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ANTIQUE

Small Housing Finance NBFCs
Small is indeed beautiful

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INITIATING COVERAGE

Small Housing Finance NBFCs

Small is indeed beautiful

The Housing Finance Companies (HFCs) continue to remain in a sweet spot given the multiple long term growth drivers - improving geographic reach, continued urbanization, affordable housing and emergence of Loan Against Property (LAP) as a retail product. Although banks and large HFCs compete aggressively in the salaried segment in urban areas, competition in non-metro areas and specifically the self-employed segment is limited. Niche HFCs such as Gruh Finance and Repco Home Finance have developed robust models to operate in the under-served markets. They are well poised to make market share gains and deliver strong earnings growth over FY13-16E and beyond. Initiate on Repco Home Finance and Gruh Finance with a positive stance.

Huge opportunity emanating from Urbanization, thrust on affordable housing and LAP

The opportunity size for housing financiers continues to remain large given the multiple growth drivers - i) Continued urbanization will ensure strong housing demand in tier-2 and tier-3 cities, ii) excessive slum development and housing shortage in urban areas resulting in increased thrust on affordable housing, which is a ~Rs6,500bn opportunity, and iii) emergence of LAP as a retail product. Players in this space could witness higher than system loan book growth over 2013-2020 as these mega trends translate into meaningful lending opportunities.

Ease of appraisal determines competitive intensity, room for niche players exists

Ability to assess the borrower's repayment capabilities and understanding the legal & practical aspects of the property being financed determines the ease of appraisal. Regular cash-flows make salaried individuals the easiest borrower class to appraise. Similarly, clear property titles in metro areas increase the ease of property appraisal. As such, commercial banks as well as large HFCs continue to focus on salaried segments in metro and urban areas. This leaves ample room for the niche HFCs like Repco Home, Dewan and Gruh Finance even in metro and urban areas, not to mention the low level of competition in tier-2 and tier-3 cities.

NHB refinancing to aid borrowing cost for niche HFCs

While access to the debt markets allows large HFCs to mobilize resources at competitive rates, niche HFCs have benefited from National Housing Bank's (NHB) refinance schemes. NHB runs various schemes under which it re-finances the banks and HFCs. Most of these schemes are formulated to encourage lending in semi-urban, rural areas and periphery of urban areas where ticket sizes are generally low. Given the increasing budgetary support for NHB and government's increasing thrust on rural and affordable housing, niche HFCs will continue to enjoy re-finance support from HFCs and control their borrowing costs.

Sector economics attractive, initiate with BUY on Repco Home & Gruh Finance

Secured nature of lending, favorable regulatory regime in terms of capital adequacy norms, liability support from NHB and large opportunity size has enabled most HFCs to deliver reasonable long term returns. In the medium term, we expect this sector to be the largest beneficiary of the rate easing cycle as well. Niche HFCs remain our preferred picks to play the sector. Aggression from banks and withdrawal of favorable regulations remain the key risks.

Recommendation Summary

	Reco	CMP (INR)	Target (INR)	P/E (x)		P/BV (x)		RoE	
				FY14E	FY15E	FY14E	FY15E	FY14E	FY15E
Gruh Finance	Buy	226	270	22.3	17.6	6.7	5.4	33.2	33.7
Repco Home	Buy	211	288	12.2	9.5	1.8	1.6	16.0	17.8

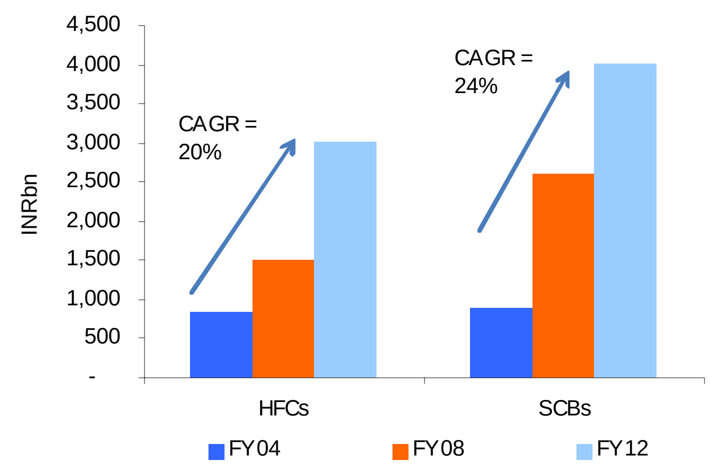
Source: Company, Antique

Aggression from bank to remain limited, room for niche players exists

Competitive dynamics have not changed meaningfully over past 10 years

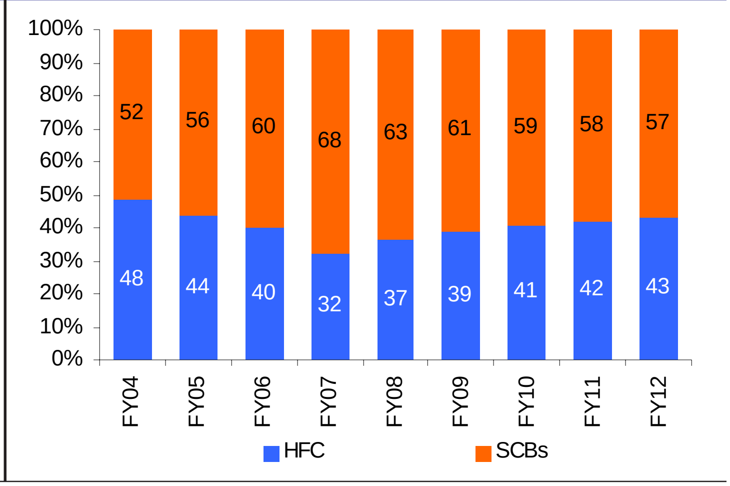
While the geographic penetration and absolute growth over the past 10 years have been nothing less than breath-taking, the competitive dynamics haven't changed meaningfully over the last 10 years. Outstanding home loans have grown at an impressive 22% CAGR over FY04-12 aided by rapid urbanization, sharp increase in property prices and improving geographic reach. However, market share of banks and SCBs haven't changed meaningfully over the period with HFCs maintaining their turf. Banks were especially aggressive in the housing finance space in 2004-2008 and gained significant market share from HFCs. Banks witnessed asset quality stress during the credit crisis of 2008-09 in this space and have gone slow since then while HFCs have steadily gained market share.

Strong loan book growth witnessed over the past decade



Source: NHB, Antique

HFCs regain their market share over the last 5 years



Source: NHB, Antique

Banks have traditionally competed on lower interest rates while housing finance companies have maintained their turf through better product offering and service quality over the life of the mortgage. Although HFCs have lost their pricing power vis-à-vis SCBs, especially amongst the salaried class in metro areas, they continue to enjoy dominance in the self-employed segment across geographies.

Ease of appraisal remains the driving force for all players......

The ease of appraisal in case of a housing loan depends on two factors - ascertaining the repayment capabilities of the borrower and assessing the legal & practical aspects of the property that is being financed. While regular cash-flows make salaried class the safest borrower class in terms of repayment capability, relatively clear property titles in metro areas increase the ease of property appraisal. As such, commercial banks as well as large HFCs continue to focus on salaried segments in metro and urban areas. This leaves a lot of room for the smaller housing finance players like Repco Home, Dewan and Gruh Finance even in metro and urban areas, not to mention the low level of competition in tier-2 and tier-3 cities.

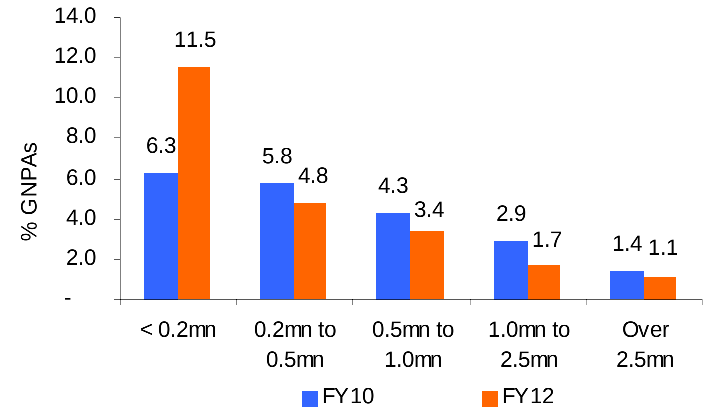
Loan book composition tilted towards salaried borrowers

	Salaried	Non salaried	Comments
HDFC	85%	15%	Government employees, private sector employees
LIC Housing	85%	15%	Mostly government employees, private sector employees in metro areas
Gruh Finance	60%	40%	40% is to government employees
Repco Home	50%	50%	Mix of government & non-government employees
Union Bank	80%	20%	Mostly government employees in non-metro areas

Source: Company, Antique

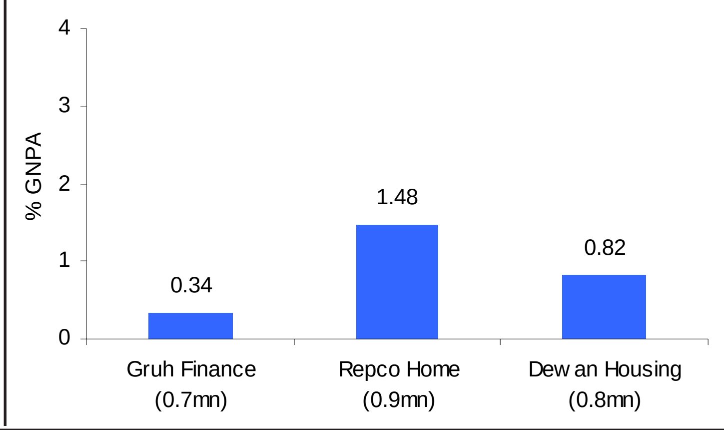
We believe that banks may not aggressively enter the non-salaried segment in urban areas or even the salaried segment in semi-urban areas given the risks associated with outsourcing appraisal to DSAs for such a segment. Banks widely use the DSA model for sourcing loans and rely on them for preliminary credit appraisal to some extent. Also, activities such as field investigation, property inspection & valuation and legal verification are outsourced by banks. That would significantly loosen the credit appraisal process in case the banks venture into non-salaried segment and semi-urban areas where property aspects are not homogenous.

Banks have witnessed stress in low ticket lending



Source: NHB

Niche HFCs have done reasonably well in low ticket lending



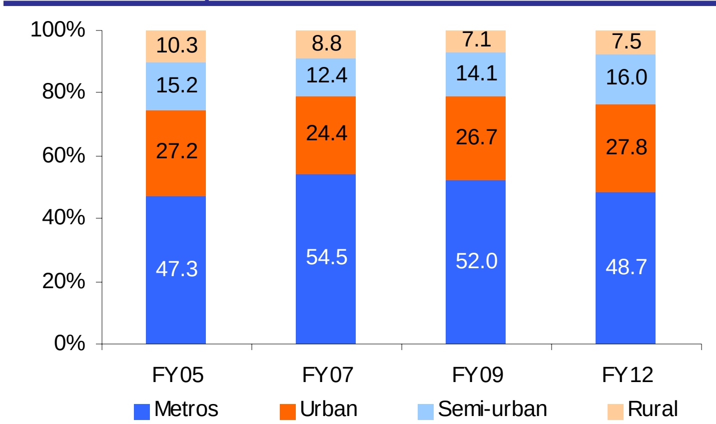
Source: Company, Antique

The aggression of banks over 2003-2007 was met by asset quality issues in the later years. Banks indulge in low ticket housing loans in to meet their priority housing requirements. These loans are generally doled out to non-salaried borrowers in non-metro areas. The asset quality performance of low ticket loans have been significantly below that in the higher ticket segment. Compared to this, niche HFCs like Gruh Finance, Dewan Housing and Repco Home have done reasonably well in controlling their NPAs despite smaller ticket sizes.

