LIC Housing Finance – BUY

13 September 2012

Management meeting

IIFL Institutional Equities

Still a preferred play in mortgages

LIC Housing Finance (LICHF) remains a key player in mortgage lending. We expect expanding distribution to sustain loan growth ahead of peers. LICHF has several levers to improve its NIM and profitability. However, increase in competitive intensity is likely to limit the upside from such levers. Nevertheless, robust loan growth and benign asset quality would drive earnings Cagr of 26% during FY12-15ii. Robust earnings growth, high RoE and inexpensive valuations underpin our positive view on the stock.

Robust loan growth likely over the medium term: Retail mortgage would remain the key driver of overall loan growth. Focus on non-metro cities, expanding distribution and competitive lending rates would drive loan growth through FY15ii. We believe increase in competitive intensity is unlikely to be a threat, since LICHF's strong brand identity, large network, and well established processes would enable it to defend its market position. Non-retail lending growth, though likely to show significant acceleration, would remain a small portion of total loans.

Competition likely to keep lending spreads at FY12 level: Banks are likely to turn more aggressive with mortgage loan pricing due to sluggish loan growth prospects in other segments and risk aversion to lending to the industrial and infrastructure sectors. Lending spreads compressed for LICHF in FY12 and we expect them to stay at these levels in FY13ii too. However, an upward revision in lending rates to the teaser loan portfolio is likely to provide a reprieve to NIMs.

RoA increase likely beyond FY13ii: Given higher competitive intensity, we temper our expectations for spread accretion, leading to an 8.9% and 7.5% cut in earnings estimates in FY13ii and FY14ii respectively. However, an overall improvement of 23bps in spread and higher operating leverage will help improve RoA to 1.6% and RoE to 18-20% by FY14ii. Valuation at 1.9X FY13ii P/B is attractive, given 26% earnings CAGR and benign asset quality.

Company update

CMP	**Rs248**
12-mth TP (Rs)	**290 (17%)**
Market cap (US$m)	**2,265**
Bloomberg	**LICHF IN**
Sector	**Banks**

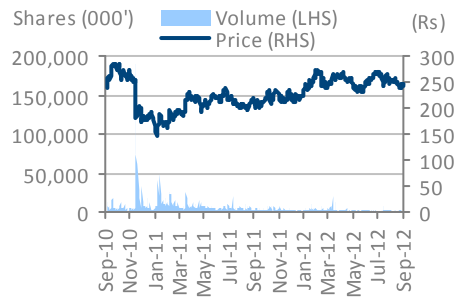
Price performance (%)

	1M	3M	1Y
Absolute (Rs)	0.0	(2.7)	19.1
Absolute (US$)	(2.1)	(0.3)	3.3
Rel. to Sensex	(2.6)	(9.4)	10.0
Cagr (%)		**3 yrs**	**5 yrs**
EPS		15.4	24.0

Shareholding pattern (%)

Promoters	40.3
FIIs	29.7
Domestic MFs	9.1
Public	20.9
52Wk High/Low (Rs)	290/200
Shares o/s (m)	505
Daily volume (US$ m)	7.2
Dividend yield FY13ii (%)	1.8
Free float (%)	59.0

Stock performance



Financial summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Pre prov. operating inc. (Rs m)	15,548	13,869	16,610	21,126	26,779
Pre-exceptional PAT (Rs m)	9,745	9,141	11,399	14,474	18,101
Reported PAT (Rs m)	9,745	9,141	11,399	14,474	18,101
Pre-exceptional EPS (Rs)	20.5	19.2	22.6	28.7	35.8
Growth (%)	47.2	(6.2)	17.3	27.0	25.1
IIFL vs consensus (%)			(4.0)	(4.4)	3.8
PER (x)	12.1	12.9	11.0	8.6	6.9
Book value (Rs)	88	113	130	151	178
PB (x)	**2.8**	**2.2**	**1.9**	**1.6**	**1.4**
CAR (%)	14.9	16.7	14.9	13.7	12.7
ROA (%)	2.1	1.5	1.6	1.6	1.7
ROE (%)	**25.8**	**20.2**	**18.6**	**20.4**	**21.7**

