branches and 137 alliances

Integration / joint collaboration to cater to all income levels and geographies

Dewan Housing Finance (DHFL) with a consolidated loan portfolio of US$4.5bn (end-FY11) is the third largest housing finance company in India. Established in 1984, the company has expanded its presence pan-India through 289 branches and 137 alliance partners and enjoys a market share of ~4%* in the Indian individual mortgage industry. Through integration and joint collaboration with a) DHFL Vysya housing finance (erstwhile Vysya Housing Finance) in 2003, b) Aadhar Housing Finance in May 2010, and c) First Blue home finance (erstwhile Deutsche PostBank Home Finance), the company now caters to customers across all income levels and in various geographies of India.

Business model: Inorganic growth aimed at pan-India presence.



**** Through fully owned SPV DHFL Holdings Pvt.Ltd.***

Key personnel:

Mr. Kapil Wadhawan: Chairman and Managing Director: An MBA from Edith Cowan University, Australia, Mr. Wadhawan joined the company in September, 1996. Under his leadership, the company has transformed itself from a national player to a significant global player. This was followed by the acquisition of the housing finance division of ING Vysya. With a view to address the needs of economically weaker sections of the society, DHFL setup Aadhar housing Finance Pvt Ltd in 2010.

Mr. Dheeraj Wadhawan: Non-Executive Director: A graduate in construction management from the University of London, he has over 10-years of experience in the real estate / developers and construction industry.

Mr. Anthony Hambro: Nominee Director of M/s. Caledonia Investment Plc. UK. An associate director of Caledonia Investment Plc, UK has been involved since 2002. Earlier, he had worked for 17-years with Samuel Montagu and Grindlays Bank.

Top-10 shareholders	Sept-11
Caledonia Investment PLC	9.56
Wasatch Emerging market	4.44
Ironwood Investment Holdings	4.11
Asiabridge Fund I, LLC	3.41
Government of Singapore	2.94
HSBC Bank (Mauritius) Ltd	2.31
Emerging Market Management	1.96
IIFL INC A/C	1.28
Mirae Asset Management	1.23
Stichting Pension fonds ABP	1.22

Source: Company, Emkay Research

Investment Rationale

Standalone entity: Loan growth momentum to remain healthy at 37% CAGR

Strongest branch network in HFC space…

… 80% of branches in GDP rich states of Western and Southern India

~94% of loan portfolio towards individual loans…

… 80% customers being either in services or self-employed

Over the past two-decades, Dewan Housing Finance (DHFL) has gained dominant position in the mortgage needs of the customers in LMI (low-and-middle income) segment. Through 289 branches and 137 alliances, the company operates pan-India. 80% of its branches are in the GDP rich states of Western and Southern India and primarily in the under-penetrated regions of tier-II and tier-III cities. a) Relatively lower ticket size (currently at Rs0.6mn) with adequate installment/income ratio (39%) b) branch model approach c) comfortable asset quality (GNPA at 0.77% as at end-FY11) and d) adequate capital (CAR at 19.4%, Tier I at 13.9%) have all worked in favor of DHFL. ~90% of loan portfolio is towards individual loans; 80% customers being either in services or self-employed.

Robust 50% CAGR in loan portfolio over FY08-11…

… presence in LMI segment enabled stable asset quality

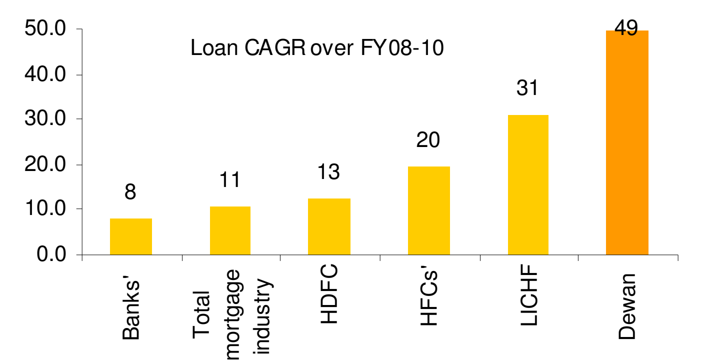
In the past: Dewan Housing Finance witnessed a robust 50% CAGR in loan portfolio over FY08-11 led by 65%/55% CAGR in sanctions/disbursements. This growth was mainly driven by DHFL's presence in the unaffected segment of LMI with soft interest rate regime, limited regulatory hindrance, stable property prices and lower balance sheet base. As a result, spreads remained intact in the range of 2.5%-3.3% with NNPA well under control. With 47%/54% CAGR in net profit/balance sheet, RoA averaged 1.9%. The improved leverage enabled RoE inched to 22% levels from 16.5% in FY07.

Market share improved from 1.2% in FY08 to ~4% by end-FY11

Over FY08-10, DHFL's witnessed 49% CAGR in its individual loan portfolio (albeit on a lower base) vis-à-vis 11% CAGR in overall industry and 13% CAGR by mortgage leader, HDFC. Through relentless organic and inorganic growth, DHFL has reported material improvement in its market share in the individual mortgage space (4% by end-FY11 against 1.2% in FY08).

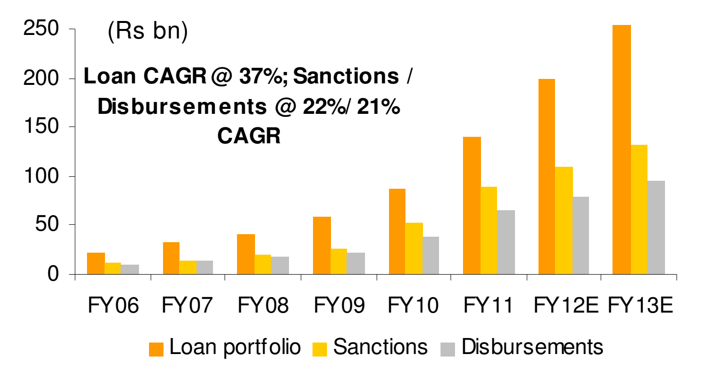
Going forward: DHFL (the standalone entity) with strong brand name and close to three-decades of expertise in the niche LMI segment is well placed to gain market share given a) improving income levels and evolution of nuclear family concept, b) migration of people from smaller towns to tier-II and tier-III cities with relatively affordable prices (compared to tier-I cities) and c) comfortable asset quality given branch business model for credit appraisals (ensuring check on asset quality). As higher base-effect kicks in, we now expect DHFL to witness 37% CAGR in its loan portfolio over FY11-13E. Interest rate cycle is believed to be at its peak and any signs of moderation in rates will only add to growth momentum. Also with relatively affordable prices in tier-II and smaller cities, growth momentum remains buoyant. **In our view, the recent NHB guidelines on the uniformity of interest rates on floating rate loans will have minimal impact on DHFL as compared to its peers owing to its customer reach (being under-penetrated region with limited competition) and borrower's profile. Also, mortgage needs are primarily towards end-use and not speculative in nature, thereby reducing any element of decline in growth.**

Loan CAGR (FY08-10); Dewan Housing outpaced its peers



Source: Company, Emkay Research

Trend in loans, sanctions and disbursements



Source: Company, Emkay Research

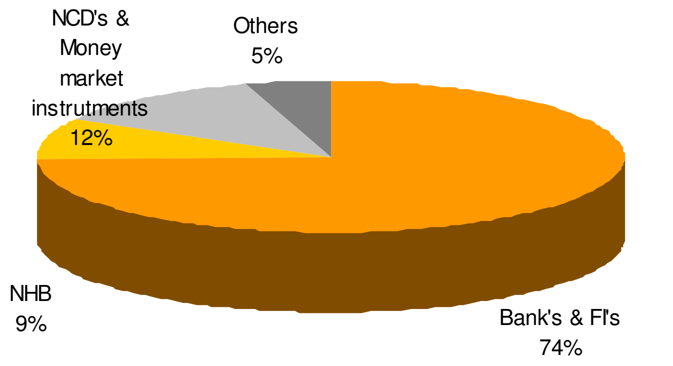
Borrowing profile skewed towards term-loans…

.. 70%+ of borrowing in form of bank term loans

Average cost of term loan up 290bps against 250bps increase in base rate

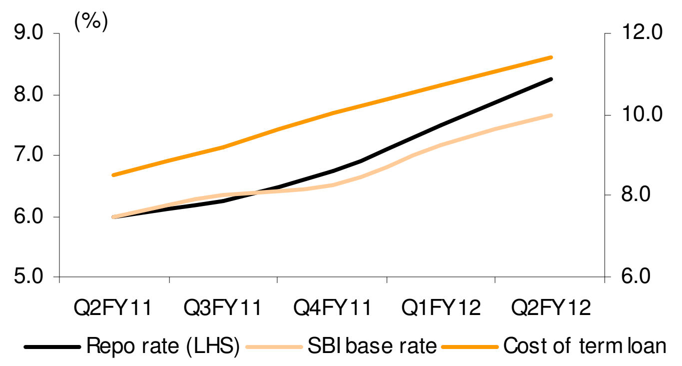
On the liabilities front, borrowing profile has remained skewed towards term loans from banks' and financial institutions (>70%+), a large part of which, is floating in nature and linked to bank's PLR / base rate. Given tight interest rate regime, average cost of bank term loans for DHFL over the past 4-quarters has increased by 289bps, against 300bps+ rise in base rate by various banks. During Q2FY12, cost of term loans stood at 11.4%, way above the banks' base rate (SBI / ICICI Bank base rate was at 10.0%).

Borrowings : Skewed towards term loans' from banks



Source: Company, Emkay Research

High cost pressures due to mix in favor of bank term loan



Source: Company, Emkay Research

Margins have remained in excess of 2.5% for a decade long

Historically, any increase in interest cost was passed on to the user (being customers), thereby negating any pressure on margins while ensuring consisent growth. This is clearly evident as calculated margins have remained in excess of 2.5% for a decade long now. We believe interest rate cycle is at its peak and any moderation in the same would ease cost pressures. Over the long run, management has retierated for a diversified borrowing mix in favor of bank loans (40%), NHB (25%), NCD (25%) and others (10%).

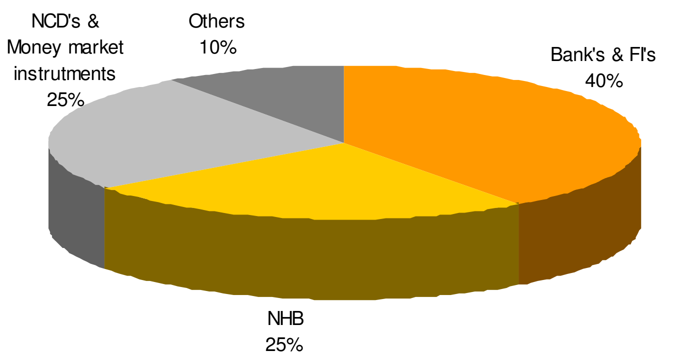
However, margins to move upwards of 2.7% by end-FY13E

90% of assets are floating against 71% of liabilities

Lending rate hike + teaser loan portfolio to aid margin improvement

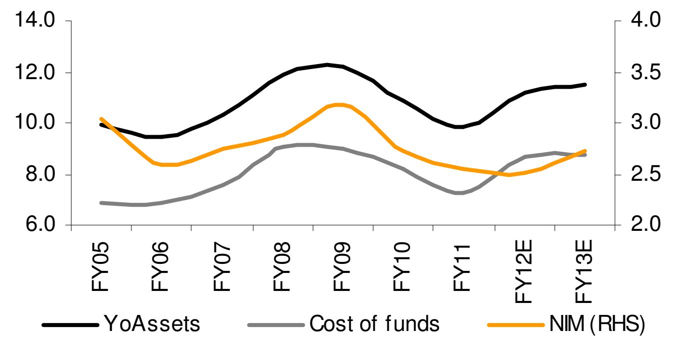
Prolonged period of elevated interest rates with excess reliance on bank term loans has urged the need for lending rate hike on regular basis. While the management is confident of healthy loan growth, we believe the growth may come at the cost of risky loan portfolio. Consequently, despite H1FY12 NIM at 2.8%, we expect full year NIM to contract to 2.5% (down 5bps yoy). DHFL's ALM managment has been exemplary with 90%+ of its assets being floating in nature as against 70%+ of liabilities. DHFL has raised its lending rates by ~250bps over the past 4-quarters (as against 230bps increase in overall cost of funds), the benefits of which will start to accrue beginning Q1CY12. Also, the teaser rate portfolio is due for expiration in Q4FY12, and the same shall be linked with floating rate. We thereby expect NIM to inch upwards to 2.7% for FY13. Any moderation in interest cycle and change in borrowing mix in favor of bond (NCD and NHB) would ease cost pressures further.

Targeted borrowing mix in the long run



Source: Company, Emkay Research

Trend in YoA, Cost-of-funds and NIM



Source: Company, Emkay Research

Improved leverage to ease operating cost pressures

Operates on branch model against DSA / in-house sourcing model

… identified regional processing units for monitoring purpose

DHFL operates on a branch business model as against LICHF (DSA model) or HDFC (in-house sourcing model). Through hub-and-spoke model, the company has identified 7-regional processing units for the purpose of monitoring. The civil, legal and technical checks, credit appraisals are done on a branch level basis, thereby assessing the customers profile at ground levels. All this, in-turn calls for higher operating cost. Also, owing to its demographic presence and target audience, collection process remains a bit cumbersome. DHFL has outsourced the collection process. Post-dated cheques form 60% of collections, ECS - 20-25% with the balance being through cash collection.

Opex/avg assets at 1.27% against 30bps for HDFC and 46bps for LICHF

While the branch model has ensured credit quality, it has come at a relatively higher cost. Operating expenses/average assets for DHFL are significantly higher at 1.27% (end-FY11) as against a mere 30bps in case of HDFC and 46bps in case of LICHF. Further, with lower ticket size and wide-spread target audience, the ratio of average loans/employee is on the lower end vis-à-vis peers. The average loan per employee for DHFL is at Rs124mn against HDFC (Rs729mn) and LICHF (Rs429mn).

Avg loan per employee at Rs124mn vs. Rs729mn for HDFC and Rs429mn for LICHF

Over FY11-13E, as DHFL leverages on its branch reach through the consolidated entity, we expect the ratio of operating expense / average assets to gradually ease to 1.22%. Also, average loan per employee is expected to improve to Rs220mn (33% CAGR) against LICHF (20% CAGR) and HDFC (14% CAGR).