.... resulting in disproportionate focus on urban areas by SCBs and large HFCs

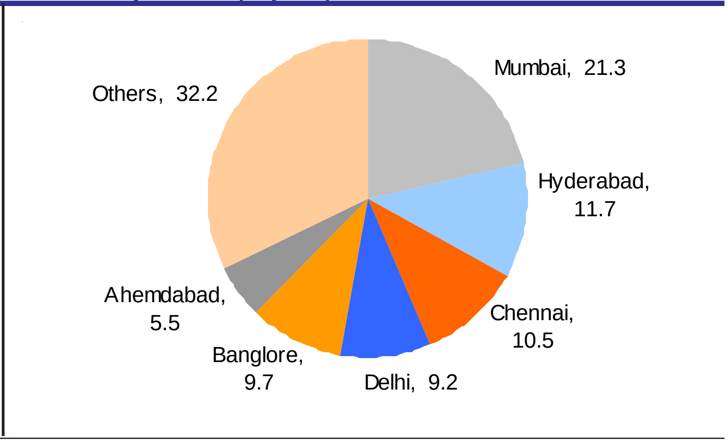
Except for the compulsions of priority housing, banks have largely focused on urban areas for growth and cater to salaried and professional customers who have banking access and a CIBIL footprint. While PSU Banks enjoy deep hinterland penetration, their organizational structure promotes non-agriculture retail asset products largely in the urban areas. As an illustration, Union Bank of India offers home loan products across all its 3000+ branches, but more than 50% of incremental home loans originate from its 57 specialized retail asset branches called Union Loan Point.

Metro & Urban areas continue to dominate banks home loan portfolio



Source: NHB

Top six cities constitute ~70% of SBI's home loan portfolio (Sep-12)



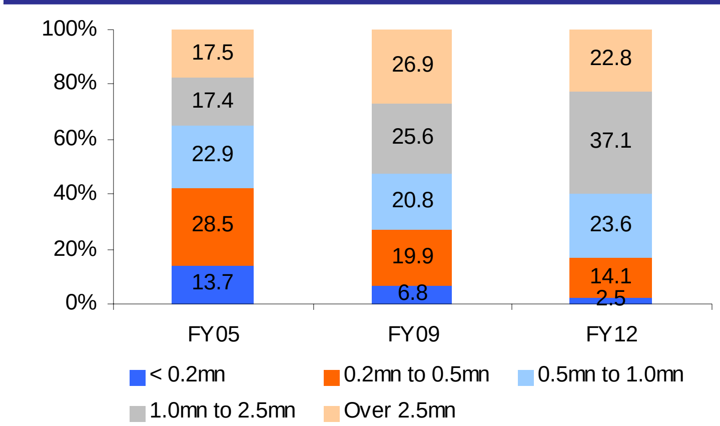
Source: Company, Antique

A large number of Private Banks operate under a similar structure where lending activity is done through retail asset centers located in urban areas. Branches of large private banks generally do not have sanctioning powers, except in case of standardized products like loan against gold or loan against shares. Thus the focus area for banks has largely been metro and urban areas. On the contrary, housing finance companies like HDFC, LIC Housing, Gruh Finance, Repco Home, etc have been able to go deeper to taluka levels either through their branch network or through referral programs. As an illustration, Gruh Finance has its branches at the district level in Maharashtra but has managed to penetrate 291 of the total 357 talukas through its referral associate program .

...and largely catering to high ticket, salaried customers

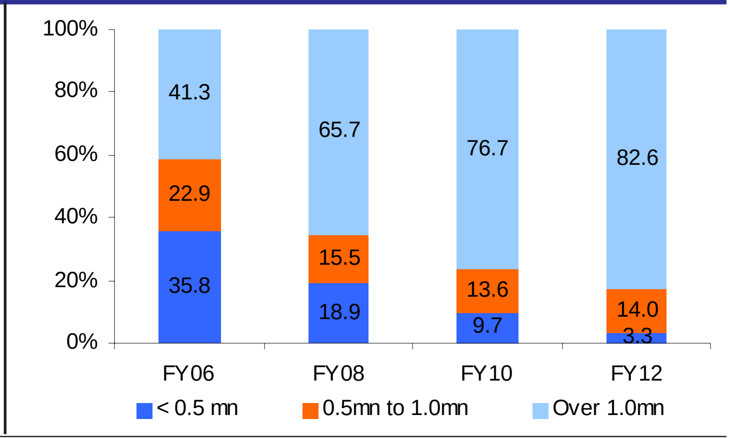
By the virtue of being largely present in metros and urban areas, the ticket sizes for banks and large HFCs such as HDFC and LIC Housing Finance have followed the rising property prices. As is visible from the charts below, share of housing loans below Rs1mn has declined from 64% of the total bank home loan portfolio in FY05 to 40% in FY12. We observe a similar trend among the housing finance companies as well.

Declining share of low ticket housing in SCB's loan book



Source: NHB, Antique

Declining share of low ticket housing in HFC disbursements too

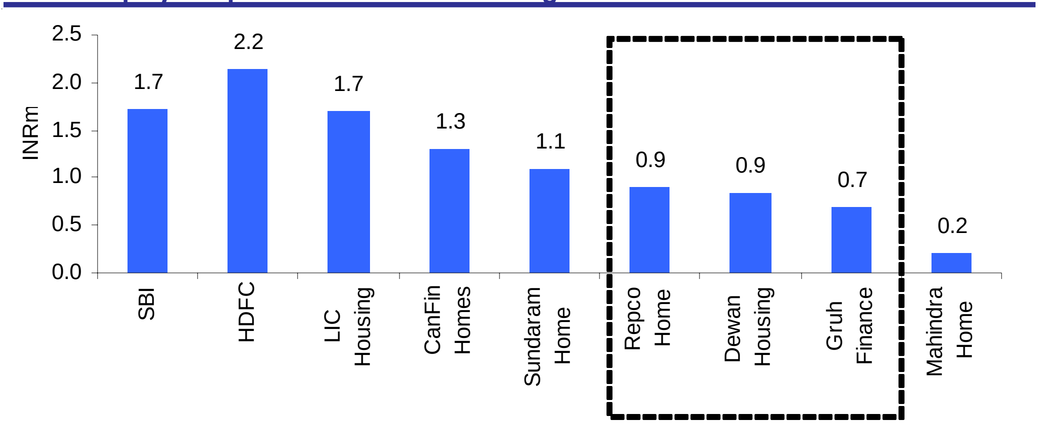


Source: NHB, Antique

......leaving the field open for niche HFCs in non-salaried and semi-urban

Disproportionate focus on urban salaried segment by banks and large HFCs has left the non-salaried as well as tier-2 and tier-3 market open to anyone who has the capabilities to operate in that segment. This segment is typically characterized by low ticket sizes and irregular cashflows. Smaller HFCs such as Gruh Finance, Repco Home, etc have operated profitably in this segment through their carefully crafted appraisal techniques and low cost operating model.

Few niche players operate in small ticket housing



Source: Company, Antique

However, we note that the loan portfolio of Niche HFCs is a mix of salaried, professionals and self employed, thus providing them adequate diversification. The incentive for the salaried segment to borrow from these niche HFCs at slightly higher rates are multiple - quick turnaround time, relaxation of certain criterion, better product customization, etc. We have come across instances of employees from reputed firms like TCS & Cognizant taking loans from niche HFCs at slightly higher rates vis-à-vis banks and large HFCs.

Master table on customer segmentation & competitive intensity

	Metro	Urban	Semi urban	Rural
Salaried	Very high	High	Moderate	No competition
Professionals	High	Moderate	Low	No competition
Self employed	Moderate	Low	Very low	No competition

Source: Antique

> "Many of the smaller HFCs are now emerging as important players in niche segments such as affordable housing, and have started making an impact in segments which were hitherto not receiving full attention from the bigger players. Therefore, various constraints notwithstanding, HFCs have been performing well during the last few years, expanding their customer base and housing loans portfolio while keeping their NPA levels under control" - **NHB trends and progress 2012.**

Competitive landscape in housing finance

	Presence	Target segment	Sourcing	Avg ticket size (INRm)	Average yields	Asset quality
SBI	Metro & Urban	Salaried & professionals	Largely DSAs	1.7	10.30%	NA
HDFC	Metro, Urban & Semi urban	85% customers are salaried	Branches, DSAs, HDFC Bank, distribution subsidiary	2.15	10.50%	0.70%
LIC Housing	Metro & Urban	88% customers are salaried	LIC agents, DSAs	1.7	10.40%	0.61%
CanFin Homes	Metro & Urban	Salaried & professionals	Branches, DSAs	1.3	11.00%	0.71%
Sundaram Home	Metro, Urban & Semi urban	NA	NA	1.3	NA	0.31%
Repco Home	Metro outskirts, Urban & Semi urban	47% customers are salaried, rest are self employed	Branches	0.9	12.00%	1.48%
Dewan Housing	Urban & Semi urban	Salaried & professionals	Branches	0.9	12.00%	0.70%
Gruh Finance	Urban, Semi urban Semi urban & rural	60% customers are salaried, rest are self employed	Branches & Referral associates	0.4	13.00%	0.32%
Mahindra Home	Semi urban rural	Mostly self-employed		0.2	16.00%	5%

Source: Company, Antique

NHB refinancing to aid borrowing cost for niche HFCs

The large HFCs that have deep access to the debt markets given their size and the parentage, thus making it easier for them to mobilize resources through debt markets. On the other hand, the niche HFCs traditionally relied on commercial banks and the National Housing Bank (NHB) for their borrowings. NHB runs various schemes under which it re-finances the banks and HFCs. Most of these schemes are formulated to encourage lending in semi-urban, rural areas and periphery of urban areas where ticket sizes are generally low.

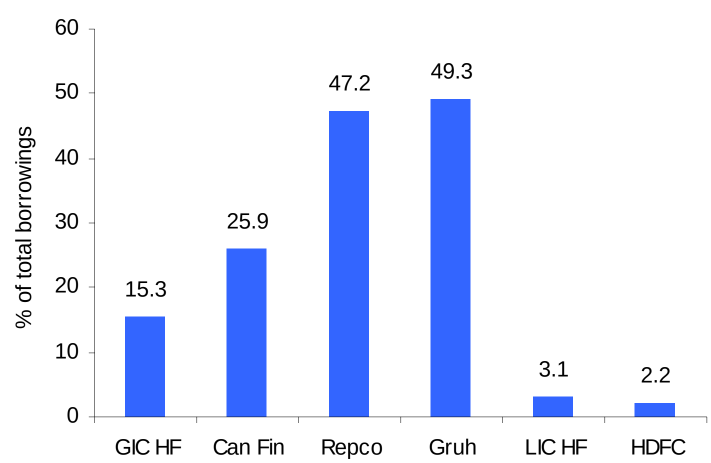
Refinance schemes by NHB

	Liberalized refinance schemes	Golden Jubilee Rural Housing	Rural Housing Fund	Energy efficient housing scheme	Urban Low Income Housing
Launch date	2002	1998	2008	2012	2012
Objective		Flagship scheme of NHB to refinance rural housing	Encourage housing to weaker sections, funds allocated from RIDF	Promote use of solar equipment in homes	Increasing credit flow to low income housing in urban areas
Disbursement		FY11: Rs37.8bn FY12: Rs26.1bn	FY12: Rs30bn FY13: Rs40bn FY14E: Rs60bn		
Till date: Rs108bn					
Loan size	Any Concessional rates to loans below Rs0.5mn	Less than Rs1.5mn	Less than Rs1.5mn	Upto Rs50,000	Less than Rs1.0mn
Location	Rural or Urban	Rural*	Rural*	Urban	Urban
Tenure	1 to 15 years	1 to 15 years	3yrs to 7yrs	1 to 15 years	5yrs to 15yrs
Interest rate	Floating or fixed	Floating or fixed	Fixed 6.5% (loans < Rs0.2mn) 7% (loans Rs0.2-0.5mn) 7.5% (loans Rs0.5-1.5mn)	Fixed	Fixed Spread cap of 250bps
Ultimate borrowers	Any	Any	Weaker sections	Any (efficiency certificate needed)	Annual income less than Rs0.2mn

*Rural area is defined as any village, including the area comprised in any town, the population of which did not exceed 50,000 as per the 1991 Census.; Source: NHB

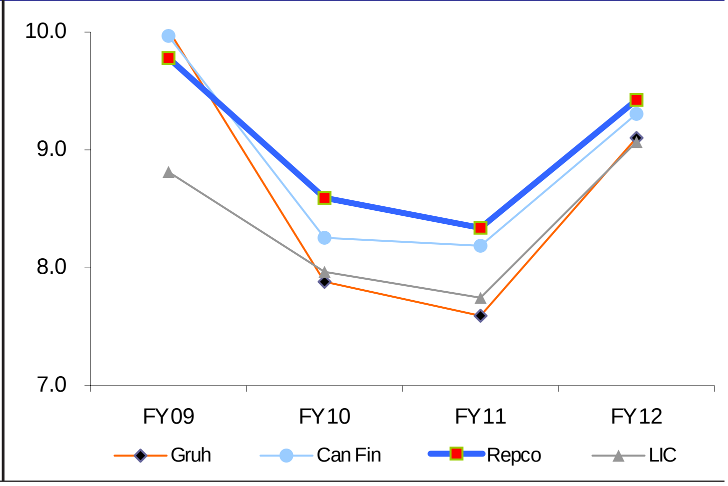
Given the design of the schemes, niche HFCs have been the disproportionate beneficiaries of the low cost funds released by NHB. Also, they aid in reducing the ALM mismatches on their balance sheets and eventually reduce cost of borrowings.