Source: Company, IIFL Research. Priced as on 12 September 2012

Sampath Kumar | sampath.kumar@iiflcap.com
+91 22 4646 4665

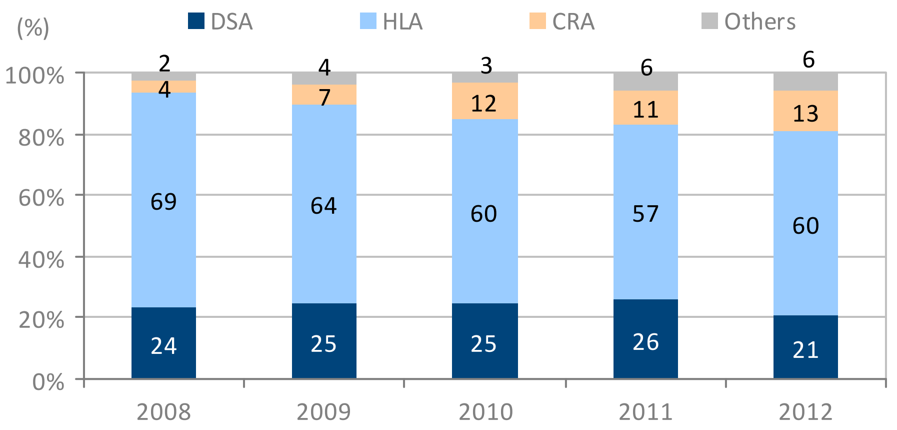
Abhishek Murarka | abhishek.murarka@iiflcap.com
+91 22 4646 4661

Growth drivers for retail mortgages intact

LICHF delivered robust loan growth in FY12 (23.5% YoY) despite significant organisational challenges. We expect the growth momentum to sustain, driven by favourable demand drivers and LICHF's expanding distribution. We forecast 22% Cagr in retail disbursements over FY12-15ii. Although non-retail lending growth is likely to show significant acceleration, it would remain a small portion of total loans.

Retail growth momentum an outcome of FOS expansion, increasing penetration in smaller cities
The key driver of retail disbursements has been increasing penetration through expansion of feet on street (FOS). We are likely to see continued investments by LICHF into building a large sales network. It has already invested significantly in ramping up the number of agents from ~5,200 in FY07 to ~8,500 as of Q1FY13. Over time, over-dependence on LIC agents (HLAs) also reduced and DSAs/CRAs now contribute ~34% of incremental sales. LICHF intends to add ~20% to its sales force each year.

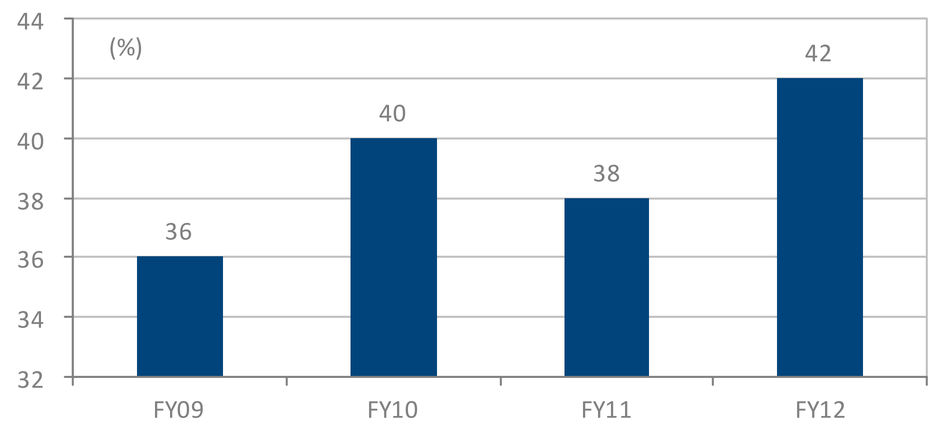
Figure 1: LIC Agents (HLAs) contribute nearly 60% to incremental sales



Source: Company, IIFL Research; DSA – Third Party Agents, HLA – LIC Agents, CRA – Own agents

Cities such as Hyderabad, Chennai, Bangalore, Jaipur, Kolkata, etc. have compensated for the slowing sales in Mumbai and NCR regions. Currently, Mumbai and NCR together contribute 13-14% of overall sales (versus 19-20% earlier). We note a slow structural shift in sales origination towards smaller cities over the past few years. We believe that with deepening penetration, this trend is likely to sustain and will provide another leg to retail disbursements growth.