Opex / avg assets : Dewan Housing vis-a-vis peers

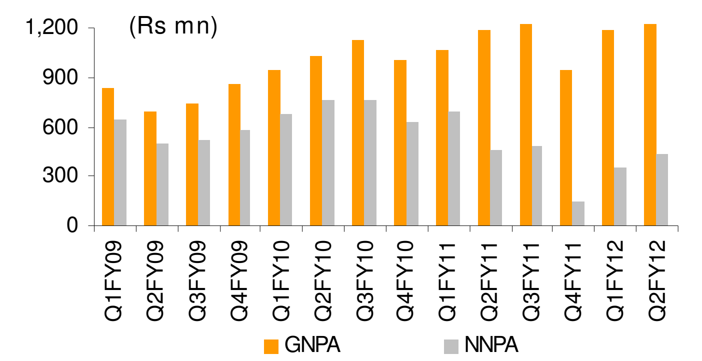
	HDFC			LIC Housing			Dewan Housing (Standalone)		
	FY11	FY12E	FY13E	FY11	FY12E	FY13E	FY11	FY12E	FY13E
Operating exp	**3,812**	**4,557**	**5,411**	**2,162**	**2,494**	**2,982**	**1,684**	**2,361**	**3,028**
% of average assets	*0.30*	*0.30*	*0.31*	*0.46*	*0.41*	*0.40*	*1.27*	*1.23*	*1.22*
Employee (nos.)	1,607	1,671	1,721	1,190	1,250	1,312	1,137	1,160	1,200
Avg loan per employee (Rs mn)	*729*	*829*	*941*	*429*	*517*	*623*	*124*	*171*	*220*

Source: Companies, Emkay Research

Asset quality remains impeccable…

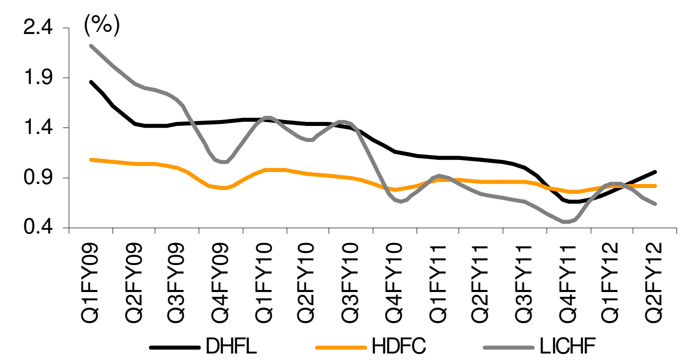
Higher operating cost for DHFL has been compensated by way of healthy asset quality. GNPA (90-day) for the company at 0.77% (end-FY11) remains close to its industry peers. This is commendable, given a business model which calls for a significantly higher risk compared to its peers (viz - collection mechanism, customer awarness etc). Credit cost too, remains miniscule at 10bps in FY11 (average of 14bps over FY06-11). During Q2FY12, NNPA at 0.26% was up 3bps qoq. We believe this is largely cyclical in nature and expect asset quality to remain well in comfort zone.

Trend in GNPA & NNPA



Source: Company, Emkay Research

Asset quality remains largely in-line with peers



Source: Companies, Emkay Research

Adequate buffer to meet additional provisioning requirements

DHFL made provision of Rs90mn on its teaser loan portfolio

Cumulative provision of ~Rs800mn on balance sheet

During FY11, with a view to tide over concerns on asset quality due to steep rise in property prices and elevated interest rates, NHB made it mandatory for housing financing companies to make provisions towards a) teaser rate loans b) general provision on standard non-housing loans c) cap on LTV, in addition to higher risk weights. Accordingly, DHFL with a cumulative teaser loan portfolio of Rs4.5bn has provided a sum of Rs90mn as teaser rate provisioning. The teaser loan portfolio is due for expiration in Mar' 12 and provisions made on these loans will reverse thereafter. The cumulative provisioning as at end-FY11 stood at ~Rs800mn (0.7% of total loans) against the regulated requirement of Rs380mn (0.27%).

NHB raised standard asset provisioning on individual loans to 0.4%...

… made a provision of Rs728mn to meet regulatory requirement

Assumed credit cost at 18bps of average assets for FY12E/FY13E

Further, in Sept' 2011, NHB made it mandatory for HFCs to make standard asset provisioning of 0.4% on individual loans. It also raised provisioning requirement on sub-standard and doubtful assets. Consequently, during Q2FY12, DHFL made a cumulative provision of Rs728mn (including Rs117mn passed through P&L account) to meet the regulatory requirement. The cumulative provisioning now stands at ~Rs1.2bn or 0.7% of total loan portfolio. While asset quality remains largely intact, we have raised our credit cost estimates to factor in higher regulatory requirement towards additional provision charges. We have factored in a 34% CAGR in GNPA over FY11-13E and raised credit cost estimates to 18bps (of average assets) over FY12-13E each (against 10bps for FY08-11).

Adequate capital for growth; Standalone RoA to average 1.8% over FY11-13E.

Comfortable CAR (18%) including Tier I CAR (14.3%)

Board resolution to raise additional capital to the tune of Rs5bn..

.. would increase FY13 book value estimates by 6%

Over the past two years (FY10-11), DHFL has raised capital to the tune of Rs7.9bn. Resultant, its capital adequacy (CAR) has inched to a comfortable level of 18.01% including Tier I CAR of 14.3% (end-H1FY12). In a recent move, the board has passed resolution to raise additional capital to the tune of Rs5bn (~US$100mn). While we have not factored the equity infusion in our estimates, the dilution would be to the tune of 16-17% of existing equity. Our book value estimates for FY13 will increase by 6% from current levels.

29%/30% CAGR in net profit/balance sheet over FY11-13E

…RoA / RoE to average 1.8%/20.5%

Over FY11-13E, we expect DHFL to report 30% CAGR in balance sheet. After factoring in combined ~140bps of operating and provisioning cost, PAT is expected to grow at 26% CAGR. We expect RoA / RoE to average 1.8% / 20.4% over FY11-13E.

DuPont analysis

RoA tree (%)	FY08	FY09	FY10	FY11	FY12E	FY13E
NII	2.88	3.17	2.72	2.56	2.52	2.73
Other Income	0.97	0.40	1.18	1.34	1.17	1.03
Total Income	**3.85**	**3.58**	**3.90**	**3.90**	**3.69**	**3.77**
Operating Exp	1.06	1.17	1.30	1.24	1.20	1.20
Pre-provision profit	**2.74**	**2.37**	**2.57**	**2.64**	**2.46**	**2.55**
Provisions	0.13	0.11	0.10	0.07	0.18	0.19
APBT	**2.60**	**2.26**	**2.46**	**2.57**	**2.29**	**2.36**
RoA	**2.04**	**1.67**	**1.84**	**1.99**	**1.62**	**1.69**
Leverage (x)	10.2	12.8	11.4	10.8	12.0	12.7
RoE	**21.28**	**19.37**	**21.88**	**21.94**	**18.49**	**20.89**

Source: Company, Emkay Research

Inorganic growth through integration of First Blue and Aadhar Housing

Acquired 100% stake in Deutsche Post bank for a consideration of Rs10.8bn

… networth stood at Rs5.8bn implying valuation of 1.9x

First Blue Home Finance (FBHF): In December'2010, DHFL with Wadhawan Housing Private Limited (promoter group), M/s. Caledonia Investment Plc, U.K and Amber 2010 Ltd., acquired 100% equity stake in First Blue Home Finance (erstwhile Deutsche Postbank Home Finance Limited) from BHW Holding AG, Germany for a consideration of Rs10.8bn. Its networth as at FY11 stood at Rs5.6bn implying a valuation of 1.9x book value. Dewan Housing had acquired 67.56% equity stake in FBHF which it holds through a special purpose vehicle company i.e. DHFL Holdings Private Limited (a 100% subsidiary company)

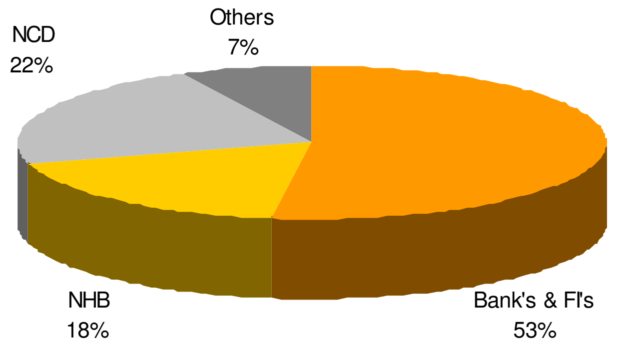
FBHF operates with 39branches, 51% of which are in states of Rajasthan, UP, Punjab, Haryana and Delhi

While DHFL enjoyed rich forte in LMI segment and Western and Southern India, the acquisition of First Blue Home Finance (FBHF) will now enable the entity to tap the upper-middle income group and particularly in Northern India. FBHF loan portfolio as at end-FY11 stood at Rs52bn (CAGR of 20% in FY08-11). Branch network stood at 39 branches, 51% of which are in the states of Rajasthan, UP, Punjab, Harayana and Delhi.

Higher LTV, loan/branch, stable asset quality and capital remain key positives

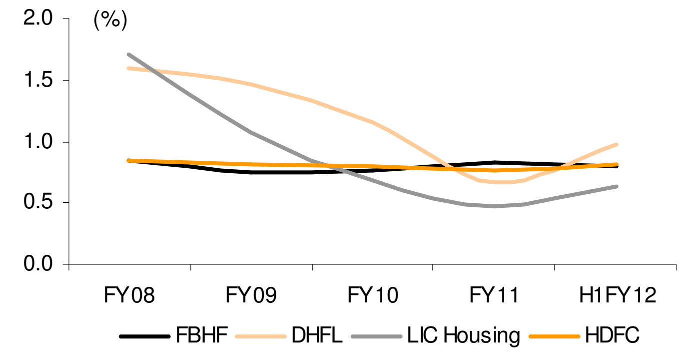
Given its relatively higher a) Ticket size at Rs1.6mn (Rs0.6mn in case of DHFL), b) loan/branch at Rs1.3bn c) stable asset quality with adequate cover (GNPA at 0.83%, vs 0.67% in case of DHFL) and d) adequate capital (CAR 17.7%), we believe the acquisition of FBHF is well in-line with DHFL's growth strategy. Lower return ratios (RoA/RoE of 1.6%/16.1%), with higher dependence on term loans from banks' and FI's remain key negatives.

Borrowing profile (FY11)



Source: Company, Emkay Research

GNPA : Stable asset quality



Source: Companies, Emkay Research

DuPont analysis

(%)	FY11	FY12E	FY13E
NII	3.3	3.0	3.3
Other Inc	0.7	0.7	0.7
Total Inc	4.0	3.7	4.0
Opex	1.5	1.4	1.4
PPP	2.4	2.3	2.6
Provision	0.2	0.2	0.2
PBT	2.2	2.0	2.3
Tax	0.6	0.6	0.7
RoA	**1.6**	**1.5**	**1.7**
Leverage (x)	9.6	10.2	10.7
RoE	**15.6**	**14.4**	**17.3**

Going forward, we expect FBHF to report significant improvement aided by leveraging on DHFL's brand name and pan-India presence. We have factored in loan CAGR of 25% over FY11-13E. Sanctions/disbursements are expected to witness a CAGR of 17%/19% over the same period. Also, as borrowing mix changes in favor of bonds, cost pressures are likely to ease. By leveraging on group branch network, Opex is likely to ease. Provision cost is however, expected to remain higher given vulnerable economic environment and regulated requirement. We have factored in 38% CAGR in GNPA over FY11-13E. Credit cost is expected to come in at 24bps (avg assets) over FY11-13E.

In a recent move, the board has approved the merger of FBHF and DHFL Holdings with itself. The swap ratio has been agreed upon at 10 shares of DHFL for every 97 equity shares of FBHF; resulting in issuance of 10.9mn shares or 9.5% dilution on consolidated basis. With minority shareholders initial investment in FBHF at Rs3.5bn, the deal is valued at Rs321 per share. We have assumed the share swap deal to be effective in FY13.

Incorporated Aadhar Housing to tap states of UP, MP, Orissa, Jharkhand, Chhattisgarh and Bihar

Aadhar Housing Finance : With a view to tap its presence in the states of Uttar Pradesh, Madhya Pradesh, Orissa, Jharkhand, Chhattisgarh and Bihar, DHFL (50 stake) in collaboration with DVHFL (30 stake) and International Finance Corp. (IFC) set up Aadhar Housing Finance in May 2010. Albeit at a nascent stage, we believe with improving economies of scale and early entry benefit, the collaboration will prove beneficial by providing access to the large under-penetrated market in this region. As of Q2FY12, DHFL has already opened 3 state branches under the Aadhar housing and it also transferred loan portfolio amounting to Rs268mn along-with underlined securities to the subsidiary.

Already opened 3 state branches in H1FY12

Vysya Housing Finance acquired to tap Southern India…

Vysya Housing Finance: Earlier in 2003, DHFL acquired 91.2% stake in Vysya Housing Finance, a mortgage company focused primarily on southern India including Karnataka, Andhra Pradesh, Tamil Nadu and Maharashtra. Its loan portfolio as at FY11 stood at Rs5.8bn

… loan portfolio stood at Rs5.8bn in FY11

Alliance with banks: Additionally, through tie-ups with Punjab & Sind Bank, United Bank of India, Central Bank of India and Yes Bank, DHFL has penetrated into the regions of North & Eastern India. According to the arrangement, DHFL has access to banks' customer database while providing the partner with an option to participate in the loan syndication program.

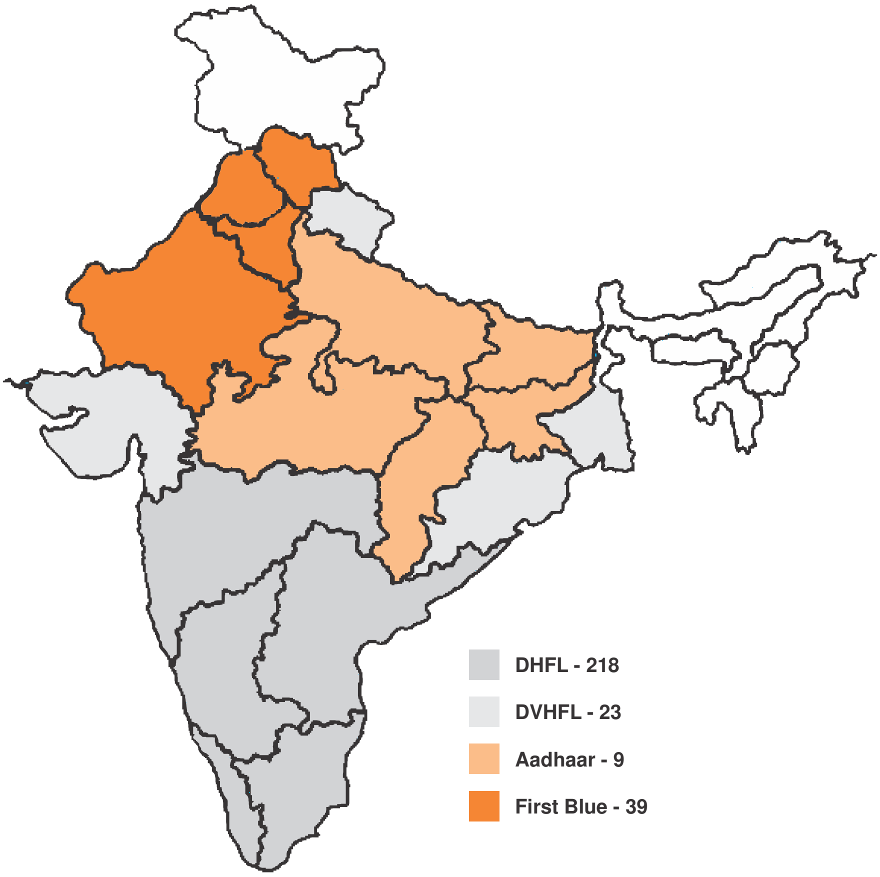
… to cater to customers across all geographies and income levels

Indian individual mortgage industry is on a strong foothold and has exhibited resilience to interest rate and property prices. While fears over steep rise in property prices remain, mortgage demand remains upbeat given the customer profile (being end-user) and demographies in India (only 31% population in India resides in urban areas).