NHB funding constitutes major proportion of niche HFCs as on March 2012



Source: Company, Antique

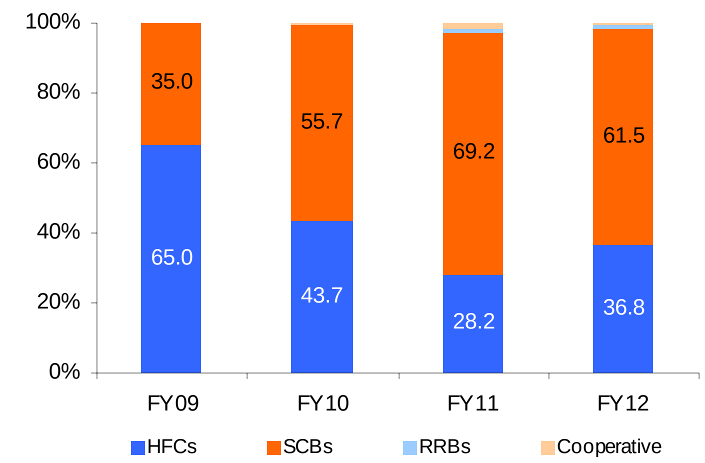
...resulting in borrowing costs similar to the larger peers



Source: Company, Antique

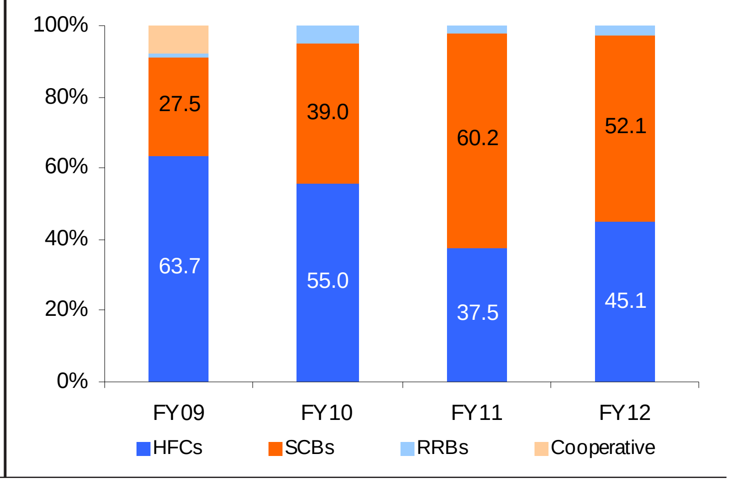
Over the past few years, Government's focus on affordable housing as well as rural housing has resulted in increasing budgetary support for NHB. We believe the same will continue in this decade given the continued housing shortage and slow progress in rural housing as well and auger well for niche HFCs such as Gruh Finance and Repco Home Finance.

SCBs get higher share of overall NHB disbursements…



Source: NHB, Antique

…however, HFCs have a better share in the low cost disburse ments (RHF + GJRHFS)



Source: NHB, Antique

The National Housing Bank (NHB) is planning to raise Rs 14,000 crore during 2013-14 for its operations, including a Rs 6,000 crore for the Golden Jubilee Rural Housing Finance Scheme, from the market. It is also expecting a long-term borrowing of $100 million from the World Bank in this fiscal that could be a part of this Rs 14,000 crore. The company expects its disbursement for the 2013-14 period to be at Rs 20,000-22,000 crore.

Summary of NHB re-finance operations

(INRbn)	FY09	FY10	FY11	FY12
NHB Disbursements - end user wise				
Housing Finance Companies	71	35	33	53
Scheduled Commercial Banks	38	45	81	89
Regional Rural Banks	-	-	1	1
Cooperative Sector	-	0	2	1
Total	109	81	117	144
NHB Disbursements - scheme wise				
RHF	18	20	20	30
GJRHRS	7	17	38	26
Regular schemes	44	44	59	88
Special refinance	40	-	-	-
Total	109	81	117	144
NHB - Loan book break-up				
Housing Finance Companies	101	110	110	129
Schedule Commercial Banks	56	78	102	143
Cooperative Banks	2	3	4	4
Other banks	2	3	4	5
Total	**169**	**198**	**226**	**285**

Source: NHB

Stringent processes - the key to niche HFC's strong asset quality

Niche HFCs have a well balanced portfolio of salaried, professionals and self-employed borrowers. Their operating models are designed to capture the complexities that are encountered in evaluating the repayment capacity of non-salaried individuals. Employee driven appraisal as well as recovery, primary research and lower LTVs and IIRs are the key differentiators compared to banks and large HFCs.

Key differences across player categories

	Banks & large HFCs	Niche HFCs
Sourcing	Branches and Direct Selling Agents (DSA's)	Largely employee based sourcing or referrals
Repayment capacity analysis	Salary slip & CIBIL record Field investigation, legal & technical evaluation is outsourced	Branch staff makes visits to employer, business premise and property to be purchased
Monitoring & recovery	Usually, credit team and origination is not involved in recovery	Same person involved in origination, appraisal, monitoring and recovery
LTV & IIR	Highest LTVs: 80% Highest IIR: 60%	Highest LTVs: 70% Highest IIR: 50%

Source: Antique

LAP could emerge as a high yield source of growth

For an average Indian household, a majority of his wealth (>70%) is embedded in his residential house, followed by gold and financial instruments. Except for the salaried & professional segment that is eligible for a home loan, car loan or a personal loan, organized retail lending in India is largely collateralized and happens against gold and property.

Despite the efforts towards financial inclusion, India remains a credit hungry nation. As an illustration, gold loans a product has been popularized over the last five years by the 3 large NBFCs - Manappuram Finance, Muthoot Finance and Muthoot Fincorp and they currently have more than 10 million loan accounts. This compares favorably with other bank driven retail loan products like car loans, education loans, etc.

High popularity of gold loans

	million
No. of bank accounts	~600
No. of individuals with bank accounts	~200
No. of home loans (banks + HFCs)	~3.5
No. of car loans (banks)	~3.7
No, of education loans	~1.8
No. of gold loans (Banks + NBFCs)	~21.3

Source: RBI, Company, Antique

Although loan against property (LAP) is a slightly trickier product on account of complications in property titles, valuation challenges, difficulty in re-possession and relative illiquidity of the asset vis-à-vis gold, we are already seeing early signs of traction in this market. Though housing finance companies are not very aggressive in this segment, other NBFCs and Banks have started getting aggressive in this segment.

LAP portfolio of select players

	Loans against property (Rs.mn)	% of overall portfolio
HDFC	76,500	4.5
Cholamandalam	43,369	22.8
Bajaj Finance	21,000	13.1
LIC Housing	17,000	2.2
Sundaram Home Finance	7,456	20.0
Repco Home Finance	5,310	15.0
Gruh Finance	2,268	4.2

Source: Company

Bajaj Finance estimates that the total size of the LAP product stand at Rs200bn as on December 2012, which is very small compared to the total value of property owned by individuals. We believe that LAP offers significant growth opportunities to the lenders. Niche HFCs, with their superior understanding of the local housing market will be in a strong position to benefit from this growth.

Currently, the NHB guidelines don't allow HFCs to have more than 25% of their portfolio in LAP. Also, LAP does not enjoy the reduced capital requirement enjoyed by small ticket housing loans. As such, we expect niche HFCs to grow only gradually in this segment.

Urban Affordable housing: A worthy opportunity for niche HFCs

Until very recently, affordable housing in urban areas has largely been a state subject with very limited participation from private sector. Continued migration from rural to urban areas has accentuated the housing shortage in the Economically Weak Sections (EWS) and Low Income Groups (LIG). Barring a few cities like Mumbai, progress has been limited and affordable housing has never translated to meaningful opportunity for the lending institutions.

Revised definition of affordable housing

	Definition of affordable housing	EMI or Rent
EWS	Minimum 300 Sq Ft Super Built Up Area	Not Exceeding 30 to 40 percent of monthly income of buyer
	Minimum 269 Sq Ft Carpet Area	
LIG	Minimum 500 Sq Ft Super Built Up Area	
	Minimum 517 Sq Ft Carpet Area	
MIG	600-1200 Sq Ft Super Built Up Area	
	Minimum 861 Sq Ft Carpet Area	

Source: Guidelines of affordable housing in partnership, MHUPA, 2011

The policy response to the slow pace of progress has been rather encouraging - the first urban focused housing policy was formulated in 2007 and was further refined by laying huge emphasis on public private partnership, which is our opinion is the tina factor for realizing the goal of affordable housing. Rajasthan's model of public private partnership has already witnessed initial success and other large states such as Gujarat and Andhra Pradesh are likely follow suit. The Rs6,500bn urban affordable housing opportunity could gradually translate into meaningful business opportunities for the niche HFCs given their expertise in the un-organized segment.

Housing shortage for real

The strong economic growth witnessed over the past two decades has resulted in accelerated migration of rural population to urban areas. As per latest census, 31.2% of India's total population resides in cities, up from 27.8% in 2001. Urban development has not kept pace with this migration and resulted in land shortage, congestion and slum development in most cities.

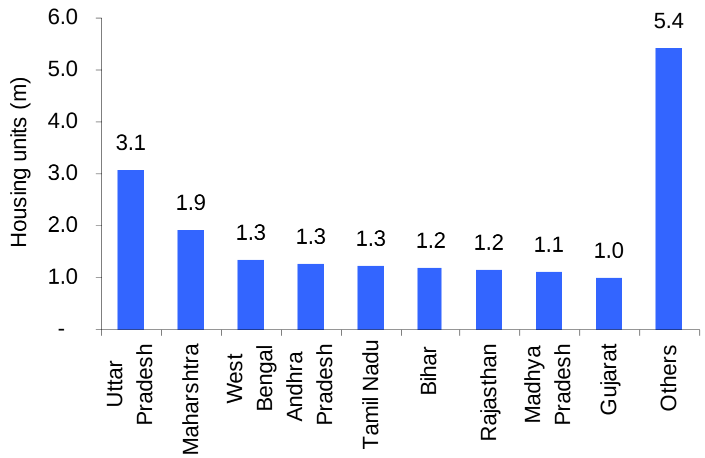
Urban housing shortage - huge investments required

	Units (mn)	Cost per unit (INR)	Total Cost (INR bn)
Families living in dilapidated houses	2.3	350,000	793
Families living in kutcha houses (includes slums)	1.0	350,000	346
Families living in congestion (includes slums)	14.9	350,000	5,211
Families without homes	0.5	350,000	185
Need for fresh housing units	18.7	350,000	6,545

Source: Report of technical group on urban housing shortage 2012-2017, NHB report on trends and progress FY12

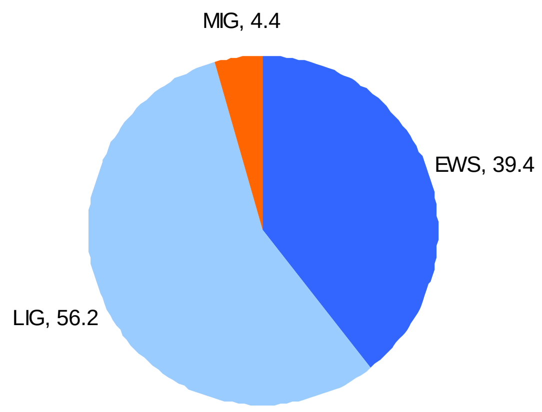
According to estimates of the Technical Group constituted by Ministry of Housing and Urban Poverty Alleviation, the urban housing shortage at the end of 11th five year plan was estimated at 18.7 million units. Approximately 95% of this shortage pertains to the EWS and LIG group while top 10 states account for more than 75% of this shortage.