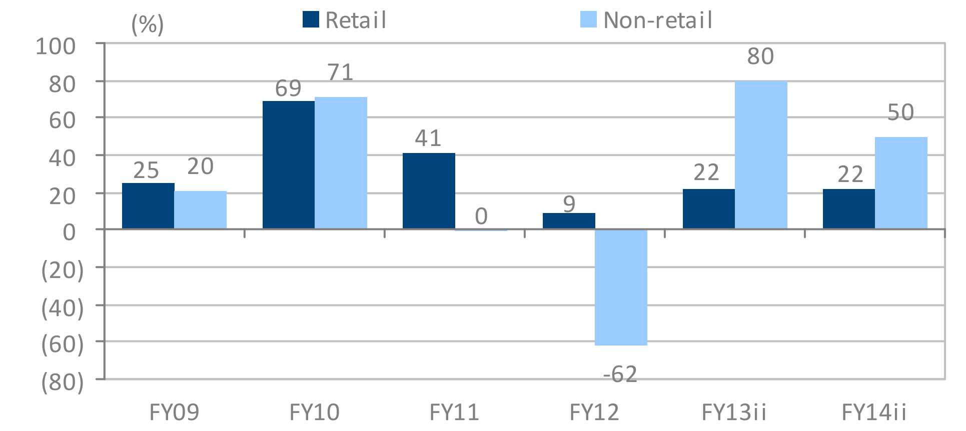
Figure 2: Smaller cities have shown a sustained increase in proportion of originations



Source: Company, IIFL Research;

Cautious approach in non-retail segment likely to continue
We estimate disbursements Cagr of ~64% over FY12-14ii in this segment, with pick-up in absolute disbursements likely to be back-ended in FY14. Unlike HDFC, LICHF strictly abstains from lease rental discounting and has a mandate of only funding projects among non-retail alternatives. The company had completely withdrawn from this segment over Q3FY11-Q1FY12. LICHF's own caution and dwindling market opportunities are likely to keep immediate disbursements momentum tepid here.

Figure 3: Disbursements growth to stabilise for retail, high non-retail growth in FY13ii off a low base



Source: Company, IIFL Research

LICHF well-entrenched, likely to defend market share

Competing effectively in the housing finance space requires capabilities in sourcing (building feet on street), appraisal capabilities (valuation of property, verification of documents, fraud control) spread over large geography. State-owned banks follow a branch-oriented model for origination and servicing that limits their ability to acquire customers actively at the point of sale. Further, most of the appraisal/valuation capabilities are outsourced. The only competitive tool that banks have versus HFCs is interest rate reduction. We note that interest rates for HFCs are extremely competitive (figure 4) and hence banks are unable to create significant differentiation vis-à-vis HFCs by simply reducing lending rates. As a result, despite enjoying the benefit of lower cost of funds, banks have been unable to outpace HFCs in loan growth over time.