Alliance with banks to access customer database

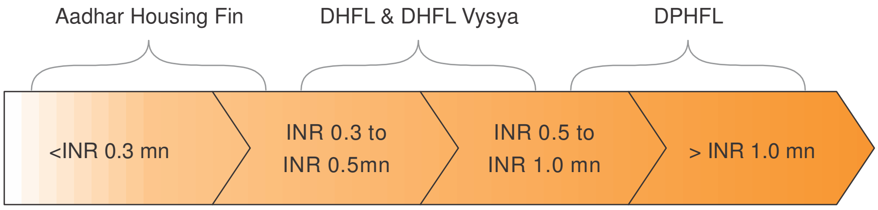
In our view, DHFL with a market share of ~4% on a consolidated basis is well placed for growth. With integration of DVHFL, FBHF and collaboration of Aadhar Housing and tie-ups with banks', DHFL is now geared to cater to the needs of customers of different income levels across all geographies in India.

Leveraging through acquisitions; Catering to customers on a pan-India basis



Source: Company, Emkay Research

Catering to the needs of customers across different income levels



Source:Emkay Research

Consolidated book to witness 33% CAGR in loan portfolio

On a consolidated basis, we expect DHFL to witness 33% CAGR in loan portfolio over FY11-13E. A marginally lower credit rating (CARE AA+) will call for bond / NCD rate tad lower than bank term loans. DHFL can also raise funds under public deposit window. However, given credit rating, the cost is expected to remain in line with NCD/bond window. Hence, we expect gradually shift in borrowing mix and result in cost pressures. We expect the consolidated entity to report 28% CAGR in balance sheet over FY11-13E. Growth in net profit albeit lower, is expected to remain commendable at 26% CAGR, owing to cost pressure and higher provisions.

(Rs mn)	FY09	FY10	FY11	FY12E	FY13E	CAGR% (FY11-13E)
Loan portfolio	**61,359**	**91,813**	**199,305**	**271,916**	**355,134**	**33.5**
- Dewan	58,066	87,584	141,112	198,558	263,895	36.8
- FBHF			52,405	65,158	81,399	24.6
- DVHFL & Aadhar	3,292	4,229	5,788	8,200	9,840	30.4
Borrowings	**61,761**	**93,055**	**206,897**	**266,839**	**341,480**	**28.5**
- Dewan	58,764	89,268	148,501	196,763	254,809	31.0
- FBHF			48,645	60,075	74,672	23.9
- DVHFL & Aadhar	2,997	3,787	9,751	10,000	12,000	10.9

Source: Company, Emkay Research

Comparison vis-à-vis peers – HDFC and LICHF

Dewan Housing Finance operates on a branch model as against LIC Housing (DSA model) and HDFC (in-house sourcing model). As a result, its operating costs have remained higher. Also, with presence in remote areas, ticket size has remained lower. Average incremental ticket size for DHFL (conso) was at Rs1mn against Rs1.9mn in case of HDFC and Rs1.6mn in case of LIC Housing Finance. Cost/Income at 36% on a consolidated basis, is significantly higher vis-à-vis its peers HDFC (7.7%) and LIC Housing (13.5%). Through cross-selling of insurance products, proportion of non-interest income has remained relatively higher. As a result, the share of non-interest income/total income is relatively higher at 22% against 14% in case of HDFC and 14% in case of LIC Housing Finance. We have factored in 27% CAGR in operating expenses and 43% CAGR in non-interest income over FY11-13E.

Trend in Cost-to-income and Non-interest income to total income ratio

C/Income	FY11	FY12E	FY13E
HDFC	7.7	7.9	8.4
LIC Housing Finance	13.5	13.3	12.1
Dewan Housing (Conso)	36.0	34.6	33.2

Non-int income / total income	FY11	FY12E	FY13E
HDFC	14.3	14.7	15.6
LIC Housing Finance	14.1	13.4	12.1
Dewan Housing (Conso)	22.2	28.5	25.1

Source: Companies, Emkay Research

DuPont analysis:

	Dewan Housing (Consolidated)			HDFC			LIC Housing Finance		
(%)	FY11	FY12E	FY13E	FY11	FY12E	FY13E	FY11	FY12E	FY13E
NII	3.3	2.6	2.8	3.3	3.3	3.1	2.9	2.7	2.9
Other Income	1.0	1.0	0.9	0.6	0.6	0.6	0.5	0.4	0.4
Total Income	**4.3**	**3.6**	**3.7**	**3.9**	**3.9**	**3.7**	**3.4**	**3.1**	**3.3**
Operating Exp	1.5	1.2	1.2	0.3	0.3	0.3	0.5	0.4	0.4
Pre-provision profit	**2.8**	**2.4**	**2.5**	**3.6**	**3.6**	**3.4**	**3.0**	**2.7**	**2.9**
Provisions	0.1	0.2	0.2	0.1	0.1	0.1	0.0	0.2	0.2
APBT	2.6	2.2	2.3	3.5	3.5	3.3	3.0	2.5	2.7
RoA	**1.9**	**1.4**	**1.6**	**2.5**	**2.6**	**2.5**	**2.2**	**1.8**	**2.0**
Leverage (x)	14.7	13.7	13.9	8.0	8.3	8.4	12.8	13.5	13.5
RoE (%) (calculated)	**27.5**	**19.3**	**22.3**	**20.3**	**21.5**	**21.0**	**28.5**	**24.7**	**26.9**

Source: Companies, Emkay Research

Well-built business model…

Over the last two decades, DHFL has catered to the increasing needs of customers in LMI segment. With presence in the GDP rich states of western and southern India, it has catered to the increasing needs of customers in tier-II and tier-III cities. With a view to tap upper-middle income group and expand its reach in Northern India market, it acquired stake in First Blue Home Finance. The consolidated entity (DHFL+FBHF+DVHFL and Aadhar Housing) through a pan India presence is now on a strong foothold.

Concerns on high interest rate and property prices are expected to haunt growth for housing finance companies in the medium term. In our view, the impact on DHFL will be minimal given the target audience and geographical presence. Interest rate cycle is close to its peak and any moderation will only act as a boon. Further, property prices in tier-II and tier-III cities still remain reasonable vis-à-vis metro cities. The only culprit remains higher operating cost (1.2% of average conso assets) and provisions towards regulatory requirements. On a consolidated basis, we have factored in ~140bps of combined operating and credit cost over FY12-13E. We expect RoA/RoE to average 1.6%/23% over FY11-13E.

… with attractive valuations; Initiate as BUY

We have valued DHFL on SOTP valuation and arrived at a target price of Rs275. DHFL is on a strong footing with stable margins and favorable return ratios. We have valued the standalone entity at 1.35x 1-yr forward P/B (also equivalent to its 5-yr average P/B). FBHF, with expertise in middle-income group and target audience primarily in North India will stand to gain as it leverages on DHFL's brand name and reach. However, given relatively lower size (loan portfolio at 1/3rd of DHFL) with improveming return ratios, we have valued the business at 1x FY13 book of Rs22. We have not valued Vysya Housing and Aadhar Housing owing to limited size, although benefits will accrue given presence and customer profile. Initiate as BUY.

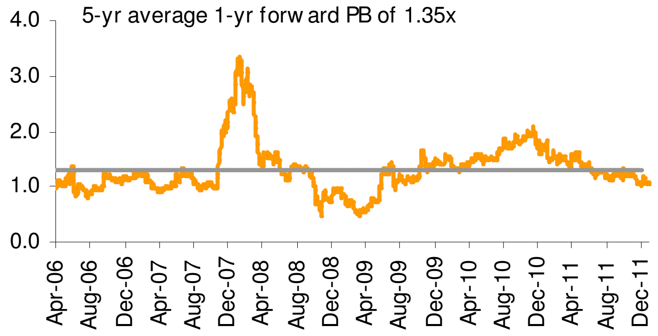
Risk to estimates : Volatile interest rate and property prices remain key hurdles on the macro front. On the company front : a) Longer than expected time for integration of FBHF; b) promoter group issues (succession and segregation of DHFL and HDIL) ; c) presence in LMI – A detriment rather than a benefit given lower ticket size and d) higher opex poses a risk to the company's profitability and growth.

Sum of the parts valuation:

FY13E	Book value	Multiple (x)	Target price (Rs)
Dewan Housing	187.4	1.35	253
First Blue Home Finance	22.4	1.0	22
SOTP value			**275**

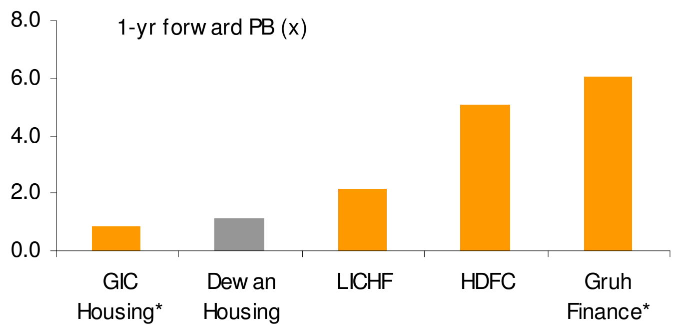
Source: Emkay Research

1-yr forward P/B



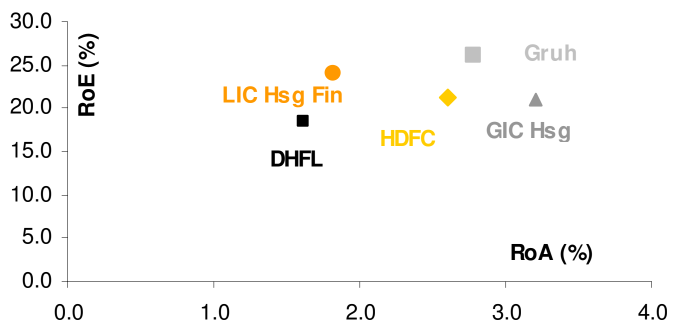
Source: Company, Bloomberg, Emkay Research

1-yr forward PB: DHFL vis-à-vis peers



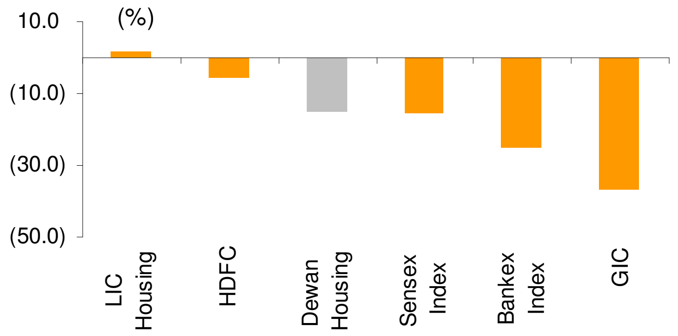
*Source: Company, Emkay Research * Bloomberg estimates for FY11*

Valuation comparison – RoA (%) and RoE (%)



Source: Bloomberg, Companies, Emkay Research

Price performance – DHFL vis-à-vis peers



Source: Bloomberg, Emkay Research

Key Financials (Consolidated)

Income Statement (Rs. Mn)

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Net interest income	2,376	5,566	6,759	9,273
Other income	1,016	1,584	2,688	3,101
Net income	3,392	7,150	9,447	12,374
Operating expenses	1,127	2,507	3,193	4,029
Pre provision profit	31	68	73	84
PPP excl treasury	2,235	4,575	6,181	8,261
Provisions	89	214	496	652
Profit before tax	2,134	4,704	5,684	7,609
Tax	549	1,131	1,610	2,112
Tax rate	26	26	28	28
Reported Profit after tax	1,584	3,574	4,075	5,497

Balance Sheet (Rs. Mn)

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Liabilities				
Equity share capital	820	1,044	1,048	1,157
Reserves And Surplus	8,019	14,512	20,571	25,599
Net worth	8,839	15,556	21,618	26,756
Borrowings	93,055	206,897	266,839	341,480
Deferred tax liability	39	(40)	(40)	(40)
Current liabilities	1,437	3,990	4,591	4,316
Total liabilities	103,687	228,928	295,298	373,022
Assets				
Net block	2,176	5,806	6,003	6,107
Investments	1,149	6,877	5,520	2,573
Loans	91,813	199,305	271,916	355,134
Current assets	8,549	16,917	11,860	9,208
Total assets	103,687	228,928	295,298	373,022

Key Ratios (%)

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Yield on assets	10.9	11.7	11.3	11.5
Spreads	3.1	3.8	2.6	2.5
NIM	2.8	3.3	2.6	2.8
Other income	1.2	1.0	1.0	0.9
Net Income	3.9	4.3	3.6	3.7
Operating expenses	1.3	1.5	1.2	1.2
Preprovision profit	2.6	2.8	2.4	2.5
Provisions	0.1	0.1	0.2	0.2
Profit before tax	2.5	2.8	2.2	2.3
RoAA	1.8	1.9	1.4	1.6
Gross NPA (%)	1.2	0.7	0.7	0.7
Net NPA (%)	1.1	0.6	0.6	0.5

Valuations Table

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Adj. PAT (Rs mn)	1,584	3,574	4,075	5,497
No of shares (mn)	82.0	104.4	104.8	115.7
FDEPS (Rs)	19.1	29.8	35.4	46.1
PER (x)	9.7	6.2	5.2	4.0
Book value (Rs)	107.8	149.0	206.4	231.3
P/BV (Rs)	1.7	1.2	0.9	0.8
Adj. book value (Rs)	95.9	138.2	191.8	215.2
P/ABV (Rs)	1.9	1.3	1.0	0.9
P/PPP (x)	6.8	4.2	3.1	2.6
RoE (%)	22.3	25.5	19.9	22.1
Dividend yield (%)	1.7	1.9	1.9	1.9

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Your success is our success

HDFC Ltd

Mr. Reliable

Initiating Coverage

January 6, 2012

Reco
Hold

CMP	Target Price
Rs 665	Rs700

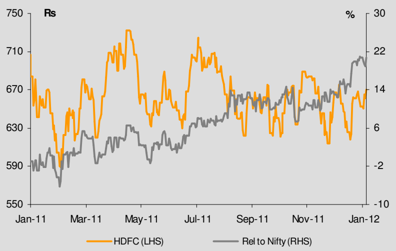
EPS change FY12E/13E (%)	NA
Target Price change (%)	NA
Nifty	4,750
Sensex	15,857