Ten largest states contribute > 75% of the urban housing shortage



Source: Report of technical group

Majority of the shortage pertains to the EWS and LIG group



Source: Report of technical group

Historical experience in urban affordable housing not too encouraging

Affordable housing projects were largely undertaken by the states through their respective housing boards such. However the pace as well as quantum of projects undertaken are grossly insufficient to cater to the burgeoning demand. Due to absence of policy level support, private developers too have largely stayed away as land prices and higher input costs in urban areas have made the affordable housing segment unprofitable. Some of the affordable housing projects in that have been completed in the urban areas are:

Affordable housing projects across various cities

Developer	City	Locations
CIDCO	Navi Mumbai	Ulwe, Ghansoli
MMRDA	Mumbai	Borivli, Powai, Jogeshwari
Tata Housing, HDIL, Neptune Group, Poddar Developers	Mumbai	Ambivali, Karjt, Palghar, Boisar
Santosh Associates, Foliage, Galaxy Developer	Ahemdabad	New Maninagar, Narol, Vatwa
Ashray Homes, Surefin Builders, Avalon Group	Delhi (NCR)	Bhiwadi, Bawal

Source: JLL, NHB

Most projects constructed by private developers are on a commercial basis and the unit cost is below 10-15Lacs due to the prevailing low market rates in those localities and not because of any form of subsidy or support from government. The key reasons why affordable housing never kicked off in a big way are:-

- Acquisition of land at affordable prices in urban areas have been a big challenge
- Inadequate support infrastructure including water, electricity, drainage, schools, roads, etc at distant locations where affordable housing is economically feasible
- Lengthy approval process, no local body support in terms of lower stamp duty and taxes
- Strained state finances never allowed enough headroom for affordable housing

Policy initiatives gravitating towards better implementation of affordable housing

Housing shortage in India has been perennial and Indian regulators have formulated numerous housing policies for the delivery of affordable housing for the Economically Weak Sections (EWS) and Low Income Groups (LIG). The first National Housing Policy was formulated in 1988 and was followed by multiple interventions from the public sector and it finally culminated to the National Housing & Habitat Policy (NHHP) in 1998. It marked a landmark change in the approach towards affordable housing, where the role of public sector would increasingly be that of a facilitator while implementation would largely rest on other stake holders including private developers, multi-lateral agencies and financiers.

Key policy developments in the hosuing space

1998	**National Housing and Habitat Policy (NHHP)** (Envisaged public sector as a facilitator and not the sole promoter)
2007	**National Urban Housing and Habitat Policy (NUHHP)** (First national level policy on urban housing) (Emphasis on public private partnership)
2009	**Affordable Housing in Partnership** (Defining contours of public private partnership) (Focus of state on building support infrastructure)

Source: Govt. of India

While these policies were generic in nature, the need for focused urban policy resulted in formulation of National Urban Housing and Habitat Policy (NUHHP), 2007. The policy has identified affordable housing for all as the key focus area and emphasizes on various types of partnerships between public, private, cooperative and institutional sectors to attain its objectives. Identifying that land acquisitions and providing incentives to private developers is the key enabler for affordable housing in urban areas, the policy have been refined to incentivize public private partnership under the banner *"Affordable Housing in Partnership - 2009"*.

Policy on Affordable Housing in Partnership, 2009

The scheme puts the onus of land acquisition on the States/ULBs and incentivizes private developers with their own land through additional FAR/TDR. The role of Centre would be to provide for 25% of the cost of provision of civic services for affordable housing projects to the tune of Rs50bn. Other key features of the policy are:

- Costs of land can be intermediated by attracting private developers to build on their land, by granting incentives such as land use conversion, extra FAR, etc
- Stamp duty costs should be a maximum of 2% for LIG and 0% for EWS.
- A tripartite agreement between borrower, bank and development agency should enable facilitation of loan procedures for the individual.

The scheme targets the heart of affordable housing - land acquisition, faster clearances and incentives for private developers. Implementation of this policy has been adopted by Rajasthan and other states such as Andhra Pradesh and Gujarat are in various stages of implementation. The latest trends & progress report of the National Housing Bank also vindicates the same - 'The Rajasthan model for public private partnership has proved to be successful and now other states are also trying to formulate their own policies'

Rajasthan - at the forefront of affordable housing in partnership

The state of Rajasthan was amongst the first to announce its affordable housing policy in partnership in 2009. Apart from the general benefits that accrue to an affordable housing project, there are incentives for private developers under three different models.

Policy objectives

- To develop 125,000 affordable houses over five years
- About 75,000 houses to be constructed for EWS, LIG and MIG through PPP model
- Selling prices of EWS at Rs2.4Lac and LIG at 3.75Lac

Incentive to developer

- Extra incentive of 0.5 TDR / FAR on timely completion
- Additional FAR to the developer, resulting in double FAR
- Un-utilized FAR to be given in the form of TDR
- Zero cost of agricultural land use conversion and building plan approval
- Responsibility of external development on ULBs / state

Incentive to buyer

- Stamp duty - LIG - Rs25 per flat
- Stamp duty - EWS - Rs10 per flat (8% earlier)
- Interest subsidy of 5% under ISHUP scheme

Financing arrangements for buyer

- Tri-partite agreement between Avas Vikas Limited (AVL)-Banker-Beneficiaries.
- In case of a default, possession of flat will be taken over by ULBs & re-allotted to next beneficiary

Public partnership model - inventive structure

Development model	Salient features	Reservation
PPP Model 1 (Private developers on private land)	- Land is to be identified and acquired by developers - Realization from sale of all houses & commercial property to accrue to developer - Developer responsible for internal development - ULBs responsible of external development	EWS / LIG : 40% MIG, HIG: 50% Commercial: 10%
PPP Model 2 (Private developers on acquired land)	- ULBs will acquired land and transfer to developer at (cost + 10%) - Realization from sale of all houses & commercial property to accrue to developer - Developer responsible for internal development - ULBs responsible of external development	EWS / LIG : 40% MIG, HIG: 50% Commercial: 10%
PPP Model 3 (Private developers on government land)	- ULBs will transfer land free of cost - Realization from MIG-B and HIG to go to the developer - Developer responsible for internal development - ULBs responsible of external development	EWS / LIG : 80% MIG, HIG: 20% Commercial: 0%

Source: Company, Antique

Progress made in PPP Model 1

- Phase 1: Work on 14 projects spread across 8 towns having more than 14,000 houses started in 2010-11
- Phase 2: Application and approval for 24 projects spread across 13 towns for more than 14,000 houses closed in Feb-13

Progress made in PPP Model 3

- Work started on more than 3,500 houses in Jodhpur and Kota. Houses to be used for rental housing
- Land identified in more than 50 towns

Case study: Financing opportunities at Bhairav Township, Jaipur

This township with 4,000 units is being developed 20kms from Jaipur city by Bhairav developers under supervision of Jaipur Development Authority. Project marketing, invitation for applications and flat booking is done by Avas Vikas, the nodal agency while the peripheral project infrastructure is undertaken by Jaipur Development Authority. The typical flat size would be 325sq.ft. and 500sq.ft. and construction of phase 1 is about to be completed in 2013. Some of the flat buyers in this township who have availed loans from an HFC are:

Sample borrw profiles at Bhairav township

	Borrower 1	Borrower 2	Borrower 3	Borrower 4
Occupation	Scrap dealer	Electric spares & repairing services	Medical shop	Kirana shop
Current residence	Single room for 4 people	17 people joint family	Bhatta Basti slum	12 members in an apartment
Monthly income	INR15,000	INR20,000	INR25,000	INR17,000

Source: Company, Antique

The above illustrations highlight the fact that pockets of opportunities exist in the affordable housing space. We also note that housing units in the phase 2 could be priced 50% to 100% higher i.e. Rs500,000 to Rs800,000 which increases the financing opportunity.

Other states following suit could offer huge opportunity

Andhra Pradesh has announced its own affordable housing policy while Gujarat is in the process of formulating its policy. While the implementation will be a gradual process, it will surely open new doors for financial institutions, mainly the niche HFCs over the next 10 years.

Rajiv Swagruh scheme, 2007 - Andhra Pradesh's affordable housing scheme

- Aims to develop 175,000 houses across 98 municipalities
- To serve people with monthly income of Rs6000 to Rs25,000
- Selling prices to be in the range of Rs1,635 to Rs2,500 per sq feet, which is approximately 25% lower than market prices
- 100% waiver of fees & other charges including stamp duty for EWS beneficiaries

Aadhar could ease appraisal and collection costs for financiers

UIDAI aims to issue Aadhaar numbers to ~600 million residents or ~50% of India's population in its first phase (FY11-FY14) and intends to set up an online biometric authentication service that will help in improving the delivery of financial services. Although it is too early to portend the extent of implementation and acceptance of Aadhaar systems by various stakeholders, some of the possible benefits for housing finance companies could be

- Ease of preliminary credit check though biometric authentication service
- Micro ATMs and collection systems envisaged in Aadhaar could lower collection costs in the low income segment.

Budget announcements in support of small ticket housing (FY12-13)

- ECBs to the tune of US$1bn allowed for low cost affordable housing projects. Also, the rate of withholding tax on interest payment on ECBs was reduced to 5% from 20% earlier on exposure to affordable housing sector.
- Credit Guarantee Trust Fund will be set up to ensure better flow of institutional credit for housing loans.
- Provisions under Rural Housing Fund have been enhanced from Rs40bn to Rs60bn.
- The limit of indirect finance under priority sector enhanced from Rs0.5mn to Rs1.0mn.
- Investment linked deduction of capital expenditure incurred in the Affordable Housing businesses enhanced to 150% from 100% earlier.

Key Risks for niche HFCs

Withdrawal of the favorable regulatory regime

Housing Finance Companies have enjoyed a favorable regulatory environment in terms of provisioning norms, capital adequacy requirements, lower risk weights and liability side support from NHB. In the past, we have seen the regulator tightening the provisioning norms on standard assets as well as NPAs. There have also been multiple occasions in the past where regulator has toyed with the idea of increasing the tier 1 requirement from the current 6% to 10%. Such a move could adversely affect the return ratios for all HFCs. We believe that regulations will continue to be benign given that housing continues to be a key focus area for the government. Nonetheless, we remain watchful of the same.

Excessive competition from private banks

Time and again, the banking regulator has heavily clamped down on banks for not meeting their priority sector lending targets. Couple of regulatory guidelines that have been effected in the past two years could force banks to seriously consider investing resources in meeting their priority sector targets. As an illustration, private banks have been forced to open 25% of branches in under-banked areas. Also, pool buy-outs or onlending that can qualify as priority sector lending has been capped at 5% of the banks ANBC. The new banks that will emerge in FY15 will have no relief on priority sector targets. At some point in time, private banks could become aggressive in semi-urban and rural areas and housing finance could be their preferred route. This could pressurize spreads for HFCs, which is the key determinant of their profitability.

We note that we are not seeing signs of such excessive competition in non-metro markets. The banking system's housing loan portfolio (<2.5mn) grew at CAGR of 8% over FY10-13, which is much lower than system loan growth.

Current Reco	:	BUY
CMP	:	INR228
Target Price	:	INR270
Potential Return	:	18%

INITIATING COVERAGE

Gruh Finance Limited

Master of hinterland financing

Gruh Finance Limited (Gruh), a subsidiary of HDFC, has many firsts to its credit, including the tag of being the most expensive stock in the Indian financial space in terms of price-to-book. Gruh has been the pioneer at financing India's non-urban housing landscape in Gujarat and Maharashtra and in the process, developed best-in-class business practices that include the combing growth model, the referral associate program, digital collection centers and peerless asset quality performance. While its historical financial performance is a reflection of these strengths, its well entrenched business model and relentless focus on its target segment leads us to believe that market share gains will continue to accrue over FY13-20E and earnings growth could surprise positively.

Our residual income analysis suggests that current stock price captures earnings growth of ~18% over FY13-35E and market share gain of more than 400bps, a feat we believe is not entirely unattainable. Its parent, HDFC and HDFC bank have posted far superior growth over past 15 years on a much higher base. In our opinion, Gruh is at a similar stage and its ability to profitably capitalize on the multiple opportunities in the form of penetration in newer states and an uptick in the INR6,500bn affordable housing segment could result in long period of super-normal earnings growth. Initiate with BUY and value the stock at INR270/share, discounting FY15E book value by 6.3x (21x EPS).

Opportunity size large, pressure on yields to be minimal

Given that ~31% of India's population resides in urban India, growth opportunities will emerge from affordable housing in existing urban areas and new housing requirement in tier-2 and tier-3 towns as urbanization accelerates. Gruh's focus on under-served borrowers will aid strong growth and stable yields over FY13-20E.

Lean operating model, asset quality control at the heart of super-normal profitability

New branches inevitably start with a two member team, small carpet area and basic technology set-up. Sourcing through the referral associate network, system driven loan management and negligible proportion of cash collections culminates to a low cost operating model. Involvement of full time employee across the loan life cycle, system driven approach, cluster based sanctions, and incentive structure linked to portfolio performance builds in strong asset quality control. Gruh's GNPA as on March 2013 stands at 0.32%, the lowest amongst housing finance companies.