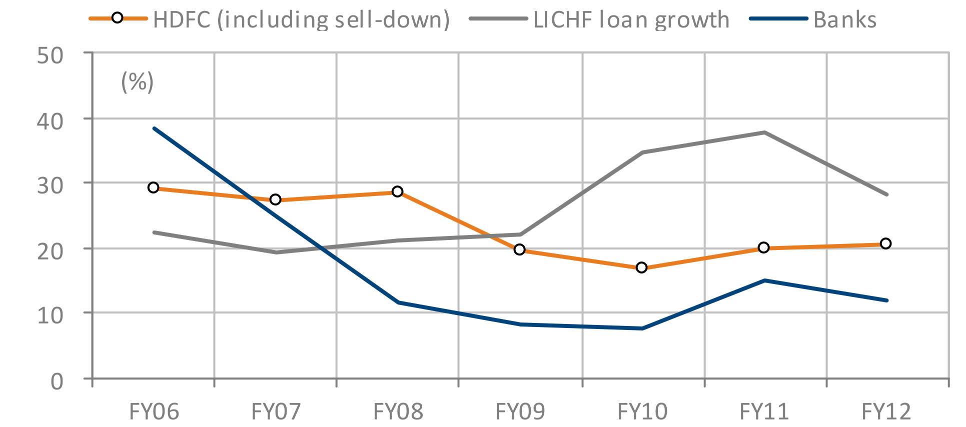
Figure 4: Competitive product pricing allows little scope for differentiation

%	ICICI	SBI	Axis Bank	HDFC	LICHF
Floating rate					
<Rs3mn	10.5	10.3	10.8	10.8	10.7
Rs3mn - Rs7.5mn	11.0	10.4	11.0	11.0	>=11.0
>Rs7.5mn	11.5	10.4	11.3	11.5	>11.25
Fixed rate	10.5 - 11.75	NA	11.75	10.75 - 11.25	10.75-11.5

Source: Company, IIFL Research; * For Axis bank the slabs are <Rs2.5mn, Rs2.5mn - Rs7.5mn, >Rs7.5mn

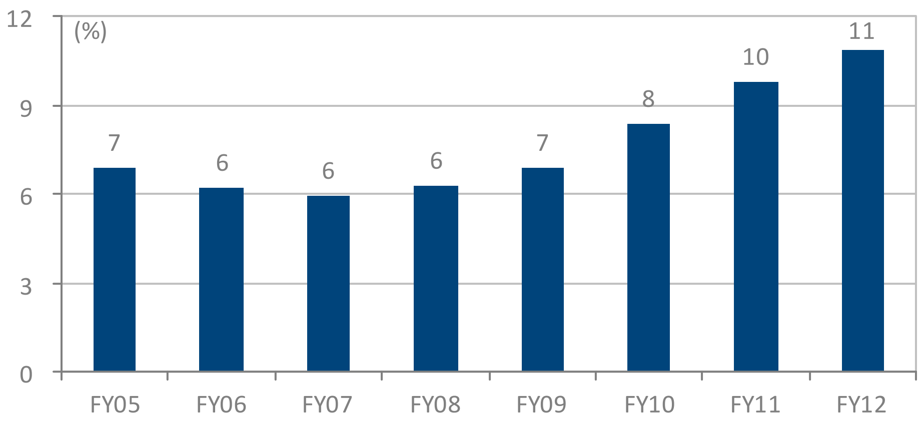
LICHF had improved market share even in the last interest rate cut cycle due to: i) deepening penetration (diversifying to lower-tier cities); and ii) improved services and turnaround time. We expect it to continue expanding sales strength, penetrate into deeper geographies and continually improve its service capabilities. As such, it should successfully defend its market share in the current period of intense competition.

Figure 5: Banks' loan growth lags that of HFCs significantly



Source: Company, IIFL Research

Figure 6: LICHF has driven sustained growth in market share over interest rate cycles



Source: Company, IIFL Research

Spreads – benefits might show only by FY14ii

LICHF's spreads troughed in FY12. Market consensus was building improvement in lending spreads due to upward re-pricing of teaser loan products. Despite the above, we expect lending spreads to remain unchanged in FY13ii. Increase in competitive intensity is likely to cap such benefits. We expect spread improvement to happen in FY14ii, as a larger portion of teaser loans will likely re-price by then.