Price Performance

(%)	1M	3M	6M	12M
Absolute	1	7	(7)	(6)
Rel. to Nifty	10	9	15	24

Source: Bloomberg

Relative Price Chart



Source: Bloomberg

Stock Details

Sector	Financial Services
Bloomberg	HDFC@IN
Equity Capital (Rs mn)	2947
Face Value(Rs)	2
No of shares o/s (mn)	1473
52 Week H/L	736/582
Market Cap (Rs bn/USD mn)	985/18,615
Daily Avg Volume (No of sh)	2381122
Daily Avg Turnover (US$mn)	29.3

Shareholding Pattern (%)

	Sep-11	Jun-11	Mar-11
Promoters	0.0	0.0	0.0
FII/NRI	73.4	73.3	73.9
Institutions	14.1	14.3	13.7
Private Corp	1.8	1.7	1.8
Public	10.8	10.7	10.7

Source: Capitaline

- **HDFC is a leader in the individual mortgage space. Diversified loan portfolio, adequate borrowing mix, stable spreads and comfortable asset quality remain key strengths**
- **Loan / balance sheet to witness 18%/15% CAGR over FY11-13E. Requirement on addln provisioning, uniformity in int rate and capital unlikely to hurt growth/ profitability materially**
- **HDFC's foray into other financial services has paid off, with these constituting 55% of its SOTP value. Value unlocking in life insurance while on the cards, seems unlikely in FY12**
- **Valuation premium to continue given leadership and superior return ratios. However, our SOTP target price of Rs 700 leaves limited room for upside. Initiate with a HOLD.**

Growth momentum to remain at steady 18% CAGR over FY11-13E

We expect the individual mortgage industry to witness a 15% CAGR over FY11-13E led by improving economies of scale. In our view, HDFC stands to gain, given its a) domain expertise in mortgage business for over three decades b) strong brand recall and c) in-house sourcing model. We expect HDFC to report a healthy 19%/17% CAGR in sanctions/disbursements over FY11-13E. Loan portfolio (adjusted for sale to HDFC Bank) is expected to witness 18% CAGR over FY11-13E. According to our analysis, higher interest rates are unlikely to significantly impact demand for mortgage. Also, while property prices have reached their peak levels, they still remain affordable in certain tier-II and tier-III cities, clearly depicting huge demand potential.

Spreads to remain intact; regulatory norms to have minimal impact

With core focus on individual loan portfolio (~65% of loan book and 20%+ CAGR over FY06-11), HDFC has potential to expand its corporate book manifold. On the borrowing front, increased base rate has hurt borrowing cost. Consequently, the management has guided for gradual shift in borrowing mix towards bonds and retail deposits by end-FY13. In addition, favorable ALM and re-pricing of teaser loan portfolio beginning Q1FY13 should aid stable spreads at 2.15-2.35% levels. On the provisioning front, cumulative provisions stood at Rs15.2bn (1.2% of loan portfolio) against requirement of Rs12bn. Also, management is confident of no material impact of withdrawal of pre-payment penalty charges / uniformity in floating interest rate loans.

Valuation premium to continue; Initiate with a HOLD and TP of Rs700

HDFC has historically commanded premium valuations owing to its a) strong expertise and brand name, b) stable spreads and comfortable asset quality with c) superior return ratios. In addition, as a diversified financial conglomerate, it now derives 55% of its value from non-mortgage businesses. We have valued HDFC on SOTP basis and arrived at a target price of Rs700. Value unlocking in life insurance, although on cards, seems unlikely in FY12. Initiate with a HOLD and target price of Rs700.

Financial Snapshot (Rs mn)

Y/EMar'31	Net income	Net profit	EPS (Rs)	ABV (Rs)	RoA (%)	RoE (%)	P/E (x)	P/ABV (x)
FY10	40,884	26,754	18.6	105.0	2.5	18.9	35.7	6.3
FY11	49,584	32,283	22.0	118.1	2.5	19.9	30.2	5.6
FY12E	57,977	39,078	26.6	131.3	2.6	21.2	25.0	5.1
FY13E	64,078	43,008	29.3	147.3	2.5	20.8	22.7	4.5

Source: Company, Emkay Research

Company Description

HDFC – Mortgage giant and a well-diversified financial conglomerate

HDFC, with a loan portfolio of ~US$25bn, is the largest mortgage player in India. With 15%* market share in the Indian individual mortgage space, the company has catered to the needs of ~3.8mn customers till date. Strong management leadership, focus on mortgage business spanning over three decades and thrust on profitability without compromising on asset quality and spreads have all augered well for the conglomerate. Over the years, HDFC has transformed itself from a pure mortgage player to a financial services conglomerate that derives 55% of its SOTP value (see-page 11) from non-mortgage businesses. The company has presence across the entire gamut of financial services including life and general insurance, venture capital including property ventures, asset management, educational loans and bank.

Table on investment in subsidiaries and associate companies

FY11	Nature of business	Stake (%)	PAT (Rs mn)
HDFC Bank	Bank	23.4	39,260
HDFC Standard Life Insurance Co. Ltd	Life Insurance	72.4	(990)
HDFC Asset Management Company Ltd	Asset Management Company	60.0	2,422
HDFC ERGO General Insurance	General insurance	74.0	(364)
HDFC Property Funds	Property fund	80.5	122
HDFC Property Ventures Limited	Investment advisory services	100.0	34
GRUH Finance Limited	Housing finance company	60.6	915
HDFC Sales Private Limited	100% subsidiary into sales and marketing business	100.0	NA
Credila Financial Services Private Limited	Education loan company	62.3	NA

Source: Company, Emkay Research

Key management personnel

Mr. Deepak Parekh: Deepak Parekh is the Chairman of Housing Development Finance Corporation, India's leading housing finance company. A pioneer in mortgage finance, he has enabled scores of Indian middle class people to own their houses or apartments through affordable loans. He is a fellow of the Institute of Chartered Accountants (England & Wales). Mr. Parekh joined HDFC in a senior management position in 1978. He was inducted as a whole-time director in 1985 and further as the Managing director in 1993. He retired as the Managing Director with effect from December 31, 2009.

Mr. Keki Mistry: Mr. Mistry is a fellow of the Institute of Chartered Accountants of India. He has been with HDFC since 1981. He currently holds the office of Managing Director (designated as the Vice-chairman & Chief Executive Officer) of the corporation for a period of 5-years with effect from November, 2010.

Shareholding pattern: September' 2011

Shareholding pattern	(%)
Citigroup Strategic Holdings Mauritius Ltd	8.79
CMP Asia Ltd	5.23
Europacific Growth Fund	4.46
LIC of India	3.21
Oppenheimer Developing Market Fund	1.97
Aberdeen Int. Indian Equity Fund (Mauritius) Ltd	1.81
JP Morgan Funds - Emerging Markets Equity Fund	1.52
Carmignac Geston A/c Carmignac Patrimonie	1.28
Vanguard Emerging Markets Stock Index Fund A-series	1.22
Government of Singapore	1.14
Aberdeen Global Emerging Markets Equity Fund	1.12

Source: Capitaline, Emkay Research.

Investment Rationale

Growth momentum to continue at a steady 18% CAGR over FY11-13E

Diversified loan mix; well-balanced borrowing profile…

… witnessed 21% CAGR in loan portfolio over FY06-11

HDFC, with a loan portfolio of ~US$26bn, is the largest mortgage player in India. With 15%* market share in the Indian individual mortgage space, the company has catered to the needs of ~3.8mn customers till-date. Diversified loan mix (retail: corporate at 63:37) with well-balanced borrowing profile has ensured adequate ALM profile. Also, despite competitive business environment involving volatile interest rate movements, introduction of teaser rate loan schemes, regulated requirements (NPA provisions including standard assets and LTV) and increasing mortgage exposure by other HFCs including banks', HDFC has witnessed a steady 21% CAGR in loan portfolio over FY06-11.

Expect individual mortgage industry to witness 15% CAGR over FY11-13…

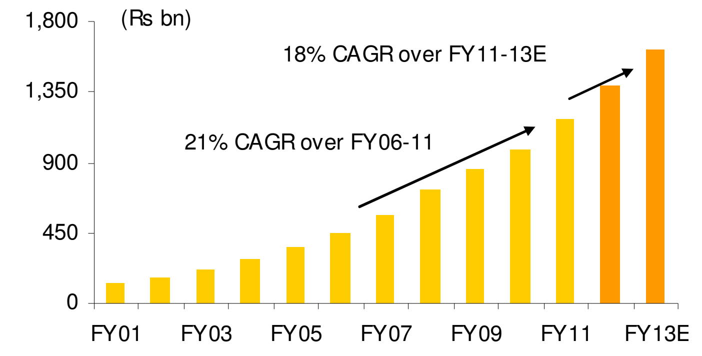
Interest rates and property prices, albeit a detriment; unlikely to hurt growth over longer-run

HDFC to report 19%/17% CAGR in sanctions / disbursements….

… loan portfolio to witness 18% CAGR

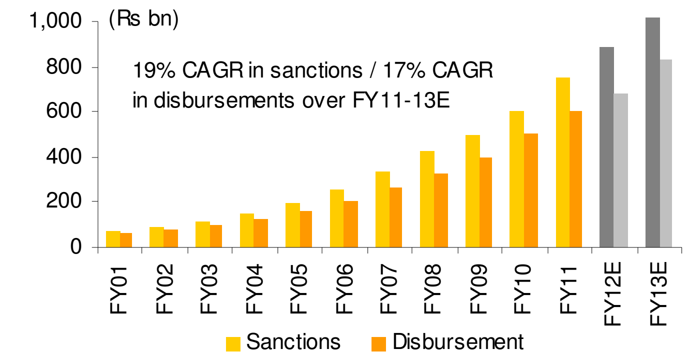
We expect the individual mortgage industry to witness 15% CAGR over FY11-13, led by increasing income levels, improved affordability and huge demand potential, particularly in tier-II and tier-III cities. According to our analysis, higher interest rates are unlikely to impact demand for mortgage on a larger scale. Also, while property prices have reached their peak levels, they still remain affordable in certain tier-II and tier-III cities, clearly depicting huge demand potential. In our view, with a) domain expertise in mortgage business for over three decades b) strong brand recall and c) in-house sourcing model, HDFC is well-poised for growth. We expect HDFC to report a healthy 19% CAGR in sanctions and 17% CAGR in disbursements each over FY11-13E. As a result, loan portfolio (adjusted for sale to HDFC Bank) is expected to witness 18% CAGR over FY11-13E.

Loan portfolio – steady 18% CAGR over FY11-13E



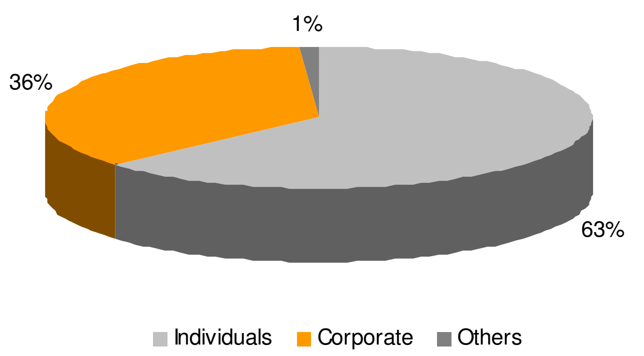
Source: Company, Emkay Research

Trend in sanctions and disbursement



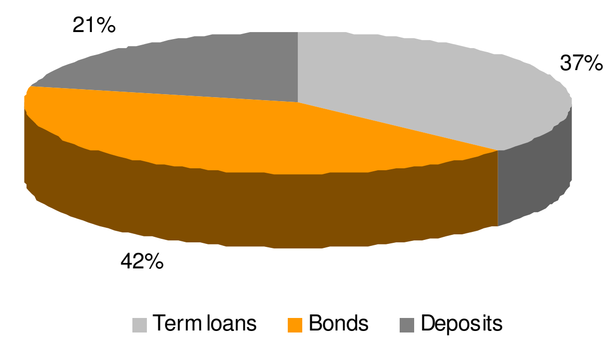
Source: Company, Emkay Research

Diversified loan portfolio (H1FY12)



Source: Company, Emkay Research

Well-balanced borrowing profile (FY11)



Source: Company, Emkay Research

Focus primarily on individual loan portfolio…

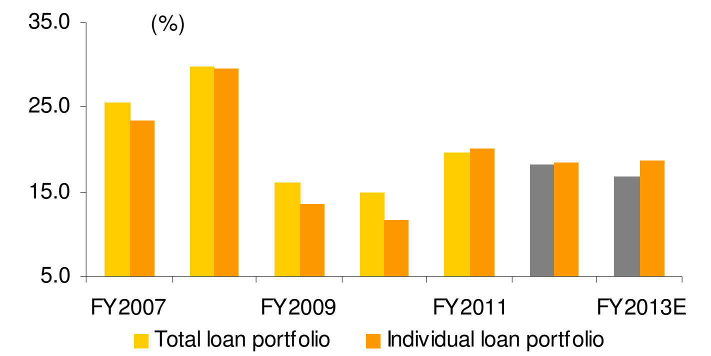
Individual loans comprise ~65% of total loan portfolio

With ~20% CAGR in individual loan portfolio over FY06-11, HDFC is amongst the preferred mortgage players in India. a) Lower loan-to-value (LTV) and income-to-installment ratio, b) exposure primarily to end-user (largely being salaried class and average age of 35-years) c) improving ticket size, d) minimal processing time and e) adequate mortgage life have remained the key stand-out points for HDFC. Also, through various initiatives including housing campaigns, the company has maintained its dominant position in the highly competitive mortgage space.

…. HDFC has maintained its spreads at 2%+ for past several quarters

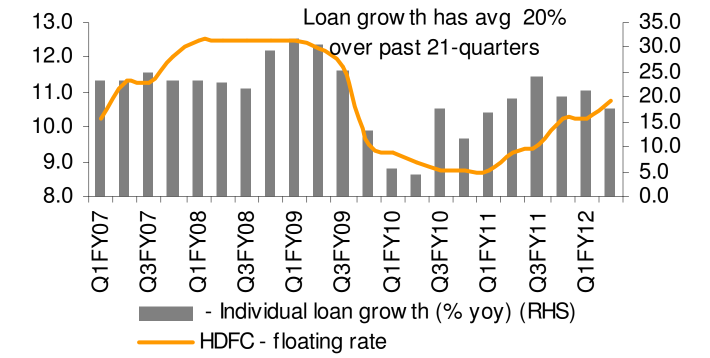
Despite volatile interest rates and competitive business environment in the past, HDFC has witnessed healthy growth in individual loan portfolio. Also, the ability to pass interest rates to final customers has enabled HDFC to maintain its spreads at stable 2%+ levels.