Valuations reflect the uniqueness of business model, maintain BUY

Earnings CAGR at 28% over FY10-13 coupled with +30% RoEs has resulted in steady re-rating of the stock, with its 1 year forward book multiple expanding from 3x in FY11 to 8x in FY13. We believe that Gruh Finance is well poised to deliver earnings growth in excess of 20% for a very long time. Initiate with a BUY and assign a price target of INR270/share based on residual income analysis.

Key financials

INRm	FY11	FY12	FY13	FY14E	FY15E	FY16E
Net interest income (INRm)	1,401	1,757	2,146	2,861	3,650	4,657
Net Profit (INRm)	915	1,205	1,459	1,828	2,310	2,914
EPS (INR)	5.2	6.8	8.2	10.2	12.9	16.3
BV (INR)	18.1	21.8	27.5	34.2	42.6	53.1
P/E (x)	43.8	33.4	27.9	22.3	17.6	14.0
P/BV (x)	12.6	10.4	8.3	6.7	5.4	4.3
RoA (%)	3.1	3.2	3.0	3.0	3.0	2.9
RoA (%)	31.4	34.3	33.3	33.2	33.7	34.1

Source: Company, Antique

Market data

Sensex	:	19,429
Sector	:	NBFC
Market Cap (INRbn)	:	41
Market Cap (USDbn)	:	1
O/S Shares (m)	:	179
52-wk HI/LO (INR)	:	250/132
Avg Daily Vol ('000)	:	46
Bloomberg	:	GRHF IN

Source: Bloomberg

Valuation

	FY14e	FY15e	FY16e
EPS (INR)	10.2	12.9	16.3
PE (x)	22.3	17.6	14.0
P/BV (x)	6.7	5.4	4.3
RoA (%)	3.0	3.0	2.9
RoA (%)	33.2	33.7	34.1

Source: Bloomberg

Returns (%)

	1m	3m	6m	12m
Absolute	10	10	8	66
Relative	13	10	8	42

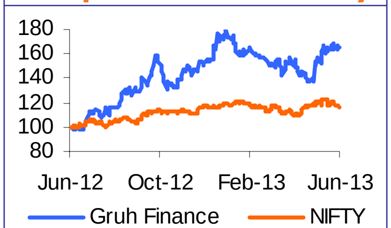
Source: Bloomberg

Shareholding pattern

Promoters	:	60%
FII	:	14%
DII	:	1%
Others	:	25%

Source: Bloomberg

Price performance *vs* Nifty



Source: Bloomberg

Relentless focus results in unmatched understanding of small ticket housing

Key differentiator 1: Consistent focus on yields over growth

Despite having a hinterland focus, Gruh has battled competitive pressures multiple times over the past decade, especially in urban areas. Back in 2006, ICICI Bank aggressively doled out home loans at 7% and a host of other banks followed suit. However, Gruh maintained its product pricing around 11% despite the competition in cities like Baroda, Ahmedabad and Mumbai. Competition surged its head again in 2009 when SBI launched its teaser rate products at 8% and Gruh preferred to slow down its lending growth to 18% in order to maintain home loan pricing at 12% levels.

Gruh's clear strategy is that loan pricing acts as a natural filter. Only those customers will opt for loans from Gruh who are insensitive to slightly higher interest rates. Service quality in terms of turnaround time, transparency and presence in under-served markets act as the key differentiators that enable it to charge high yields vis-à-vis larger HFCs. As an illustration, turn-around time for a salaried individual is just 3 days.

Key differentiator 2: Geographic expansion through combing model

Often associated with military operations, the word combing has been well imbibed in Gruh's growth strategy. Gruh Finance would typically follow a strategy where new branch is opened at district or taluka closest to the existing branch. Multiple benefits of this strategy include 1) solid understanding of local area dynamics, 2) ease of operations in terms of transportation and logistics at the time when technology was not very advanced, and 3) gaining a large market share in the local area before expanding to another area.

Although this strategy results in relatively slower branch growth, it allows the branch to obtain solid understanding of local area dynamics and to build robust operating processes. As an illustration, Gruh Finance took 20 years to penetrate every district and taluka of Maharashtra. The company continues to follow a similar model in South India, where it entered in the second half of the last decade. The progress in terms of loan book accretion is currently slow but is expected to pick up once it consolidates its position in those areas.

This strategy has resulted in best-in-class asset quality despite operating in segment perceived risky by most other players. We note that Gruh has negligible net NPAs since the last seven years and its historic credit losses have been a mere 10bps.

Key differentiator 3: Penetrating deeper through the innovative referral associate model

Devastated by earthquake, 2001-03 was a black period for Gujarat's real estate sector too as permission for new construction were hard to come. Around the same time, ICICI Bank entered the home loan market aggressively and host of other banks followed suit across the country. Given Gruh's priority of maintaining yields over volumes, growth slowed down considerably. Gruh started to explore alternative sourcing models in addition to the existing branch employee based sourcing.

Having closely watched the disconnect between the sanctioning officer and customer in case of the DSA model that was widely followed by banks, Gruh stayed away from it. Instead, it introduced the referral associate program, where the only task of a referral associate is to pass on the leads to a Gruh employee. Credit appraisal, monitoring and recovery are the complete responsibility of Gruh's branch employee. A referral associate can be anyone - Gruh's own public deposit seeking agents, agents of other NBFCs, freelancers, etc. These referral associates are given incentives based on their loyalty and the quantum of business they refer.

Currently, referral associates account for 60% of the total value of Gruh's home loans. It has also helped in expanding reach without opening a branch at the taluka level, thus minimizing operating costs. As an illustration, despite having only 40 branches in Gujarat, Gruh is present in almost all the 225 talukas.

Key differentiator 4: Inculcating banking habits to minimize collection costs

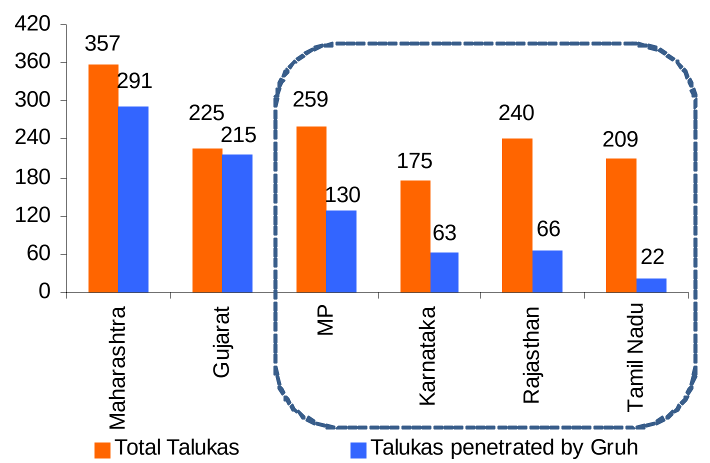
Monthly collection is the single most challenging aspect faced by hinterland financers due to preference of cash or general lack of banking habits among its customers. Imagine if Gruh's employee force of 500 have to spend time in collecting monthly payments from over 70,000 customers scattered across 600 talukas!

Gruh has consciously pushed its customers to route repayments through the banking channels. Majority of collections are managed by taking post dated cheques (PDCs) for twelve months and replenishing the same at the end of twelve months. It also established a network of collection centers i.e. it enters into tie-ups with banks having wide rural network and instructs borrowers to deposit cash into collection accounts at nearest branches of those commercial banks. Cash collections constitute less than 5% of total collections and only few branches are allowed to collect cash.

Target markets large, disproportionate beneficiary from possible thrust on low income housing

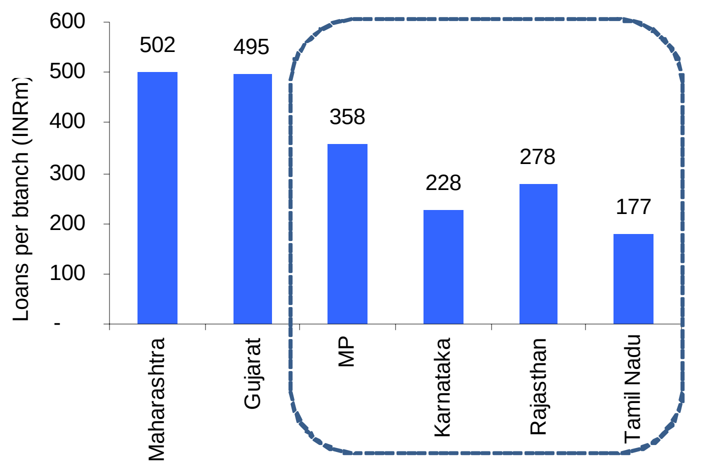
Growth strategy for Gruh Finance has been synonymous with the combing model. A large part of 1998-2007 was spent in penetrating the interiors of Gujarat and Maharashtra district after district and taluka after taluka. Around 2002-03, it also started developing the referral associate network, that helped in penetrating talukas without actually having to open a branch. Post 2005, it ventured into Madhya Pradesh, Rajasthan and Karnataka with a similar strategy and later in Tamil Nadu and Chattisgarh in 2008. This strategy has aided strong loan book CAGR of 26% over FY06-13.

Huge scope for penetration driven growth in most states…



Source: Company, Antique

Scope for operating leverage from Karnataka, Rajasthan and Tamil Nadu



Source: Company, Antique

As evident from the charts above, penetration levels in states other than Maharashtra and Gujarat (which still contribute ~75% of loan book) are low. Also, business per branch in other states is significantly lower than those in Maharashtra & Gujarat, and offer scope for operating leverage. We believe this is typical to the Gruh model of spending adequate time to develop local capabilities before embarking on a strong growth path. The housing markets of Karnataka and Tamil Nadu are large markets and offer significant growth opportunities for Gruh Finance.

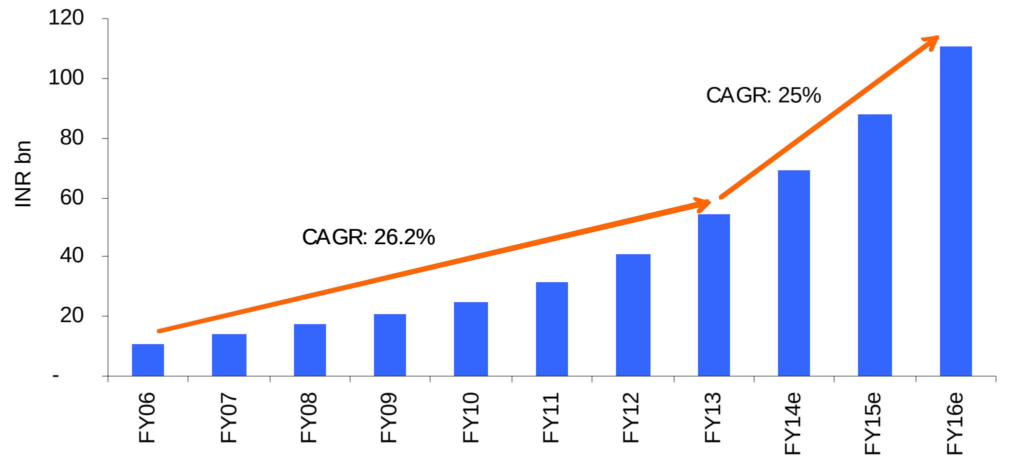
Huge growth potential in existing geographies

	Branches	Gruh's Loan book (INRm)	Annual HFC disbursements (INRm)
Maharashtra	41	20,574	172,870
Gujarat	40	19,791	33,750
Madhya Pradesh	18	6,437	17,420
Karnataka	14	3,186	61,290
Rajasthan	9	2,506	22,120
Tamil Nadu	5	886	108,670

Source: Company, Antique

Although not an unexplored segment for Gruh Finance, affordable housing could pick up meaningfully over the next 10 years given that policy and stakeholders are now getting increasingly aligned. State of Rajasthan has already announced a detailed policy on developing affordable homes and successfully implemented the first phase. NHB pegs the affordable housing opportunity at +INR6,500bn and Gruh's dominance in non-metro regions will augur well to capture such opportunities as and when they come. Secular growth in non-metro housing market, large scope for increasing geographic penetration and opportunities in the affordable housing space would enable Gruh to make market share gains for a long time. We build in loan book CAGR of 25% over FY13-16E.