Figure 7: Fixed rate book as of FY12

	Amount (Rsbn)	Average yield (%)	Converts to floating at (%)	Residual maturity	Contribution to spreads*
Fix-O-Floaty	128	8.9	10.6	1yr	11bps in FY13ii, 9bps in FY14ii
Advantage 5	98	9.25	NA	4yrs	Converts FY16 onwards
Other fixed rate loans	169	10.75	NA	3yrs	Converts FY15-16 onwards
Total	395				
% of retail loans	66				

Source: Company, IIFL Research; *on converting to floating rate

Competition might limit pricing freedom on floating rate book

A comparison of interest rates (figure 4) reveals that products of LICHF are competitively priced vis-à-vis peers. Hence, decline in funding costs would most likely have to be passed on to customers to hold on to market share. Further, abolishment of the pre-payment penalty on floating rate loans has reduced the exit barrier for customers. To prevent large-scale migration of customers, floating rate loans are likely to re-price downwards almost immediately, along with interest rate declines. Hence, keen competition might limit spread improvement from re-pricing.

Sharper growth in developer loan portfolio could provide upside surprise

Developer loans earn 4-5% higher yield than the retail portfolio. These are critical to a sharp bounce back in LICHF's spreads and RoA. Currently, this increase does not add materially to our forecast spreads. However, a sharper growth could generate material upside to numbers. The proportion of developer loans, in our estimate, will increase to ~6% by FY14ii and ~7% by FY15ii.

ALM course correction will reduce variance in spreads in the short term

As at end-FY12, 34% of LICHF's loans were at variable rate while 33% of its liabilities (interest rate swaps of 4% and bank loans of 30%) were variable rate in nature.

Figure 8: Asset Liability mismatch stands corrected, might reduce variance in spreads

(%)	FY08	FY09	FY10	FY11	FY12
Fixed rate assets	6	4	21	46	63
Fixed rate liabilities	52	62	63	68	67
Change in 10-yr G-Sec rate	(0.42)	(0.55)	0.82	0.12	0.59
Spreads	2.84	2.88	2.57	1.80	1.07

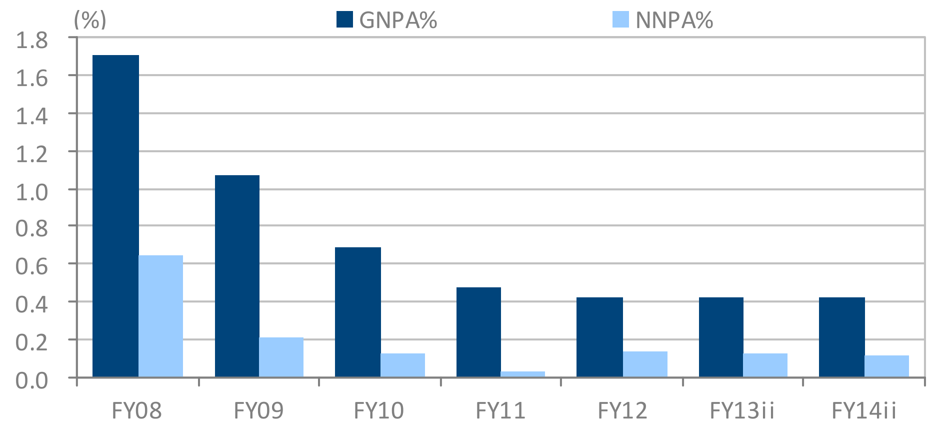
Source: Company, IIFL Research; Fixed rate assets & liabilities as a % of total loan book

The large gap between repricing of assets and liabilities that existed until FY11 stands reduced substantially. Incrementally, ~70% of the sales in retail loans are under fixed rate assets while the liabilities have historically contained ~60-70% fixed rate borrowings. Hence, we expect the current ALM profile to continue in the foreseeable future. Unfortunately, a well-matched book will unlikely aid a sharp bounce back in spreads as interest rate changes will largely be neutralised.

Asset quality not an area of concern

LICHF's asset quality outlook remains benign. Retail loans are against house property for self-consumption and hence secured. Further, LTV on incremental sanctions at 58% is quite conservative and provides a cushion to the loan book. The outstanding balance sheet provisions amount to Rs6.89bn, of which Rs2.19bn (47% of GNPAs) are NPA provisions, Rs2.57bn are for teaser loans and the rest are for standard assets.