Loan growth – Overall and individual loan portfolio…



Source: Company, Emkay Research

… has consistently grown its loan book at 20% yoy



Source: Company, Emkay Research

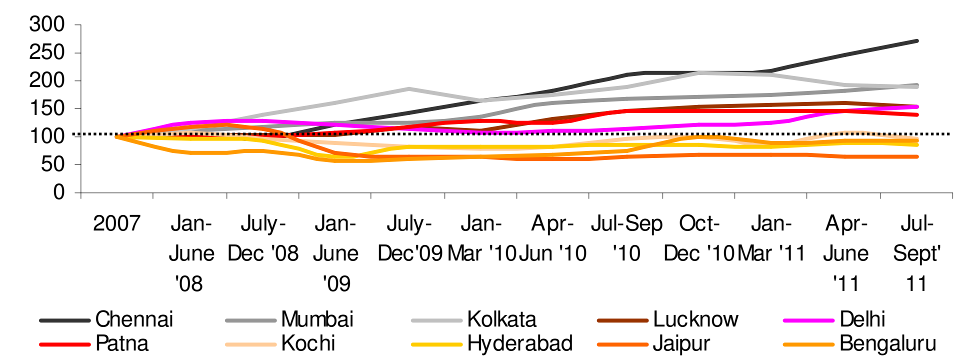
Significant traction in tier-II and tier-III cities

We expect demand for individual mortgage business to remain buoyant owing to increasing urbanization, improved income levels, evolution of nuclear family concepts and tax incentives under income-tax act. In our view, higher interest rates are unlikely to impact demand for mortgage on a larger scale. Also, while property prices are expected to dampen demand in select tier-I cities, our interaction with mortgage players suggest huge potential for penetration in tier-II and tier-III cities.

In addition to Delhi, Chennai and Mumbai region, HDFC witnessed demand from Bengaluru, Baroda, Indore etc.

Selective approach towards lending in certain geographies of India has enabled HDFC to tide over concerns of steep correction in property prices. While Delhi including NCR, Chennai and Mumbai continue to remain key areas of business, in recent times, the company has been witnessing increasing demand from states of Gujarat, Karnataka, Maharashtra and Assam. According to price index released by NHB, property prices are still affordable in pockets of Hyderabad, Jaipur, Pune, Bengaluru, Surat etc. The recent survey stated that tier-II cities of Bengaluru and Hyderabad have emerged as the top-10 most populous cities in India. With immense growth potential, HDFC stands to gain and we expect its individual loan portfolio to report 19% CAGR over FY11-13E.

National Housing Board - City-wise Housing Price Index, potential for penetration in tier-II and tier-III cities



Source: National Housing Board, Emkay Research

… corporate loan portfolio has potential to expand at faster pace

Corporate loan portfolio has been on an up-tick and stands at ~35%+…

… comprises of a) loan to corporates for real estate purpose b) lease rental discounting c) developer financing

Over FY06-11, HDFC's exposure towards corporate loans has been on the rise and constituted ~36% of the total loan portfolio in FY11 against 31% in FY06. With 25% CAGR in this book over FY06-11, the exposure comprises of a) loans to corporates for meeting their real estate requirement b) lease rental discounting and c) developer financing.

Developer loan is for working capital loans with avg tenure of 2-3years and collateral of 1.7-1.8x.

In case of loans to corporates, the exposure is to established entities for meeting their real estate requirements in the nature of building, properties etc. The average tenure on this book is ~4-5years with limited risk of default. The risk of default is also lower on lease rental discounting (LTV at 60%, with mortgage over the property). On the developers' loans, the exposure is for working capital with average tenure of 2-3 years. This loan portfolio is adequately securitized with a collateral cover of 1.7-1.8x the value of the project.

HDFC provides 100% risk-weight

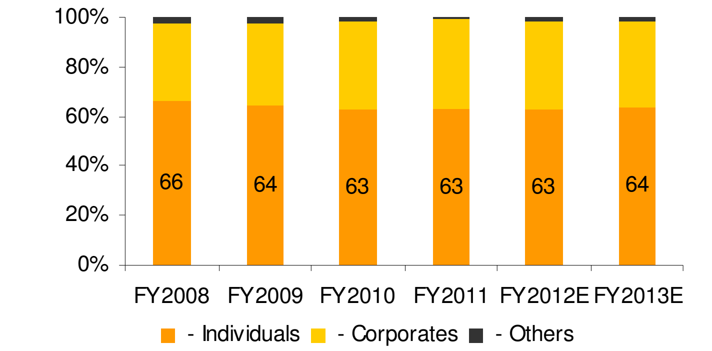
Also, following NHB guidelines, HDFC has been providing 100% risk-weight on the total corporate loan portfolio. Interestingly, while HDFC has potential to expand its corporate portfolio manifold, it has guided for a loan mix in favor of individual loans (65:35) in the long run.

RPLR raised by ~275bps...

…on other hand, floating rate has declined by 175bps

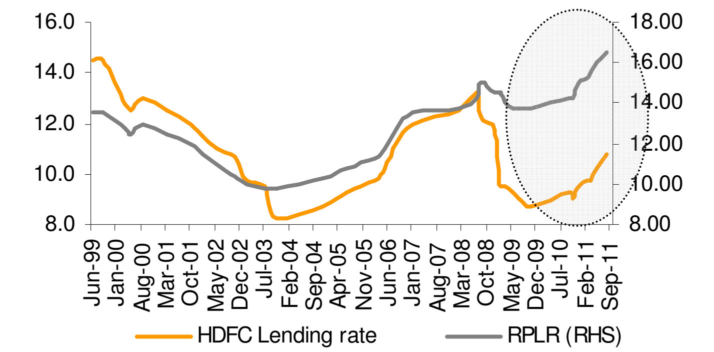
For HDFC, higher exposure towards risky segment of corporate loans has been compensated by way of higher lending rates. A large part of these loans are linked to RPLR. Accordingly, since the advent of global crisis in Jan'2008, following uncertainties over real estate market and tight liquidity, RPLR has risen by 275bps. In contrast, floating rates have declined by 175bps till-date.

Loan mix targeted at 65:35 levels in the long run…



Source: Company, Emkay Research

HDFC : Adjustable residents rate and RPLR



Source: Company, Emkay Research

We have factored in a steady 18% CAGR in loan portfolio over FY11-13E. Sanctions and disbursements are expected to witness CAGR of 19/17% FY11-13E. With core focus on individual loan portfolio, we expect the book to witness 19% CAGR, against overall loan CAGR of 18% over FY11-13E.

Healthy borrowing profile; mix to skew in favor bonds and deposits by FY13

Borrowing comprises of a) term loan from bank b) Bonds / debentures and c) retail deposit…

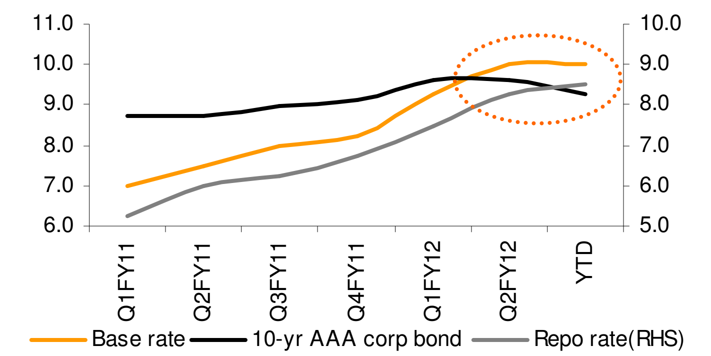
Superior credit rating, established brand name and access to retail deposits have enabled HDFC maintain an adequate borrowing profile. The borrowing mix broadly comprises of a) term loans from banks, largely being floating in nature and linked to their base rate, b) bonds, debentures, FCCBs with average duration of 5 to 7-years and c) balance in form of retail deposits with average maturity of 3-5years.

…. HDFC has recently resorted to raising funds under the bond / retail deposits window

…Management has guided for a mix in favor of bonds and retail deposits by FY13E

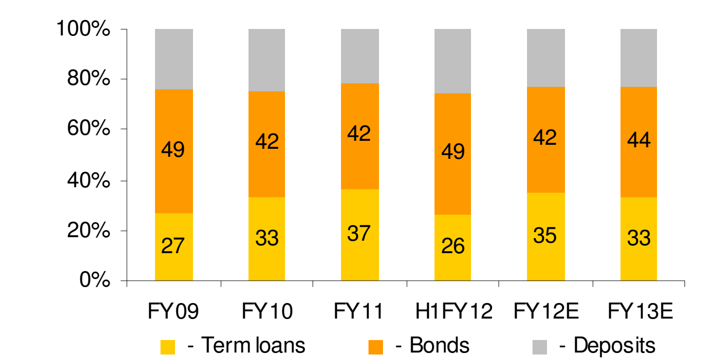
With easing of wholesale rates vis-à-vis bank base rate, HDFC has recently resorted to raising funds under the bond market window. Following the 325bps increase in key policy rates since Q1'2011, banks' have raised their base rate by 300bps+ (SBI / ICICI Bank base rate +300bps). During Q1, HDFC raised 1-year paper at 9.6% and 10-yr paper at 9.4%. This in-turn enabled HDFC shed its bank term loans. During Q2FY12, proportion of term loan in total borrowings declined to 26% against 37% as at FY11. Over FY11-13E, the management has reiterated a borrowing mix in favor of bonds and retail deposits. Given elevated interest rates and tight liquidity regime, mgmt has guided for increasing share of bonds and retail deposits over the next few quarters. We expect borrowings to witness 17% CAGR over FY11-13E with mix skewed in favor of bonds (44%) and retail deposits (23%).

Bond yields have eased significantly over base rate



Source: Companies, RBI, Emkay Research

Gradual shift in borrowings to bonds and deposits by FY13

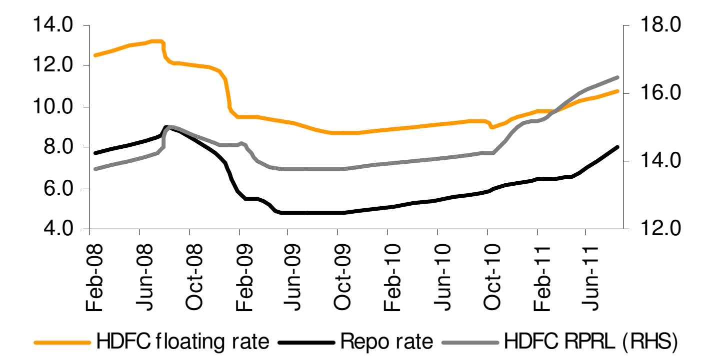


Source: Company, Emkay Research

Spreads, however, to remain intact at 2.1-2.3% levels

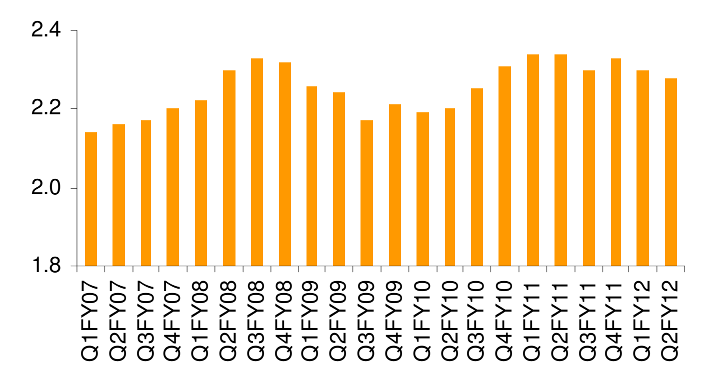
Despite volatile interest rate regime, HDFC has been able to maintain its spread in the broad range of 214-234bps for the past 24-quarters. This is commendable given huge gyrations in interest rate over the same period. Well-diversified loan mix and adequate borrowing profile has ensured minimal ALM mismatch in the past. As at end-FY11, 87% of assets were floating in nature as against 85% in case of liabilities. Going forward, with easing wholesale rates, borrowing mix is expected to skew in favor of bonds and deposits (65-66% of total borrowings). Also, with individual loan growth targeted at 19% CAGR over FY11-13 and loans granted during dual rate scheme (30% of individual loan portfolio) converting into floating rate beginning Q1FY13, we expect spreads to remain intact.

Trend in repo rate and HDFC floating rate



Source: Company, Emkay Research

Spreads remained intact in 2%+ range for past 20-quarters



Source: Company, Emkay Research

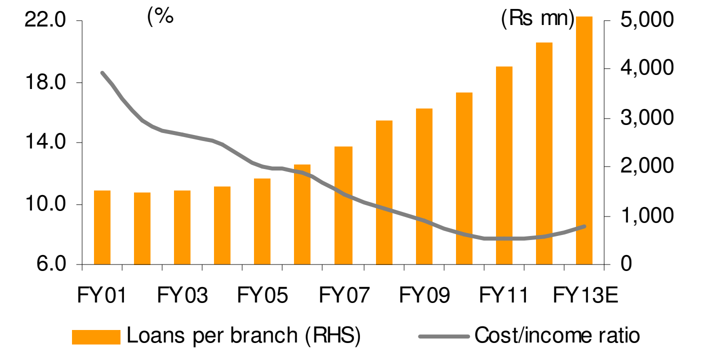
Best in class operating matrix; leverage on in-house sourcing model

90% of business is sourced in-house…

… resulting in lower C/Income ratio

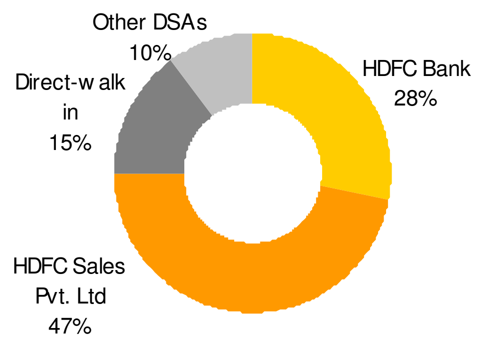
HDFC, with over three decades of experience in mortgage business, has leveraged on its in-house loan sourcing model. From a mere 87 branches as at end FY01, it has expanded its reach to 298 branches catering now to the needs of over 3.8mn customers. As at end-FY11, ~90% of the loans originated were through its own channels (28% - HDFC Bank, 47% - HDFC Sales, 15% - Direct walk-ins). This, in-turn, has resulted in lowest C/income ratio amongst its peers. C/Inc. ratio has remained in low teens for past several quarters. Commission charges at ~90-100bps to loans originated by HDFC Bank and ~60-65bps through HDFC sales subsidiary and agents remain competitive amongst its peers.