Strong loan book growth to continue

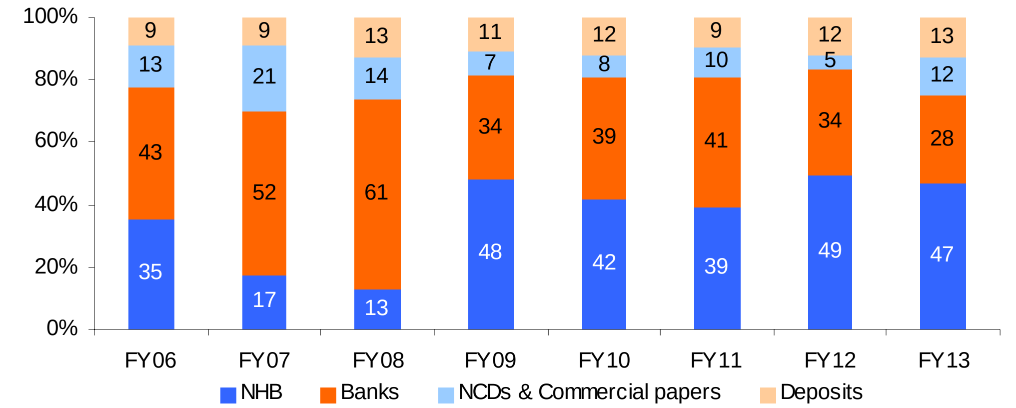


Source: Company, Antique

Best-in-class liability profile to aid spreads

Given its long track record, profitability profile and strong parentage, Gruh Finance has a well diversified liability profile. Public deposits, commercial banks, refinance from NHB and NCDs are the main sources of funds. Given than more than 45% of disbursements continue to happen in areas where population is below 50,000, Gruh will continue to be the disproportionate beneficiary of low cost NHB refinancing.

Well diversified liability profile



Source: Company, Antique

As on March 2012, Gruh Finance has the largest proportion of NHB funding vs. its peers. It continues to have the lowest ticket size among the peers and the average ticket size of incremental disbursements is ~0.7mn, which is significantly below the NHB cap of Rs1.5mn of ticket size eligible under low cost rural housing schemes. As such, we expect the benefit from NHB refinance to continue over FY13-16e.

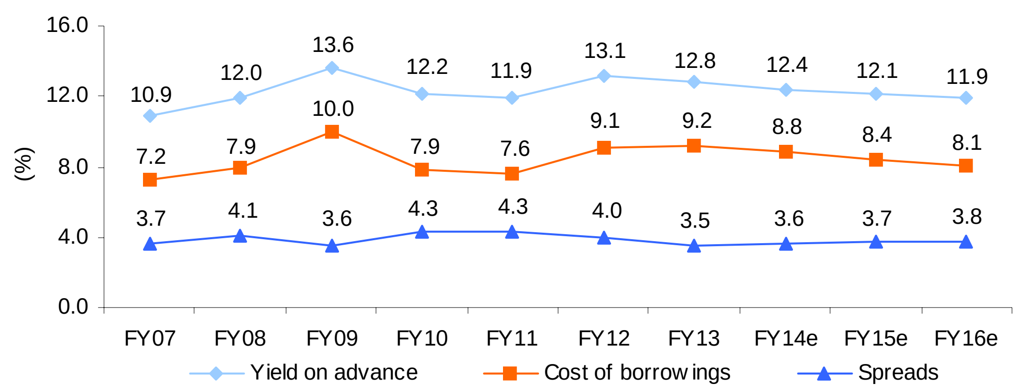
Highest proportion of NHB borrowings (FY12)

	GIC HF	Can Fin	Repco	Gruh	LIC HF	HDFC
NHB borrowings (% of total)	15.3%	25.9%	47.2%	49.3%	3.1%	2.2%
Avg ticket size (INRm)	NA	1.3	0.9	0.7	1.7	2.1

Source: Company, Antique

Gruh enjoys AA+ credit rating for most of its instruments and bank facilities. It public deposits program now enjoys AAA rating from CRISIL and ICRA, the highest rating awarded to a financial company of such a small size. Most of the banks lend at base rates to Gruh Finance, thus aiding it to lower its borrowing costs. Advantage on the borrowing cost front coupled with strong yields have aided Gruh Finance in maintaining its spreads above 3.5% across cycles and will continue to do so over FY13-16E. Ability to borrow through the ECB window, given that Gruh is now in conformation with the networth criterion, could result in some more cost benefit.

Spreads to remain healthy



Source: Company, Antique

Asset quality control & lean operating structure - the cornerstone of super normal profitability

Employee based customer servicing

Given the customer segment and the geographies where it operates, Gruh follows an employee based servicing model where in a full time employee is involved in credit appraisal, documentation, monitoring and recovery. In case of leads generated by the referral associate network, a Gruh employee is completely responsible for servicing the customer. This ensure superior service quality as well as strong asset quality control as employee incentive is linked to the business generated as well as the performance of those loans.

Credit scoring model based pricing

Gruh has developed its own internal credit scoring model which calculates the borrower's credit score based on 21 different inputs. The model captures the income generating capability, spending patterns and historic credit behavior, if any for each of its customer classes - salaried, professionals and self-employed. The pricing is designed to price the risk within each customer class. These inputs are captured by the branch executive through field visits to the residence & workplace of the borrower and through the personal interview.

Product card

Product	Description	Interest rate	% of total book
Suraksha	Loans to salaried & professionals	Competitive	60%
Suvidha	Loans to professionals & self employed	Risk based	30%
Sajavat	Loans for repair & renovation	Higher than home loans	1%
Samruddhi	Loans for office premise for business	Higher than home loans	4%
LAP - Housing	Loan against property	Risk based	2%
LAP - Commercial	Loan against property	Risk based	3%

Source: Company, Antique

System based approach, sanctioning powers not with branch

Every aspect of Gruh's business passes through its internal loan management system, which acts as a check-point at every stage of the sanction and monitoring process. Every stage of the loan process - scanned documents, field investigation report, other inputs from personal interview, etc are captured in the system. The branch manager as well as the area, regional and the head office have real time access to the system.

Except for a few senior branch managers, sanctioning powers are mostly with the area office. This acts as a maker-checker system where branch prepares the application and recommends the borrower while the sanctioning authority gives the final approval, post which the branch disburses the loan amount. Larger ticket size loans go to the head office level for approval.

Collections and recovery model

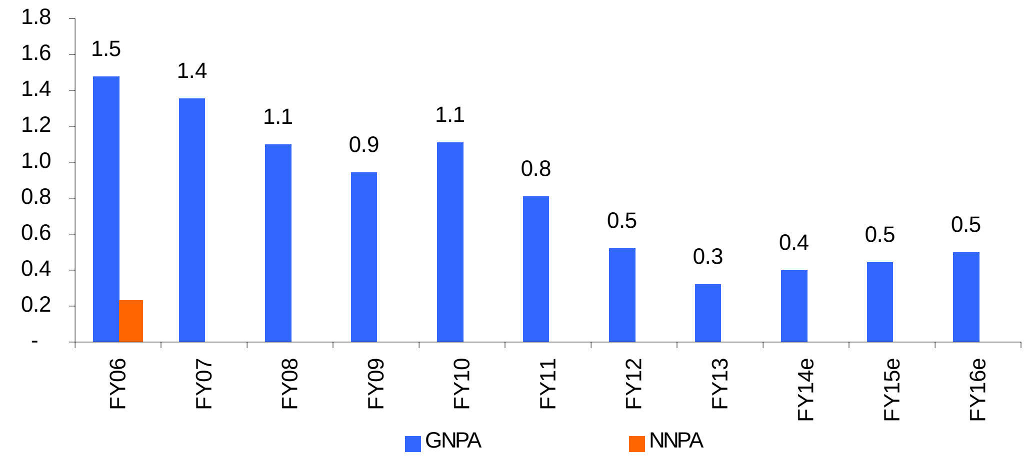
Gruh's customers are spread across district as well as taluka locations, while most of its branches are at district level, making it impractical for customers to walk into the branch to pay their monthly EMIs. As such, collections are mostly done through post dated cheques, collected on a periodic basis from the customer. In order to further ease up the process of collections, Gruh has entered into tie-ups with some commercial banks, where borrowers can deposit the EMI amount into collection accounts at nearest branches of those commercial banks.

Cash collections constitute less than 5% of total collections and only few old branches are permitted to accept cash. Gruh has always strived to induct the cashless culture in their borrowers despite the lower levels of banking habits peculiar to its customer base.

In case of a default, all possible techniques are used to persuade the borrower to repay the loan - text sms, home visits, notice under negotiable instruments act, etc. SARFESI act is used sparingly and in cases where the borrower is a willful defaulter. Once an account becomes an NPA, 60 days notice is served to the borrower, post which the company obtains a seizure order from magistrate. All the while, efforts are on to convince customer to pay up.

Historic credit losses have been 10bps. Stringent appraisal criterion, system based loan process and incentive structure linked to loan performance will ensure best-in-class asset quality going ahead.

Peerless asset quality to be maintained



Source: Company, Antique

Lean branch structure allows stringent cost control

Prior to 2000, a typical Gruh branch had bank like structure, where every branch has a designated sales officer, credit officer, collections & recovery officer and accounts person. The resulting high costs constrained branch expansion into deeper geographies. This was changed after the new management took charge in 1998 and cost control became central to Gruh's branch strategy since then.

New branches inevitably start with a two member team, small carpet area and basic technology set-up. The branch employees are involved in the entire loan life cycle, right from origination to credit appraisal to collections and monitoring. System driven processes ensure there is little need for travel of employees to the head-office or courier the files for approval. Everything is available on the system on a real time basis. The referral associate structure also contributes in lowering employee requirement at the branch level.

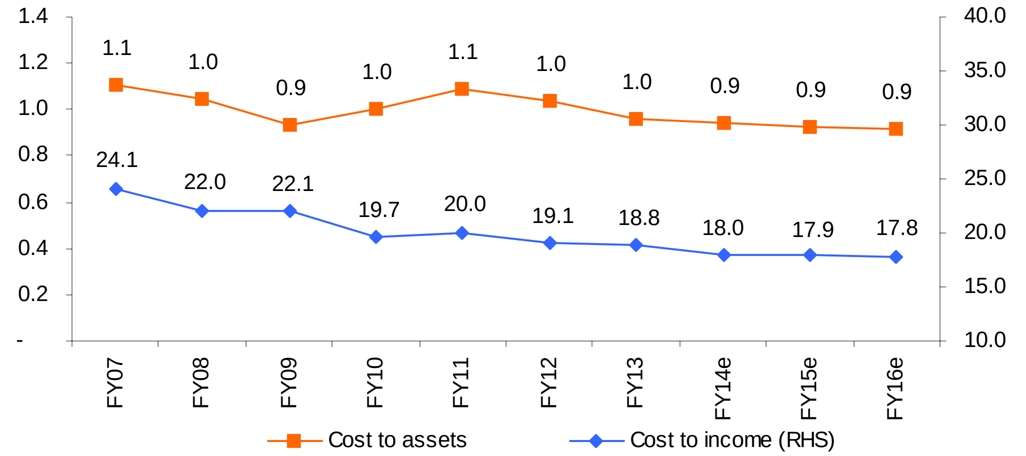
Low cost branch structure

	CanFin	Repco	Gruh
Opex per branch (INR m)	1.7	0.8	1.4
Business per branch (INR m)	514.0	322.7	340.3

Source: Company, Antique

Gruh will expand its branch network by adding 12 to 15 new branches annually and widen its referral associate network in the catchment areas. Cost control will remain central to its expansion plans and we expect cost ratios to remain stable-to-improving over FY13-16E. We expect some cost benefit to accrue on the back of operating leverage from its South Indian operations.

Cost ratios expected to remain stable



Source: Company, Antique

Valuations reflect the uniqueness of business model, maintain BUY

Earnings CAGR at 28% over the past three years coupled with +30% RoEs has resulted in steady re-rating of the stock over the last three years, with its 1 year forward book multiple expanding from 3x in FY11 to 8x in FY13. The fact that it has never raised capital since FY05 despite growing at CAGR of 26% over FY06-13 highlights the strength of the business model. Current valuations suggest strong market share gains and a long period of super-normal growth for the company.

Current valuations assume sustained market share gains

The currently stock price discounts FY14E book value by 8x, making it the most expensive financial stock in the country. Residual income analysis at current market prices suggests that Gruh could potentially grow its earnings at CAGR of 22% over FY13-20E, 15% over FY21-35E and 8% there on.