Figure 9: NPAs to remain benign



Source: Company, IIFL Research

LICHF's outstanding loans for project finance are also significantly lower than peers at 4.6% of loans and the NPA on this portfolio stands at only Rs100-150mn or 0.5%, which is fully provided for. The company has also been cautious in this segment for nearly two years now, having wound down a large portion of this book earlier. Hence, our expectation of any adverse asset quality hit from the non-retail loans is low. We estimate overall GNPAs to remain at ~0.4% over FY12-14ii with provision coverage of ~70% and an average loan loss provision of 0.2% of average loans.

RoA improvement over the medium term, led by increase in spreads and higher operating efficiency

We prefer LICHF for its high disbursements growth momentum, improving quality of earnings and benign asset quality culminating into 26% earnings Cagr over FY12-14ii.

The spread improvement from 1.41% in FY12 to 1.64% in FY14ii will likely drive a NII Cagr of 25%. Benefits from the gradually improving operating leverage and benign credit costs will allow for full benefit of spread expansion to reflect in RoA. Driven by healthy Cagr of 24% in overall disbursements over FY12-14ii, financial leverage is expected to rise to 12.5x, driving RoE higher.

Figure 10: Earnings revision summary

	FY13ii	FY14ii
Net profit (Rs m) - Old	12,517	15,648
Net profit (Rs m) - New	11,399	14,474
% change	(8.9)	(7.5)
EPS (Rs.) - Old	24.8	31.0
EPS (Rs.) - New	22.6	28.7
% change	(8.9)	(7.5)
ROE (%) - Old	20.4	21.8
ROE (%) - New	18.6	20.4
Change in bps	(176)	(145)

Source: Company, IIFL Research

Figure 11:Key earnings drivers for LICHF

	FY10	FY11	FY12ii	FY13ii	FY14ii	FY15ii
Loan growth	37.6	34.2	23.5	23.1	21.5	22.3
Net interest margin	2.6	3.0	2.4	2.3	2.5	2.6
Net interest income growth	21.5	54.9	1.9	21.6	28.5	27.7
Core fee income growth	86.2	18.3	(11.9)	5.0	5.0	6.0
Non-interest inc as % of total	17.0	22.0	13.4	12.0	10.2	8.8
Operating costs growth	24.2	12.9	9.7	19.1	18.4	18.9
Cost/income ratio	17.8	12.2	14.6	14.5	13.7	12.9
Gross NPAs as % of loans	0.7	0.5	0.4	0.4	0.4	0.4
Total provision charges as % of loans	0.0	0.6	0.3	0.2	0.2	0.2
Tax rate	27.4	24.7	25.7	26.0	26.0	27.0

Source: Company, IIFL Research

Figure 12:ROA/ROE decomposition of LICHF

Y/e 31 Mar	FY10	FY11	FY12ii	FY13ii	FY14ii	FY15ii
Interest income	9.4	9.5	10.0	10.2	10.2	10.4
Interest expense	6.9	6.6	7.7	7.8	7.8	7.8
Net interest income	2.6	2.9	2.4	2.3	2.5	2.6
Non-interest income	0.5	0.5	0.4	0.3	0.3	0.2
Total operating income	3.1	3.5	2.7	2.7	2.7	2.8
Total operating expenses	0.6	0.5	0.4	0.4	0.4	0.4
Pre provision operating profit	2.5	3.0	2.3	2.3	2.4	2.5
Total provisions	(0.1)	0.6	0.3	0.2	0.2	0.2
Profit before tax	2.6	2.5	2.1	2.1	2.2	2.3
Taxes	0.7	0.7	0.5	0.5	0.6	0.6
ROA	1.9	2.1	1.5	1.6	1.6	1.7
Leverage	12.4	12.4	12.1	12.0	12.6	13.1
RoE	23.6	25.8	18.6	18.6	20.4	21.7

Source: Company, IIFL Research

Assumptions

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Core fee income growth (%)	18.3	(11.9)	5.0	5.0	6.0
Individual loan growth (%)	37.6	28.2	22.9	20.6	21.1
Project loan growth (%)	5.5	(26.9)	26.8	36.3	42.5