Trend in Cost/Income ratio and loan per branch



Source: Company, Emkay Research

90%+ of business is sourced in-house (H1FY12)



Source: Company, Emkay Research

Operating matrix: HDFC stands to gain over its HFC peers - LICHF & Dewan

Banks have an edge over HDFC owing to its branch network. However, concerns over ALM mismatch, longer processing time with limited expertise and relatively higher operational cost have remained key constraints for banks. HDFC's in-house sourcing model stands to gain vis-à-vis its housing finance peers – LIC Housing Finance (DSA model) and Dewan Housing (branch model). This is clearly reflected from the fact that Operating expenses / avg assets for HDFC stand at a mere 30bps against 46bps in case of LICHF and 127bps in case of Dewan Housing. The in-house sourcing model has also helped maintain check on cost. C/I for HDFC at 7.7% is way lower than LICHF (13.5%) and Dewan Hsg (32%)

Opex / average assets – HDFC vis-à-vis peers

	HDFC			LIC Housing			Dewan Housing		
	FY11	FY12E	FY13E	FY11	FY12E	FY13E	FY11	FY12E	FY13E
Operating exp	**3,812**	**4,557**	**5,411**	**2,162**	**2,494**	**2,982**	**1,684**	**2,361**	**3,028**
% of average assets	*0.30*	*0.30*	*0.31*	*0.46*	*0.41*	*0.40*	*1.27*	*1.23*	*1.22*
Employee	1,607	1,671	1,721	1,190	1,250	1,312	1,137	1,160	1,200
Avg loan per employee (Rs mn)	*729*	*829*	*941*	*429*	*517*	*623*	*124*	*171*	*220*
Cost/Income ratio	***7.7***	***7.9***	***8.4***	***13.5***	***13.3***	***12.1***	***32.4***	***33.3***	***32.3***

Source: Companies, Emkay Research

HDFC already adheres to tightened regulatory norms...

With a view to avoid any concerns on asset quality owing to real estate market and volatile interest rate regime, the regulator came out with guidelines on loan-to-value ratio, provisioning norms on both individiual and non-individual loan portfolio, including capital requirement in FY11 (see page 3)

Cumulative provisions of Rs11.2bn (1% of loan portfolio) as at end-FY11…

…. provided Rs4.5bn as provisioning for teaser rate loan

In our view, the stringent regulatory requirement towards capital adequacy, LTV ratio and provisions are unlikely to have any major impact on HDFC's profitability and growth. Average LTV for HDFC at 68% (end-FY11) is well within the regulated requirement. Also, capital adequacy remains healthy with CAR at 14.0% (Tier-I CAR at 12.2%). In terms of provisioning requirements, cumulative provisions at Rs11.2bn (0.95% of o/s. loan portfolio as at end-FY11) stand well-above the requirement of ~Rs8bn. HDFC has made a provision of Rs4.5bn on its teaser rate loan portfolio and the same shall be reversed beginning Q1FY13, when the portfolio turns floating in nature. Asset quality too, remains impeccable, with GNPA (90-days) well-under 1% level for the last 10-quarters.

Provided Rs2.5bn via additional reserve route in Q2…

… cumulative provisions increased to Rs15.2bn (1.2% of loan book)

Further, in Sept'2011, the regulator raised provisioning requirement for sub-standard and doubtful assets including higher 0.4% provisioning on standard individual loans. Accordingly, the company in Q2FY12 made a provision of Rs2.5bn towards standard assets via the additional reserve route. Consequently, the cumulative provision for contingency now stands at Rs15.2bn (1.21% of loan book) against the regulatory requirement of ~Rs12bn.

Additionally, in October'2011, NHB made it mandatory for HFCs to:

- Not charge any pre-payment penalty on pre-closure of housing loans (both floating and fixed rate loan, subject to condition) and
- Charge uniform rates on floating loan portfolio to both old and new customers with the same credit or risk profile and irrespective of the time of entry of the borrower.

Mgmt reiterated that the new provisioning norm on uniform interest rate will have minimal impact on growth

In case of HDFC, pre-payment penalty charges during H1FY12 amounted to Rs170mn or mere 1% of total profit. Thus withdrawal of pre-payment charges is unlikely to have material impact on profitability. On uniformity in interest rate, the management clearly stated that it has always facilitated its existing borrowers to shift to current lending rates if they find that their rates are higher, albeit at some cost. Currently, the difference between lending rate for old and new customers is in the range of ~125-150bps.

In order to gauge the impact of the new regulation, we have run two case-scenarios:

Case I - We have raised the lending rate for new customers by ~30bps. Assuming cost pressures remain constant, the lending rate hike may result in lower loan growth. So, against our current assumption of 19%/17% CAGR in sanction/disbursements with loan cagr of 18% over FY11-13E, we expect growth to ease to 19%/13% CAGR in sanctions and disbursements with loan CAGR at 14% (-400bps). This however would be compensated in form of improved margin. While there is no material impact on BV estimates, growth rate would ease.

Case-II - Assuming lending rates for old customers are lowered by ~30bps to bring on par with new customers and assuming cost pressures remain the same, loan growth clocks higher 22% CAGR aided by 19%+ CAGR in sanctions/disbursements. NIM, albeit would decline by 25bps to 3.0%.

While their remains lack of clarity on implementation of uniformity in interest rate towards floating rate portfolio, we expect the same to be laid out in the phased manner. Lending rates have remained competitive across HFC and Banks, and any churn by the end-user would be difficult. HDFC has historically commanded premium margins (vs LICHF, DHFL) given its loan mix and steady loan growth. However, going forward, with growth pressures given competitive business environment and tightened regulatory requirement, we expect the premium valuation to ease. We have factored 20bps margin contraction for FY13.

	Current scenario				Higher yield and lower loan growth				Lower yield and higher loan growth			
	FY11	FY12E	FY13E	CAGR (%)	FY11	FY12E	FY13E	CAGR (%)	FY11	FY12E	FY13E	CAGR (%)
Loan portfolio	1,171	1,386	1,620	17.6	1,171	1,371	1,521	13.9	1,171	1,430	1,731	21.6
- Sanctions	752	887	1,065	19.0	752	887	1,065	19.0	752	887	1,065	19.0
- Disbursements	603	683	830	17.3	603	692	767	12.7	603	727	873	20.3
NIM (%)	3.3	3.3	3.1	3.2*	3.3	3.4	3.2	3.3*	3.33	3.29	3.04	3.2*
PAT	32.3	39.1	43.0	15.4	32.3	38.7	42.0	14.0	32.3	38.4	42.0	14.1
RoA (%)	2.5	2.6	2.5	2.5*	2.5	2.6	2.5	2.5*	2.5	2.5	2.3	2.5*

*Source: Emkay Research. * denotes average for the period FY11-13E*

Comfortable asset quality; factoring 6bps of provisions cost over FY12-13E

Raised our credit cost assumption to average 45bps over FY12/13E…

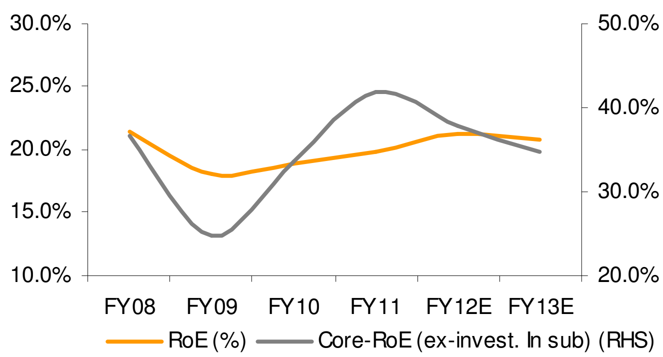
Despite increasing exposure to corporate loan portfolio and healthy 23% CAGR in individual loan portfolio over the past decade, HDFC has made remarkable improvement in its asset quality. GNPAs have remained well within the comfort zone even during the crisis period. Also, with cumulative provisioning at 1.2% of total loan portfolio, it is well guarded to absorb any major provisioning requirement. However, given tightened regulatory requirement we have raised our provisioning cost to 6bps of average assets over FY12-13E.

Return ratios remain intact; core mortgage RoE in excess of 30%+

… RoA/RoE to average 2.5%/21% over FY11-13E

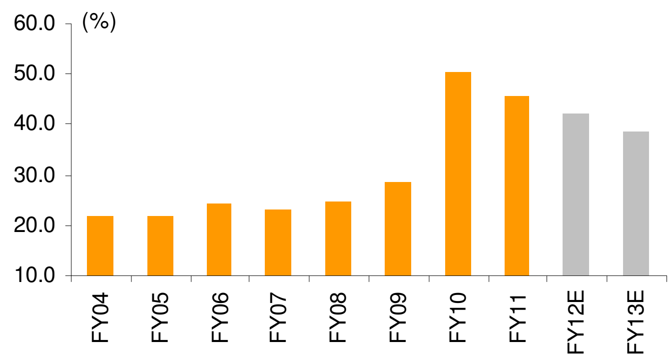
HDFC remained an outstanding player in the mortgage space owing to its healthy loan growth with stable spreads, lower operating cost and superior return ratios. Over FY11-13E, while challenges like interest rates, credit cost and lower growth prevail, we expect HDFC to report satisfactory return ratios (RoA / RoE) of 2.5%/21% respectively. However, excluding investment in subsidiaries, core mortgage RoE has remained high at an average of 36%.

Trend in RoE and core-mortage RoE



Source: Company, Emkay Research

Investment in subsidiaries as % of total networth



Source: Company, Emkay Research

DuPont analysis:

RoA Tree (%)	FY09	FY10	FY11	FY12E	FY13E
NII	3.29	3.11	3.33	3.29	3.12
Other income	0.55	0.64	0.56	0.57	0.58
Total income	**3.83**	**3.75**	**3.88**	**3.86**	**3.70**
Opex	0.32	0.28	0.28	0.29	0.30
Provisions	0.05	0.05	0.05	0.06	0.05
PBT	**3.47**	**3.60**	**3.81**	**3.49**	**3.33**
Tax	1.01	1.00	1.04	0.89	0.85
RoAA	**2.44**	**2.46**	**2.53**	**2.60**	**2.48**
Leverage (x)	7.7	7.7	8.0	8.3	8.4
RoAE	**18.06**	**18.88**	**19.86**	**21.23**	**20.78**

Source: Company, Emkay Research

Valuation premium to continue; Initiate coverage as HOLD

HDFC has historically traded at premium valuations owing to its a) domain expertise and strong brand name b) focused management approach c) well diversified loan mix with stable spreads d) comfortable asset quality with adequate capital and e) superior return ratios (RoA / RoE – 2.5%/22.4%). In addition, it has diversified as a financial conglomerate that derives 55% of its SOTP value from non-core businesses.

Going forward, with buoyant mortgage demand and with gradual withdrawal of banks from the housing finance space, we expect HDFC to gain market share at a faster clip. With increasing penetration, particularly in smaller cities, we expect HDFC to clock 18% CAGR in loan portfolio over FY11-13E. Spreads are likely to remain intact at 2.1%-2.3% on the back of well-diversified borrowing profile and ability to pass rate hike to the end-user. Further, despite higher provisioning requirement, RoA / RoE to average 2.5%/21% over FY11-13E.

Valuation methodology: We have valued HDFC on SOTP valuation and arrived at a target price of Rs700.

The core business continues to command valuation premium owning to its dominant position, well-balanced loan and borrowing mix, ability to maintain spreads with check on asset quality. **We have assigned a multiple of 3.5x 1-yr forward to the core mortgage book and arrived at a value of Rs316 (45% of SOTP value)**

We remain structurally positive on HDFC Bank from medium to longer term perspective due to its balance sheet mix, CASA profile and margin maintenance, asset quality and growth strategies. HDFC, through its subsidiaries holds 23.4% stake in HDFC Bank. **We have valued the business at 3.5x 1-year forward (HDFC Bank commands valuation premium) and arrived at a SOTP value of Rs205. (29%)**

HDFC Standard Life is amongst the largest private insurance companies with market share of 13% in private insurance business (4% overall). Reported NBAP margin on the individual business stood at 18.8% with embedded value at Rs42.1bn (end-FY11). Life insurance business continues to remain capital intensive and HDFC has been in talks to unlock value in the same for long now. As clarity over IPO emerges, we expect value unlocking to add to the SOTP valuation. The insurance industry continues to be in doll-drums for over a year now. As overall growth rate moderates, we expect HDFC Life to witness a mere 13% CAGR (23% CAGR over FY08-11) in total business over FY11-13. **We have assigned NBAP multiple of 12x to 1-yr forward NBAP and arrived at valuation of Rs54 on the life insurance business. (8% of SOTP value)**

HDFC Ergo continues to enjoy healthy market share in general insurance (74% stake), AMC (60% stake) and venture capital (80.5% stake). General insurance business reported a loss of mere Rs364mn; while AMC and venture capital continue to remain profitable. **Cumulatively, the value of stake in these ventures stands at Rs30 (4% of SOTP value).** HDFC also has a listed investment book of Rs213bn (H1FY12). **We have assigned 38% discount to market price and arrived at value of Rs91 (13% of SOTP)** HDFC also holds 60.6% stake in Gruh Finance, fifth largest housing mortgage company in India. **We have valued the stake in Gruh Finance at market cap (assigned 35% holding company discount) and arrived at target price of Rs5 (1% of SOTP value).**

SOTP valuation

Company	Basis	Period	Rs m	Multiple (x)	Val of stake (Rs m)	% in total	Value/ sh (Rs)
Standalone	BV	FY13ii	131,661	3.50	460,814	44.9	314
HDFC Bank stake	BV	FY13ii	366,339	3.50	300,031	29.3	205
HDFC Standard Life	EV+NBAP	FY13ii	108,877	12.0	78,827	7.7	54
HDFC General Ins	PAT	FY13ii	604	18.00	8,050	0.8	5
HDFC AMC	AUM	FY13ii	1,160,395	5.0	34,812	3.4	24
HDFC Venture Cap	AUM	FY13ii	19,367	10.00	1,559	0.2	1
Gruh Finance	Mkt val		18,490	0.65	7,283	0.7	5
Unrealised gains - Others	Mkt val	H1FY12	213,000	0.63	134,190	13.1	91
Total					**1,025,566**	**100**	**700**

Source: Emkay Research

Key Financials

Income Statement (Rs. Mn)

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Net interest income	33,875	42,471	49,480	54,058
Other income	7,008	7,113	8,497	10,020
Net Income	40,884	49,584	57,977	64,078
Operating expenses	3,056	3,620	4,355	5,193
Depreciation	182	192	202	218
Preprovision profit	37,646	45,772	53,420	58,667
Provisions	580	700	966	938
Profit before tax	39,160	48,670	52,454	57,729
Tax	10,895	13,320	13,376	14,721
Tax rate	*27.8*	*14.8*	*25.5*	*25.5*
Adjusted Profit after tax	26,754	32,283	39,078	43,008

Balance Sheet (Rs. Mn)

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Equity share capital	2,871	2,934	2,934	2,934
Reserves And Surplus	149,106	170,231	192,025	216,010
Net worth	151,977	173,165	194,959	218,943
Borrowings	965,653	1,154,105	1,356,073	1,566,264
Deferred tax liability	-2,857	-4,481	-4,481	-4,481
Current liabilities	48,785	67,751	67,854	67,854
Total liabilities	1,163,557	1,390,540	1,614,404	1,848,580
Net block	2,221	2,340	3,215	3,215
Investments	107,275	118,324	123,327	128,292
Loans	979,670	1,171,266	1,385,891	1,620,361
Current assets	74,391	98,610	101,970	96,712
Total assets	1,163,557	1,390,540	1,614,404	1,848,580

Key Ratios (%)