Gruh Finance expected to make market share gains

(INR bn)	FY06	FY12	FY20E
Loan book (Gruh)	11	41	236
Loan book (Housing sector)	310	704	2,155
Market share	3.4	5.8	10.2

Source: Company, Antique

Assuming that margins are maintained at 4% over FY13-20E vs. 4.6% currently and operating costs continue at current levels of 0.9% of assets, Gruh's loan book should grow to INR223bn by 2020. This implies a loan book CAGR of 23% over the next seven years and that its market share in housing finance would improve from the current 6% to 10% over the period, a feat that is not entirely attainable.

Our assumptions build in stronger earnings accretion over FY13-20E

While it can easily be argued Gruh is at the peak of its profitability, we believe that it could sustain for many years. Opportunity size for Gruh over the next ten years is absolutely large given the low levels of penetration outside West India and new possibilities emerging out of the thrust on affordable housing. Given its small size at INR54bn as on March 2013, we believe that 25% loan book CAGR over FY13-20E is attainable. We look at other profitability drivers to ascertain if Gruh can maintain its profitability over this growth period.

Margins: Focus on non-metro areas and non-salaried segment has resulted in strong margins over the past 10 years. This is expected to continue as Gruh is far from attaining saturation. Also, affordable housing opportunities would come at higher yields. However we remain slightly conservative and our residual income analysis assumes a 50bps decline in margins to 4.0% by FY20

Operating costs: Despite the lean operating model, cost to assets at 0.9% is considerably higher than ~0.5% maintained by LIC Housing Finance and HDFC. Although we don't build in any reduction in operating cost ratios up to FY20, we believe that operating leverage will play out at later stages when majority of geographic expansion is over.

Provisioning: Credit costs have been at their lows since 2007 and further improvement looks unlikely. At the same time, asset quality control has been at the heart of the Gruh culture and we do not expect any material deterioration in it. We have factored in the impact of higher standard assets provisioning in our estimates.

Growth assumptions - residual income model

	High growth stage FY13-20E	Moderation FY21-35E	Maturity FY45 onwards
Loan book (% cagr)	24.5	15.9	8.0
Earnings (%cagr)	23.1	15.9	8.0

Source: Company, Antique

We believe that Gruh Finance is well poised to deliver earnings growth in excess of 20% for a very long time. Initiate with a BUY and assign a price target of INR270/share based on residual income analysis. The target price discounts FY15E book value by 6x and offers 18% upside from current levels.

Key risks

Declining spreads in wake of rising competition

Owing to the under-served nature of its customer segment and superior service quality, Gruh maintains lending rates that a slightly higher than those of banks and large HFCs. In case the private sector banks become aggressive in Gruh's target segment in their pursuit for growth and achieving priority sector targets, pricing power could decline. Pricing power is one of the key determinants of Gruh's profitability. There have been instances of excessive competition in past but Gruh has largely maintained its pricing power.

Withdrawal of favorable regulations could severely impact profitability

Although regulations on standard asset and NPA provisioning have been tightened over FY11-13, HFCs still enjoy lower capital adequacy norms and funding support in terms of NHB re-financing. Return on equity for Gruh Finance has been upwards of 25% for many years now as it is able to leverage its networth in excess of 8 times. The low capital adequacy requirement is on account of lower risks involved in housing finance segment while NHB has witnessed increased budgetary support over last few years.

Rich valuations leave little room for earnings deviation from current trajectory

Our residual income analysis suggests that 17% of Gruh's market value accrues from earnings expectations over FY13-20E and 70% from FY21E and beyond. In case any of the above mentioned risks materializes, earnings may disappoint and we could see meaningful value erosion.

Large value accrues from future earnings

Target price	270
BV (FY14)	34
Value from earnings over FY13-20E	47
Value from earnings beyond FY20	188

Source: Antique

Financials

Income statement (INRm)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Interest earned	4,858	6,190	7,782	9,639	11,979
Interest expended	3,101	4,044	4,921	5,989	7,322
NII	**1,757**	**2,146**	**2,861**	**3,650**	**4,657**
Other income	284	315	350	390	436
Net income	2,041	2,460	3,211	4,040	5,093
Operating expenditure	389	463	579	724	904
Staff costs	197	234	293	366	458
Pre provisioning profit	**1,651**	**1,997**	**2,632**	**3,317**	**4,189**
Bad debts written off	14	(25)	104	120	160
Provisions	8	54	59	75	91
PBT	1,630	1,968	2,470	3,122	3,937
Current tax	414	509	642	812	1,024
Deferred tax	11	-	-	-	-
PAT	**1,205**	**1,459**	**1,828**	**2,310**	**2,914**

Balance sheet (INRm)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Share capital	353	357	357	357	357
Reserves & Surplus	3,503	4,553	5,739	7,238	9,129
Networth	3,856	4,910	6,096	7,595	9,486
Borrowings	38,424	49,145	62,686	79,897	100,898
Total liabilities	**42,280**	**54,055**	**68,782**	**87,493**	**110,385**
Assets					
Advances	40,837	54,378	69,060	87,706	110,510
Investments	244	652	782	938	1,126
Net current assets	963	(1,217)	(1,339)	(1,472)	(1,620)
Fixed assets	116	118	135	156	179
DTA	120	125	143	165	190
Total assets	**42,280**	**54,055**	**68,782**	**87,493**	**110,385**

Per share data

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
EPS	34.1	8.2	10.2	12.9	16.3
BVPS	109.2	27.5	34.2	42.6	53.1
DPS	11.5	2.5	3.1	3.9	4.9

Source: Company, Antique

Growth indicators (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Advances	28.5	33.2	27.0	27.0	26.0
Borrowings	29.5	27.9	27.6	27.5	26.3
NII	25.4	22.1	33.3	27.6	27.6
PPP	28.8	20.9	31.8	26.0	26.3
PAT	31.8	21.0	25.3	26.4	26.1
Total assets	28.7	27.9	27.2	27.2	26.2

Margin analysis (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Yield on funds	13.1	12.8	12.4	12.1	11.9
Cost of deposits	9.1	9.2	8.8	8.4	8.1
Spreads	4.0	3.5	3.6	3.7	3.8
NIMs	4.8	4.5	4.6	4.6	4.7

Cost ratios (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Cost to income	19.1	18.8	18.0	17.9	17.8
Cost to avg loans	1.0	1.0	0.9	0.9	0.9

Return ratios (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
RoAA	3.2	3.0	3.0	3.0	2.9
RoAE	34.3	33.3	33.2	33.7	34.1

Asset quality (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
GNPA (%)	0.5	0.3	0.4	0.5	0.5
NNPA (%)	-	-	-	-	-
Coverage (%)	100.0	100.0	100.0	100.0	100.0

Source: Company, Antique

Current Reco	:	BUY
CMP	:	INR210
Target Price	:	INR288
Potential Return	:	37%

INITIATING COVERAGE

Repco Home Finance Limited

Buy for Keeps

Repco Home Finance (RHF) is a long term play on the major Indian trends of urbanization and the shift towards nuclear family structure. It has built a niche through lending to salaried as well as self employed borrowers in tier-2, tier-3 towns and peripheries of tier-1 cities. Along with the high yields typical to RHF's target segment, it has developed a low cost operating model and a robust asset quality control mechanism that translated into loan book CAGR of 37% and earnings CAGR of 34% over FY09-13.

Geographic expansion outside South India, deeper penetration in existing geographies and potential opportunities in affordable housing segment will aid loan book CAGR of 30% over FY13-16E. Liability side benefits will aid stable spreads at 3% while stable asset quality will ensure earnings CAGR of 29%. Owing to the strong capital adequacy post the recent public issue, RoE will return to its +20% trajectory post FY15E, which we believe is a sustainable level for RHF. Initiate with a BUY and value it at INR288/share, which discounts FY15E book value by 2.1x.

Growth opportunities ample, liability benefits will aid stable spreads

Deeper penetration in existing geographies and expansion in regions outside South India will ensure long term growth opportunities. At the same time, continued focus on non-salaried customers in underserved markets will enable market share gains. At INR35bn as on March 2013, Repco's loan book remains small and we build in a 30% loan book CAGR over FY13-16E. Small ticket size of loans will ensure continued NHB refinance at lower costs while possibility of improved credit rating will enable Repco Home Finance to tap into alternative sources such as fixed deposits and NCDs. We expect spreads to remain stable at ~3% over FY13-16E.

Nimble operating model to contain operating costs

Employee costs are low as a typical branch consists of three or four employees who possess local knowledge, while administrative costs are low on account of the centralized credit appraisal model. Rental costs are in tier-2 and tier-3 towns are lower. As such, we expect cost-to-income to remain stable at 17% over FY13-16E despite annual addition of 12 branches.

Branch based origination, stringent processes ensures robust asset quality

Sourcing is largely handled by branch employees while appraisal involves mandatory visits at the property to be financed, visit at borrower's place of work, legal opinion and final approval from the head office. Staff compensation structure attaches equal importance to monitoring and collections as well. Credit losses over past thirteen years have been Rs390mn or 0.08% of total disbursements.

Earnings trajectory strong, Recommend BUY

Earnings CAGR of 29.9% over FY13-16E will be driven by strong loan growth, stable spreads and cost ratios. We expect Repco to report healthy return ratios with average ROA of 2.6%. We value Repco at 2.1X FY15 ABV (implied P/E of 13x), implying March'14 target price of INR288/ share.

Key financials

INRm	FY11	FY12	FY13	FY14E	FY15E	FY16E
Net interest income (INRm)	864	1,033	1,255	1,735	2,249	2,883
Net Profit (INRm)	566	676	800	1,088	1,393	1,754
EPS (INR)	12.2	14.5	12.9	17.5	22.4	28.2
BV (INR)	52.0	65.3	102.1	116.5	135.0	158.2
P/E (upper band)	17.6	14.7	16.6	12.2	9.5	7.6
P/BV (upper band)	4.1	3.3	2.1	1.8	1.6	1.4
RoA (%)	3.2	2.7	2.4	2.6	2.6	2.5
RoE (%)	26.2	24.8	17.1	16.0	17.8	19.2

Source: Company, Antique

Market data

Sensex	:	19,429
Sector	:	NBFC
Market Cap (INRbn)	:	13
Market Cap (USDm)	:	229
O/S Shares (m)	:	62
52-wk HI/LO (INR)	:	227/158
Avg Daily Vol ('000)	:	59
Bloomberg	:	REPCO IN

Source: Bloomberg

Valuation

	FY14e	FY15e	FY16e
EPS (INR)	17.5	22.4	28.2
PE (x)	12.2	9.5	7.6
P/BV (x)	1.8	1.6	1.4
RoA (%)	2.6	2.6	2.5
RoE (%)	16.0	17.8	19.2

Source: Bloomberg

Returns (%)

	1m	3m	6m	12m
Absolute	20	-	-	-
Relative	23	-	-	-

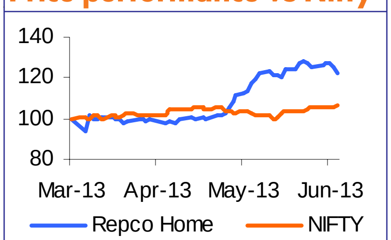
Source: Bloomberg

Shareholding pattern

Promoters	:	37%
FII	:	6%
DII	:	12%
Others	:	45%

Source: Bloomberg

Price performance *vs* Nifty



Source: Bloomberg

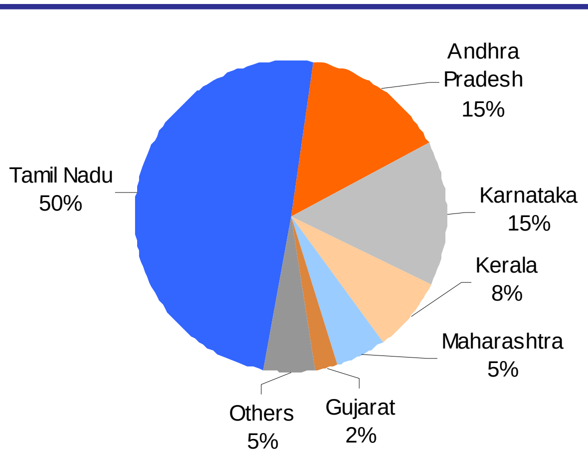
Presence in niche segment offers multiple growth opportunities

Repco Home Finance (RHF) has a strong focus in areas and customer segments that are under served by banks and the large HFCs. It has built a niche through its three pronged strategy - i) focus on tier 2, tier 3 and peripheries of tier 1 cities, ii) focus on self-employed segment through its strong appraisal technique, iii) focus on salaried employees through superior customer service. Repco has a network of 92 branches & satellite offices as on March 2013, of which 84% are located in under-served areas and 53% of its total customers belong to the self-employed category.