Source: Company data, IIFL Research

Figure 13:P/B trend for LICHF

Source: Bloomberg, IIFL Research

Figure 14: Valuation premium of HDFC over LICHF

Source: Company, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net interest income	13,805	14,067	17,107	21,977	28,066
Fee Income	1,501	1,322	1,388	1,457	1,545
Others	2,404	852	941	1,038	1,147
Non-interest income	3,905	2,174	2,328	2,496	2,692
Total operating income	17,710	16,241	19,435	24,472	30,758
Total operating expenses	2,162	2,372	2,826	3,347	3,979
Pre provision operating profit	**15,548**	**13,869**	**16,610**	**21,126**	**26,779**
Provisions for loan losses	2,669	1,608	1,253	1,615	2,031
Other provisions	(61)	(48)	(48)	(48)	(48)
Profit before tax	12,939	12,308	15,404	19,559	24,796
Taxes	3,197	3,167	4,005	5,085	6,695
Net profit	**9,745**	**9,141**	**11,399**	**14,474**	**18,101**

Balance sheet summary (Rs m)

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Net loans & advances	510,898	630,802	776,740	943,395	1,154,004
Placements to other banks	1,430	2,051	2,256	2,707	3,249
Cash & equivalents	7,767	7,917	8,744	10,616	20,021
Other interest-earning assets	14,032	13,751	15,263	17,095	19,146
Total interest-earning assets	**534,127**	**654,521**	**803,003**	**973,813**	**1,196,421**
Fixed assets	474	768	921	1,151	1,439
Other assets	1,698	2,208	2,650	3,312	3,975
Total assets	**536,300**	**657,496**	**806,574**	**978,277**	**1,201,835**
Customer deposits	2,458	2,692	3,096	3,560	4,166
Other interest-bearing liabilities	449,170	558,180	692,144	847,876	1,047,127
Total interest-bearing liabilities	451,628	560,873	695,240	851,437	1,051,293
Non-interest-bearing liabilities	42,980	39,802	45,772	50,349	60,419
Total liabilities	**494,609**	**600,674**	**741,012**	**901,786**	**1,111,712**
Total Shareholder's equity	**41,691**	**56,822**	**65,563**	**76,491**	**90,123**
Total liabilities & equity	**536,300**	**657,496**	**806,574**	**978,277**	**1,201,835**

Source: Company data, IIFL Research

Ratio analysis - I

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Balance Sheet Structure Ratios (%)					
Loan Growth	34.2	23.5	23.1	21.5	22.3
Growth in Deposits	(24.6)	9.5	15.0	15.0	17.0
Growth in Total Assets (%)	33.3	22.6	22.7	21.3	22.9
Profitability Ratios					
Net Interest Margin	3.0	2.4	2.3	2.5	2.6
ROA	2.1	1.5	1.6	1.6	1.7
ROE	25.8	20.2	18.6	20.4	21.7
Non-Int Income as % of Total Income	22.0	13.4	12.0	10.2	8.8
Net Profit Growth	47.2	(6.2)	24.7	27.0	25.1
FDEPS Growth	47.2	(6.2)	17.3	27.0	25.1
Efficiency Ratios (%)					
Cost to Income Ratio	12.2	14.6	14.5	13.7	12.9
Salaries as % of Non-Interest costs	31.5	30.5	32.8	34.6	36.1

Ratio analysis - II

Y/e 31 Mar, Parent	FY11A	FY12A	FY13ii	FY14ii	FY15ii
Credit Quality Ratios (%)					
Gross NPLs as % of loans	0.5	0.4	0.4	0.4	0.4
NPL coverage ratio	93.8	68.0	70.7	73.6	75.6
Total prov charges as % avg loans	0.6	0.3	0.2	0.2	0.2
Net NPLs as % of net loans	0.0	0.1	0.1	0.1	0.1
Capital Adequacy Ratios (%)					
Total CAR	14.9	16.7	14.9	13.7	12.7
Tier I capital ratio	8.6	11.0	10.4	10.1	9.7

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