(Year Ending Mar 31)	FY10	FY11	FY2E	FY13E
Yield on assets	9.6	9.2	9.6	9.5
Spreads	3.1	3.3	3.5	3.2
NIM	3.1	3.3	3.3	3.1
Other income	0.6	0.6	0.6	0.6
Net Income	3.8	3.9	3.9	3.7
Operating expenses	0.3	0.3	0.3	0.3
Preprovision profit	3.5	3.6	3.6	3.4
Provisions	0.1	0.1	0.1	0.1
Profit before tax	3.6	3.8	3.5	3.3
RoAA	2.5	2.5	2.6	2.5
Gross NPA (%)	0.7	0.8	0.8	0.9
Net NPA (%)	0.1	0.0	0.2	0.2

Valuations Table

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Adj PAT (Rs mn)	26,754	32,283	39,078	43,008
No of shares (mn)	1,436	1,467	1,467	1,467
FDEPS (Rs)	18.6	22.0	26.6	29.3
PER (x)	35.7	30.2	25.0	22.7
Book value (Rs)	105.9	118.1	132.9	149.3
P/BV (Rs)	6.3	5.6	5.0	4.5
Adj. book value (Rs)	105.0	118.1	131.3	147.3
P/ABV (Rs)	6.3	5.6	5.1	4.5
P/PPP (x)	25.4	21.3	18.3	16.6
RoE (%)	18.9	19.9	21.2	20.8
Dividend yield (%)	1.1	1.4	1.4	1.4
Core mortgage RoE (%)	33.5	41.8	37.8	34.7

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Your success is our success

LIC Housing Finance

Too good to resist

Company Update

January 6, 2012

Reco	Previous Reco
Buy	Buy
CMP	**Target Price**
Rs225	Rs250

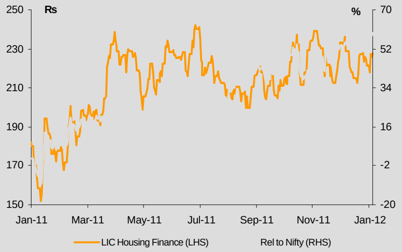
EPS change FY12E/13E (%)	-/-
Target Price change (%)	-
Nifty	4,750
Sensex	15,857

Price Performance

(%)	1M	3M	6M	12M
Absolute	(2)	7	2	21
Rel. to Nifty	7	10	26	59

Source: Bloomberg

Relative Price Chart



Source: Bloomberg

Stock Details

Sector	Financial Services
Bloomberg	LICHF@IN
Equity Capital (Rs mn)	949
Face Value(Rs)	2
No of shares o/s (mn)	475
52 Week H/L	245/150
Market Cap (Rs bn/USD mn)	108/2,041
Daily Avg Volume (No of sh)	3110934
Daily Avg Turnover (US$mn)	13.1

Shareholding Pattern (%)

	Sep-11	Jun-11	Mar-11
Promoters	36.5	36.5	36.5
FII/NRI	38.6	40.4	41.9
Institutions	8.9	7.8	5.9
Private Corp	3.8	2.9	2.7
Public	12.1	12.4	13.0

Source: Capitaline

- **LICHF has seen a sharp 370 bps jump in its market share to 10% over FY08-11, led by a stupendous 33% CAGR in its individual loan portfolio (currently at 65% of HDFC)**
- **Expect LICHF's loan portfolio to report 26% CAGR aided by 21% CAGR in individual disbursements over FY11-13E. Margins to inch towards 2.9% levels by end-FY13**
- **Asset quality woes to remain miniscule; Mgmt confident of higher recoveries in H2FY12. Factoring 23bps of credit cost over FY12-13E following NHB requirement**
- **Superior return ratios with decent valuations provide comfort. Further, as gap with mortgage giant, HDFC narrows, expect valuations to inch upwards. Maintain BUY with TP of Rs250**

Growth momentum to continue; loan book to witness 26% CAGR

LICHF, with a loan portfolio of ~US$11bn+ is a preferred mortgage lender in the individual HFC space. Despite stiff competition, LICHF's a) rich expertise in the mortgage space, b) strong parentage, c) brand name and well-defined business model have enabled it to gain traction. Over FY08-11, LICHF's retail loan portfolio grew at a 33% CAGR, outperforming its peers, HDFC (15%) and SBI (24%). Consequently, its retail loan portfolio now stands at 65% of HDFC and 19%* of combined loan portfolio of top four mortgage players (see chart on page 2). Going forward, as LICHF increases its reach in tier-I and tier-II cities, we expect it to further consolidate its position and report 26% CAGR in loan portfolio, aided by 21% CAGR in retail loan disbursements.

Margin to improve aided by favorable borrowing mix and asset re-pricing

Q2FY12 NIM at 2.5% declined 35bps qoq and was largely attributed to higher proportion of bank term-loans (30% of total borrowing). We, however believe that margins have bottomed-out and should improve in H2FY12 aided by a) lending rate hike (raised lending rates by 40bps in end-Q2, the effect of which will flow beginning Q3) and b) shift in borrowing mix to NCD / bonds (borrowing cost at ~9.5%; bank base rate at 10%+). Further, management is confident of higher share of developer loans in H2FY12 which will aid NIM improvement. We thereby expect NIM to inch to 2.7% levels by end-FY12. Teaser loan portfolio is set to re-price beginning Q1FY13 and will aid margins

Asset quality remains comfortable; regulatory provision to hurt profits

Q2FY12 GNPA at Rs3.6bn was well-within management guidance and was aided by strong recovery (~Rs8bn in H1FY12). Management has guided for GNPA of Rs3bn by end-FY12. However, NHB requirement towards additional provision will hurt growth. We have raised our provision cost to 23bps of average assets over FY12-13E.

Too good to resist; narrowing gap with superior return ratios remains key +ve – Buy

LICHF has outperformed its peers in recent past and currently trades at 1.7x FY13 book. Given its positioning in the housing finance space and narrowing gap to the mortgage giant, HDFC, we expect LICHF to gain market share. We have valued the company at 1.9x FY13 ABV and arrived at a target price of Rs250. With 20%/25% CAGR in net profit / balance sheet respectively, we expect RoA / RoE to average 2.0%/26% over FY11-13E. Maintain BUY.

Valuation table

Y/E Mar'31	Net income	Net profit	EPS (Rs)	ABV (Rs)	RoA (%)	RoE (%)	P/E (x)	P/ABV (x)
FY10	10,733	6,443	13.6	70.3	1.9	22.9	16.6	3.2
FY11	16,022	10,406	21.9	87.5	2.2	27.5	10.3	2.6
FY12E	18,681	10,969	23.1	103.7	1.8	24.1	9.7	2.2
FY13E	24,740	15,062	31.7	131.0	2.0	26.9	7.1	1.7

Growth momentum to continue; loan book to witness 26% CAGR

LICHF enjoys 10% market share in individual mortgage space in India…

Indian mortgage industry is on a strong foothold and has exhibited resilience even during the crisis period. In India, a) improving demographics (in form of increasing urban population), b) stable/increasing income levels and c) easy availability of finance have all augured well for increasing mortgage demand. Property prices and interest rates although a detriment; have had minimal impact on mortgage needs in the past.

26% CAGR in loan portfolio over FY01-11…

… with material improvement in asset quality

Loan portfolio to witness 26% CAGR over FY11-13E…

LICHF, with a loan portfolio of ~US$11bn+ is a preferred mortgage lender in the individual HFC space. Competitive lending rates with wide spread reach and strong parentage have enabled the company to gain an edge over its peers. Individual loan portfolio comprises 90%+ of the total loan portfolio and witnessed healthy 26% CAGR in loan portfolio over FY01-11 against 23% CAGR for HDFC. The loan exposure is primarily towards salaried class (~80% of loan portfolio) and more in nature of government services (50% of book). This, in-turn has ensured check on its asset quality. The restructuring exercise in 2005 has helped reduce GNPA to comfortable levels of sub-1% (in-line with peers). Going forward, as LICHF continues to penetrate further into the tier-I and tier-II cities and with improving economies of scale, we believe the company is well placed to gain market share. While the management is confident of strong traction in developer loan portfolio, we have not factored any material growth in this segment for FY12. We expect LICHF to report 21% CAGR in individual disbursements over FY11-13E. Resultant, loan portfolio is set to witness 26% CAGR over FY11-13E.

... growth in individual disbursements to remain at 21% over FY11-13E

Recent NHB norms on uniform interest rates to have minimal impact on LICHF…

… difference between old / new customer lending at <40bps.

In a recent move, NHB made it mandatory for HFC to charge uniform rates on its floating rate portfolio to both old and new customers with same risk profile. In our view, it is practically impossible for an HFC to re-align its interest rates given a) the interest rate regime prevailing at the time of disbursement b) customer profile c) ALM mismatch etc. Also, while the HFCs are in conversation with the regulator over the new norm, we do not see any major shift / pressure on LICHF given a marginal sub-40bps difference in rates between its old and new loans and its customer profile (first time home loan borrowers).

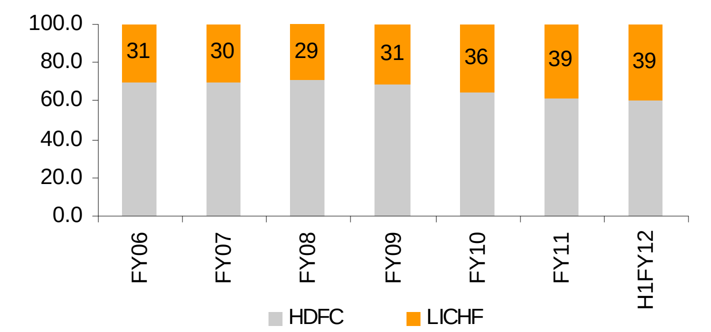
Loan portfolio @ 65% of HDFC; Accounts for 19% amongst top 4-players

Individual loan portfolio now stands at 65% of HDFC's…

… and 19% of combined top 4-players' (SBI+HDFC+LICHF+ICICI Bank)loan portfolio

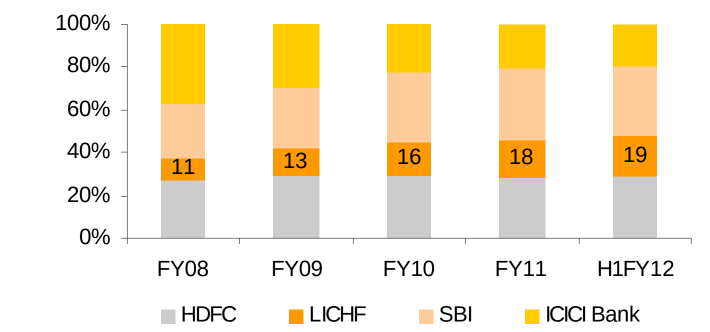
The period of 2008-09 was characterized by real estate slowdown and a soft interest regime. Accordingly, with a view to support growth, teaser rate schemes were floated by various banks and housing financial companies. Introduction of teaser rate loan schemes (including floating and fixed housing schemes) at relatively reasonable rates compared to its peers with wide presence and brand name, enabled LICHF gain substantial market share (10% in H1FY12 against 5.9% in FY08). Its loan portfolio witnessed a CAGR of 33% against 15% in case of HDFC and 24% in case of SBI during FY08-11. Consequently, its individual loan portfolio now stands at 65% of HDFC (41% in FY08) and 19%* of combined loan book portfolio for SBI+HDFC+ICICI Bank and LICHF.

LICHF market share vis-à-vis HDFC



Source: Companies, Emkay Research

…. and other leading mortgage finance companies



Source: Companies, Emkay Research

Margin to improve aided by favorable borrowing mix and asset re-pricing

NIM has remained in a narrow range of 2.7-3.5% for past 7-quarters…

…85% of loans are floating in nature, 50% of liabilities are fixed

Q2FY12 margins declined 35bps qoq largely due to higher borrowing cost…

Despite volatile interest rate regime and competitive business environment, LICHF has been able to maintain its margins in the narrow range of 2.7- 3.5% over the past 7-quarters. This has largely been due to a favorable borrowing mix and ability to pass on the rate hike. ~80% of LICHF's loan portfolio was floating in nature against 50% of liabilities which are fixed. During Q2FY12, margins however declined 35bps qoq to 2.5%, primarily due to higher borrowing costs. ~30% of LICHF borrowings are in nature of term loans from banks and attributed for higher interest outflow during the quarter. ***However, the company has raised its lending rates by 40bps end-Q2FY12, the effect of which will flow beginning Q3FY12.***

… lending rate hike to the tune of 40bps in end-Q2FY12 to aid margin improvement in H2FY12

Plans shift in borrowing profile from bank loans to NCD / bonds…

Margin improvement will also be aided by increasing reliance on non-bank borrowing portfolio. With increase in base rate by banks, borrowing under the bank term-loan window is turning costlier (against NCD / bonds route). The company recently raised funds under NCD window at 9.4%; 60bps lower than base rate for the bank (SBI base rate at 10%).

… additionally, part of fix-o-floaty scheme due for re-pricing in Q1FY13.

Management confident of substantial uptick in high yielding developer loan segment…

… we have however, not factored any material increase in exposure

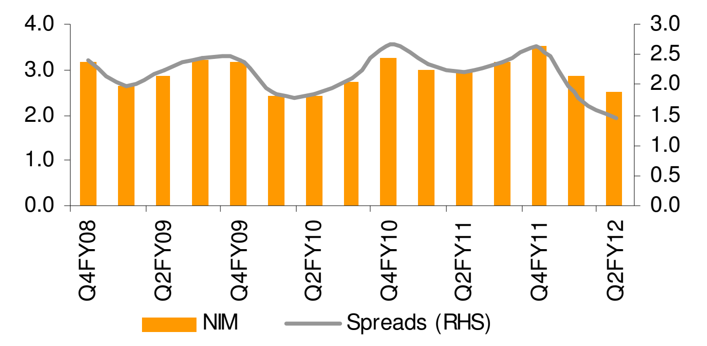
In addition to changed borrowing mix, margin expansion will also be aided by re-pricing of ~Rs30bn of loan portfolio under the fix-o-floaty scheme (RoI fixed at 8.75%/8.9% for 3-years) beginning Q1FY13. With a view to remain competitive, LICHF introduced various teaser rate schemes and disbursed loans cumulating to Rs128bn (27% of retail loans as at FY11). With current lending rate at ~11.65%, this loan portfolio will now earn an incremental spread of 275bps over its actual spread. Also, following the outbreak of loan scam in November'2010, LICHF had been going slow on its exposure to developer loans. However, after a brief halt, management has now guided for material increase in its exposure towards this high interest yielding segment. We have, however not factored in any material increase in the developer loan portfolio given risky nature of exposure and slump in the real estate space. Any up-tick in exposure towards this segment would only support margin expansion.

Re-balancing of borrowing mix, asset re-pricing and lending rate hike to aid NIM improvement…

… FY12 NIM to inch to 2.7% levels.

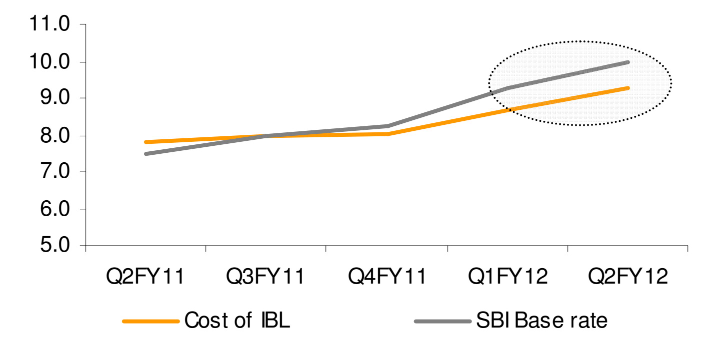
In our view, the conscious efforts towards re-balancing of borrowing mix in favor of NCD / bonds, with timely lending rate hike and re-pricing of loan portfolio will clearly aid margin improvement. We expect NIM to inch to 2.7% levels (in-line with management expectation) by end FY12E.

NIMs have remained intact at 2.9% levels for past 14-qts



Source: Company, Emkay Research

Cost of IBL significantly lower than bank base rate



Source: Companies, Emkay Research

Minimal concerns on asset quality…

Q2 GNPA at Rs3.6bn well within management guidance…

.. aided by recovery of ~Rs8bn in H1FY12

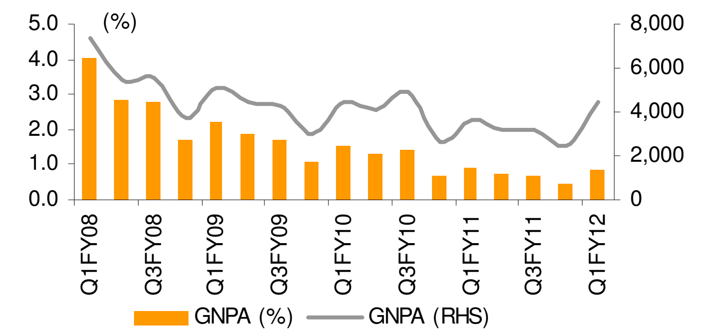
FY12 GNPA to come in lower at Rs3bn…

… Management confident of recovery rate @ Rs3bn per month

While Q1FY12 GNPA at Rs4.4bn (up 21% yoy) came in as a surprise, the management during its Q1 concall clearly guided for trend reversal in Q2. Resultant, Q2FY12 GNPA at Rs3.6bn (0.64%) declined 19% qoq. The management attributed the reason for material improvement in NPA to higher recoveries (combined recovery of ~Rs8bn in H1FY12). It has also stated for an average recovery of Rs3bn per month in H2FY12, thereby reducing the absolute GNPA levels to Rs3bn by end-FY12. During Q2FY12, LICHF made an additional provisioning of Rs350mn on NPAs. As a result, NNPA too, declined by 64% qoq to Rs660mn (0.12%), PCR improved to 82%.

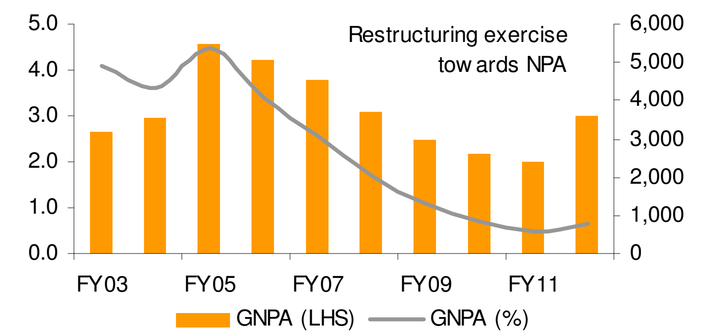
Restructuring exercise helped ease asset quality woes…

Over past few quarters…



Source: Company, Emkay Research

… and on annualized basis.



Source: Company, Emkay Research

Restructuring exercise during FY04-07 helped clean legacy NPL…

… GNPA declined from 4.5% in FY05 to 0.5% in end-FY11

In the past, LICHF had been grappling with concerns over its asset quality. The restructuring exercise undertaken during FY04-07 enabled the company clean its balance-sheet of legacy NPL and also reduce incremental NPL formation. The major balance sheet clean up 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. *As a result of these initiatives, GNPA for the company declined from a peak of 4.5% in FY05 to a mere 0.47% as at end FY11 with PCR at 94%.*

… and lowest amongst its peers – HDFC and SBIN

GNPA at 0.64% lowest when compared to HDFC (0.82%), SBI (2.38%)

GNPA for LICHF at 0.64% is the lowest when compared to its peers – HDFC (0.82%) and SBI (2.38%). We continue to hold our argument that HFCs are better placed in the mortgage space vis-à-vis banks given its domain expertise, credit appraisal mechanisms and customer profile.

Loan portfolio and GNPA levels

H1FY12	Individual loan portfolio (Rs mn)	GNPA (%)
LICHF	521,498	0.64
HDFC	802,680	0.82
SBIN	923,830	2.38
Dewan Housing	159,503	0.97

Source: Companies, Emkay Research

In adherence to regulatory norms, factored provision/assets at 20bps

LICHF provided Rs2.7bn towards addln NPA requirement in FY11…

With a view to tide over volatile property prices and interest rates, NHB has time and again tightened its belts to avoid any major risk of asset quality deterioration. In FY11, National Housing Board, made it mandatory for housing companies to introduce a) cap on LTV b) standard asset provisioning of 2% on teaser rate loans and general provisions of 0.4% on non-individual loan portfolio and c) increased risk weights. Accordingly, LICHF provided a sum of Rs2.7bn towards additional NPA requirement, including Rs2.56bn towards standard asset provisioning on teaser rate loan portfolio.

…. and further Rs2.05bn in Q2

Cumulative provisioning on B/s sheet now at Rs7.2bn (1.4% of total book)…

Management might reverse Rs1bn of excess provisioning in H2FY12

Factoring 36bps (average) credit cost over FY11-13E

Further, in September, 2011, NHB raised provisioning requirement on sub-standard and doubtful assets including 0.4% provisioning on individual loan portfolio. As a result, LICHF provided Rs2.05bn in Q2FY12 towards the additional provisioning requirement via its P&L (contrary to its peers, who passed the same via balance sheet.) Of the total provisioning of Rs2.05bn – Rs1.6bn was towards standard asset provisioning and the balance Rs450mn towards additional provisioning on sub-standard / doubtful assets. Thus, the cumulative provision on balance sheet now stands at Rs7.2bn (1.4% of total loan portfolio) against the statutory requirement of Rs6.2bn. The management has reiterated for reversal of excess provisioning of Rs1bn in H2FY12 subject to board approval. In view of higher provisioning requirement, we have raised our credit cost assumptions to 20bps over FY12-13E.

Return ratios, however, to remain at healthy 2.0%/26% (RoA / RoE) levels

Higher provisioning cost to be offset by improvement in margins

Healthy loan growth with stable margins, lower operating and credit cost and material improvement in asset quality over the past few years have all contributed towards significant improvement in return ratios. Going forward, higher provisioning cost would be offset by improvement in net interest margins. We expect LICHF to report average RoA / RoE of 2.0%/26% over FY11-13E.

DuPont analysis

	FY08	FY09	FY10	FY11	FY12E	FY13E
NII	2.87	2.82	2.56	2.94	2.69	2.88
Other Inc	0.37	0.52	0.53	0.48	0.42	0.40
Total Income	**3.24**	**3.33**	**3.09**	**3.42**	**3.11**	**3.28**
Opex	0.62	0.57	0.53	0.45	0.40	0.39
Pre-prov profit	2.61	2.75	2.54	2.96	2.69	2.89
Provisions	**0.12**	**0.02**	**-0.01**	**0.01**	**0.23**	**0.23**
PBT	2.54	2.76	2.62	2.76	2.15	2.65
Tax	0.69	0.74	0.72	0.68	0.53	0.66
RoAA	**1.81**	**2.00**	**1.86**	**2.22**	**1.82**	**2.00**
Leverage (x)	12.7	13.1	11.9	12.8	13.5	13.5
RoAE	**22.53**	**25.80**	**22.92**	**27.54**	**24.08**	**26.94**

Source: Company, Emkay Research

Valuation and view…

Narrowing gap with mortgage giant, HDFC

33% CAGR in loan portfolio over FY08-11 against 15% for HDFC

LICHF, through relentless measures reported sturdy 33% CAGR in its loan portfolio over FY08-11. The growth was also aided by stable margins and improvement in asset quality including return ratios. Rich expertise with brand recall, strong parentage, customer profile (end-user with limited risk) enabled LICHF stand tall in the highly competitive mortgage space. As at H1FY12, LICHF's individual loan portfolio stood at 65% of HDFC's individual loan portfolio. This ratio has improved from 41% in FY08.

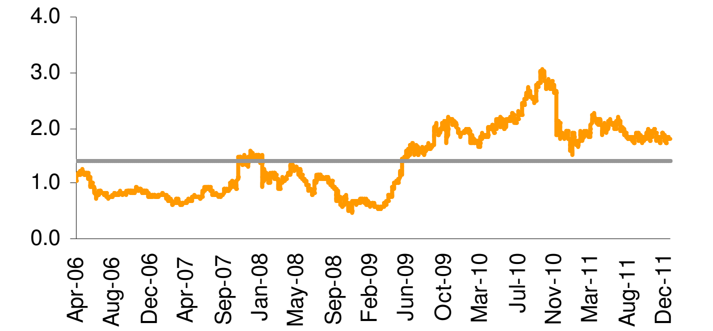
… and now has an edge over other NBFCs; Maintain BUY

Asset financing companies (AFC), in the past have operated at relatively higher RoAs. Niche target audience with limited competition enabled them command premium spreads. Also, with lower operating expenses and minimal provisioning requirements, return ratios remained attractive. Resultant, AFCs historically had traded at premium valuation to LICHF. However, in the backdrop of higher interest rates and material slowdown in corporate capex and infrastructure activities, growth rate for AFCs have now been on a decline. Further, with fears over deterioration in asset quality, provisioning norms have been strengthened, resulting in lower profitability.

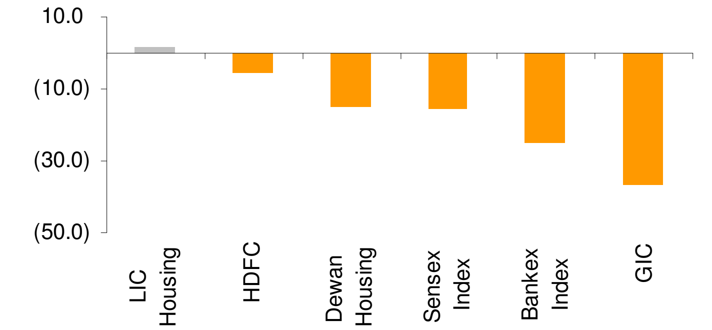
Going forward, as LICHF expands its footprint in tier-I and tier-II cities, we expect loan growth momentum to continue. In our view, given a) customer profile and appetite for housing b) risk-aversive behavior and c) huge demand-supply mismatch, the need for housing mortgage is on the rise. Given LICHF's positioning in the housing finance space and narrowing gap to the mortgage giant, HDFC, we expect LICHF to witness material improvement in market share.

The stock has outperformed its peers (both banks and other NBFC's) in the recent past on expectations of stable loan growth with improvement in margins in H2FY12. Further, despite higher provisioning requirement, return ratios are expected to remain intact which should drive valuations. We have thereby valued the company at 1.9x FY13 book (against 1-yr forward of 1.7x) and arrived at target price of Rs250. Maintain BUY. Any correction in the stock prices offers decent investment opportunity in the medium to long term.

LICHF : 1-yr forward PB



Price performance: LICHF vis-à-vis peers



Source: Bloomberg, Emkay Research

Key Financials

Income Statement (Rs. Mn)

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Net interest income	8,897	13,770	16,177	21,741
Other income	1,837	2,252	2,504	2,999
Net Income	10,733	16,022	18,681	24,740
Operating expenses	1,852	2,099	2,424	2,905
Depreciation	64	62	70	77
Preprovision profit	8,818	13,860	16,187	21,759
Provisions	-50	41	1,409	1,743
Profit before tax	9,112	12,941	12,937	20,015
Tax	2,491	3,197	3,202	4,954
Tax rate	27.3	24.7	33.0	33.0
Adjusted Profit after tax	6,443	10,406	10,969	15,062

Balance Sheet (Rs. Mn)

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Equity share capital	950	950	950	950
Reserves And Surplus	32,927	40,741	48,476	61,425
Net worth	33,877	41,691	49,425	62,375
Borrowings	347,582	451,628	578,095	735,976
Deferred tax liability	-891	-1,698	-1,888	-2,304
Current liabilities	20,961	42,980	43,050	43,162
Total liabilities	401,528	534,601	668,683	839,209
Net block	356	474	467	460
Investments	13,887	14,032	14,032	14,032
Loans	380,814	510,898	646,197	816,730
Current assets	6,471	9,197	7,988	7,988
Total assets	401,528	534,601	668,683	839,209

Key Ratios (%)

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Yield on assets	9.5	9.6	10.2	10.0
Spreads	2.1	2.3	1.8	2.1
NIM	2.6	2.9	2.7	2.9
Other income	0.5	0.5	0.4	0.4
Net Income	3.1	3.4	3.1	3.3
Operating expenses	0.5	0.4	0.4	0.4
Preprovision profit	2.5	3.0	2.7	2.9
Provisions	0.0	0.0	0.2	0.2
Profit before tax	2.6	2.8	2.2	2.7
RoAA	1.9	2.2	1.8	2.0
Gross NPA (%)	0.7	0.5	0.4	0.3
Net NPA (%)	0.1	0.0	0.0	0.0

Valuations Table

(Year Ending Mar 31)	FY10	FY11	FY12E	FY13E
Adj. Profit after tax	6,443	10,406	10,969	15,062
No of shares (mn)	475	475	475	475
FDEPS (Rs)	13.6	21.9	23.1	31.7
PER (x)	16.7	10.4	9.8	7.2
Book value (Rs)	71.3	87.8	104.1	131.3
P/BV (Rs)	3.2	2.6	2.2	1.7
Adj. book value (Rs)	70.3	87.5	103.7	131.0
P/ABV (Rs)	3.2	2.6	2.2	1.7
P/PPP (x)	12.2	7.8	6.7	5.0
RoE (%)	22.9	27.5	24.1	26.9
Dividend yield (%)	1.3	1.5	1.6	1.7

Emkay Rating Distribution

BUY	Expected total return (%) (stock price appreciation and dividend yield) of over 25% within the next 12-18 months.
ACCUMULATE	Expected total return (%) (stock price appreciation and dividend yield) of over 10% within the next 12-18 months.
HOLD	Expected total return (%) (stock price appreciation and dividend yield) of upto 10% within the next 12-18 months.
REDUCE	Expected total return (%) (stock price depreciation) of upto (-)10% within the next 12-18 months.
SELL	The stock is believed to under perform the broad market indices or its related universe within the next 12-18 months.

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