Seasoning of existing branches, geographic expansion to aid growth

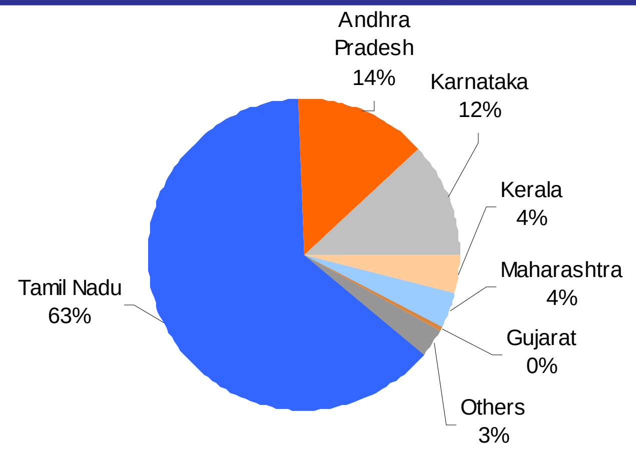
From being a Tamil Nadu based player until 2008, RHF embarked on a branch expansion as well as diversification drive. Its branch network, inclusive of satellite centers, more than doubled from 44 in FY09 to 93 in FY13 and its presence in states of Andhra Pradesh, Karnataka and Maharashtra was enhanced. Branches in Tamil Nadu now constitute 51% of the total branch network while business contribution is higher at 63%.

South India continues to dominate the branch network



Source: Company, Antique

Business contribution of South India even higher



Source: Company, Antique

Since a large number of branches have been opened in FY11 and FY12, seasoning benefits will accrue over the next two years. As an illustration, the five oldest and largest branches of RHF are in the Chennai city and have loan book of over Rs7bn or 20% of its total loan book. Average business in branches outside Tamil Nadu is lower than their peers in Tamil Nadu and we expect this gap to narrow as the newly opened branches in other states attain maturity.

Potential for operating leverage from branches outside Tamil Nadu

	Loan book (INR mn)	Branches (nos.)	Loan per branch (INR mn)
Tamil Nadu - top 5 branches	7,000	5	1,400
Tamil Nadu - remaining 41 branches	15,440	41	377
Andhra Pradesh	4,910	14	351
Karnataka	4,240	14	303
Kerala	1,320	7	189
Maharashtra	1,400	5	280

Source: Company, Antique

Also, the branch footprint of RHF is rather under penetrated in all the regions except Tamil Nadu. Given the RHF's current business model of branch based sourcing, a single branch can cater only to areas which fall within 15-20km radius of the branch location. With this model, RHF can potentially expand to every possible district and not cannibalize the business of a neighboring branch. The larger states such as Maharashtra, Gujarat and Karnataka have large population even at the taluka level. Thus, the potential for expanding the branch network is immense.

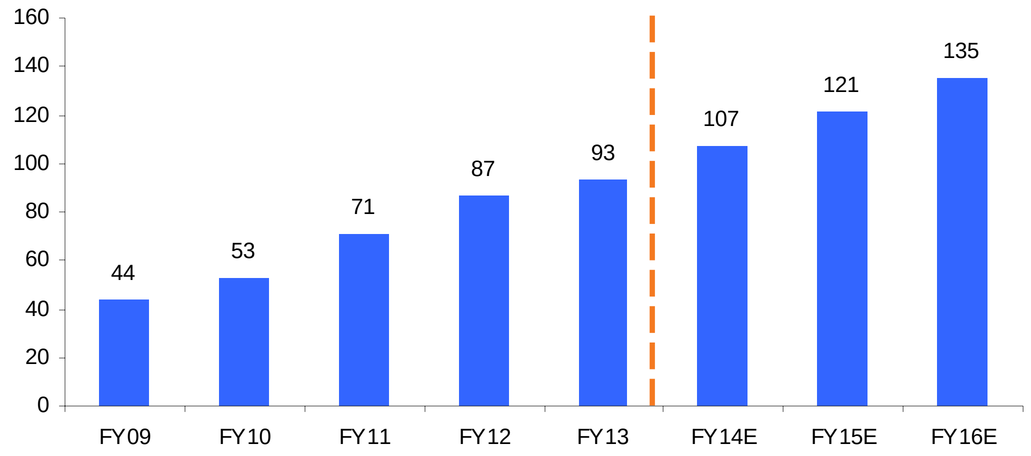
Huge scope for geogaphic expansion

	Total districts	Total talukas	Repco branches
Tamil Nadu	32	209	46
Andhra Pradesh	23	210*	14
Karnataka	27	175	14
Kerala	14	63	7
Maharashtra	35	357	5
Gujarat	25	225	2
Orissa	30	138*	1
West Bengal	19	373*	1
Madhya Pradesh	50	259	0
Rajasthan	32	240	0
Others	NA	NA	3
Total	>287	NA	93

Source: State websites, company data *towns, exact no. of talukas unavailable

However, we believe RHF's branch strategy would be a calibrated one rather than quick expansion, given the nature of its business. Setting up a team which is equipped with expertise in evaluating self-employed borrowers, understanding the local markets, developing local eco-system of lawyers, valuation experts, etc is generally a time consuming process and we expect Repco to open 12 to 15 new branches per year of which ~65% of branches would be opened in South India to penetrate deeper.

Branch network expansion to be calibrated



Source: Company, Antique

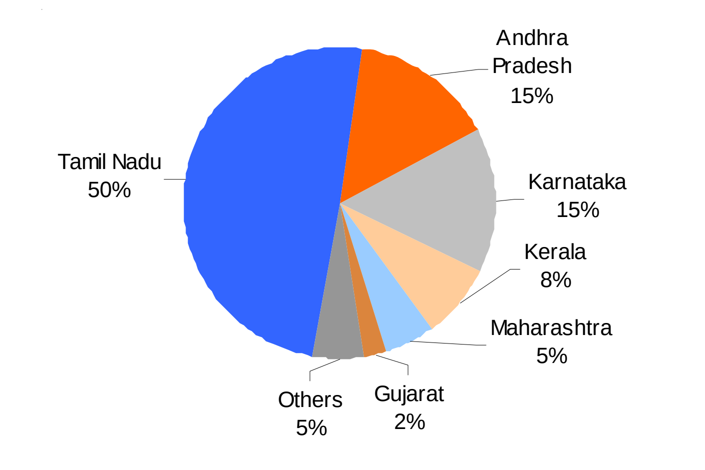
Looking beyond loan melas for sourcing

Loan melas, branch walk-ins and references from Repco Bank are the sourcing channels used by RHF. Of the three, loan melas are the most important channel for sourcing and constitute ~60% of the total loans sourced. Every branch is responsible for conducting loan melas in their catchment area on a bi-monthly or quarterly basis. Aspects of a typical loan mela are:

- Usually held on Saturdays so that maximum customers are able to attend
- Publicity for the loan mela is done by circulation of 8,000 to 10,000 pamphlets and a print advertisement through the local newspaper two days prior to the mela
- The key incentive for customer to attend the loan mela is quick in-principal approval and waiver of administrative fees of 0.5%
- A typical loan mela generates 50 to 60 leads, of which about 50% translates into business.

- Generally, a credit officer from headquarters or a senior branch manager from neighboring branches assist the branch conducting loan mela so that quick in-principal approvals can be given.

Loan mela - the key sourcing channel for RHF



Source: Company, Antique

Local marketing for loan melas through newspaper pamphlets and ads

Source: Company, Antique

Experimenting with the Direct Sales Team (DST) approach

Although the loan mela model has been successful, the company in its bid to penetrate deeper is experimenting with the DST model. The company has appointed 10 DSTs in the Tamil Nadu region and aims at penetrating into talukas that are under-served by the branches. These DSTs have a lower fixed salary vis-à-vis a branch employee but are entitled to a variable component that is proportional to the business sourced by them as well as the performance of those loans. We believe this is a better model compared to DSA as credit appraisal, monitoring and recovery remains the responsibility of an internal employee.

Well poised to capture the affordable housing opportunity

According to estimates of the Technical Group constituted by Ministry of Housing and Urban Poverty Alleviation, the urban housing shortage at the end of 11th five year plan was estimated at 18.7 million units. Approximately 95% of this shortage pertains to the EWS and LIG group while top 10 states account for more than 75% of this shortage.

Urban housing shortage – huge investments required

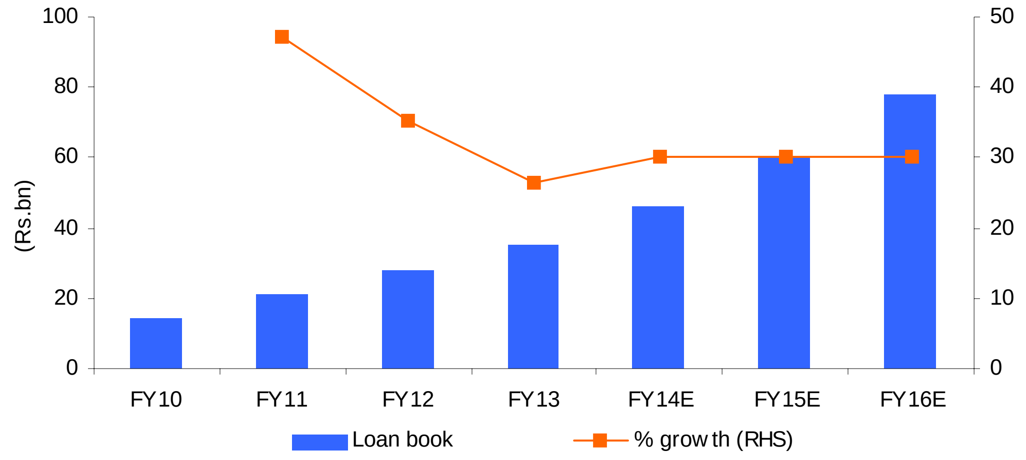
	Units (mn)	Cost per unit (INR)	Total Cost (INR bn)
Families living in dilapidated houses	2.3	350,000	793
Families living in kutcha houses (includes slums)	1.0	350,000	346
Families living in congestion (includes slums)	14.9	350,000	5,211
Families without homes	0.5	350,000	185
Need for fresh housing units	**18.7**	**350,000**	**6,545**

Source: Report of technical group on urban housing shortage 2012-2017, NHB report on trends and progress FY12

RHF through its presence in under-served markets has already developed some experience in financing affordable homes. In the past, it has financed several affordable housing schemes such as residential houses for workers at engineering units in Yelahanka, Karnataka and for industrial workers at Karur, Tamil Nadu. The various government initiatives in the affordable housing segment could translate into meaningful business opportunities.

Seasoning of newly opened branches, additions to branch network, increasing reach through the DST channel and opportunities in the affordable housing space will ensure 30% CAGR over FY13-16e.

Strong loan book growth over FY13-16E



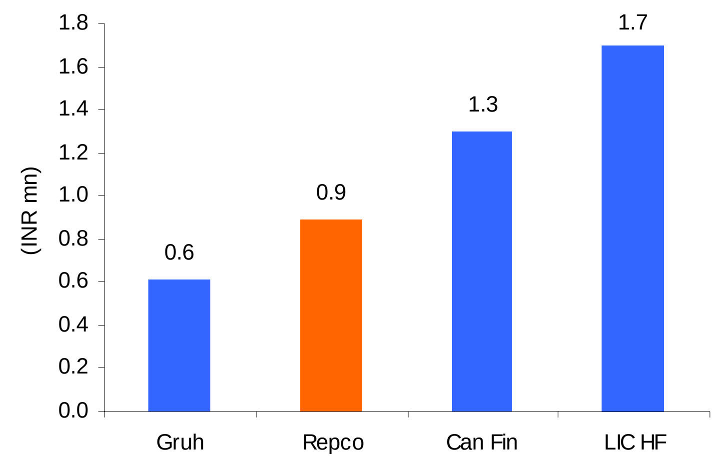
Source: Company, Antique

Niche customer segment, superior service quality key to high yields

RHF's customer mix is not overly reliant on the salaried class, which is generally a competitive segment and loans to non-salaried borrowers constitute ~50% of its total loans as on March 2013. Even within the salaried class, RHF is able to command a higher yield due to its superior service levels which include quick turnaround time and better product matching. RHF's local expertise and employee based appraisal allows it to make deviations that banks and large HFCs shy away from, but at the same time not jeopardizing its credit standards.

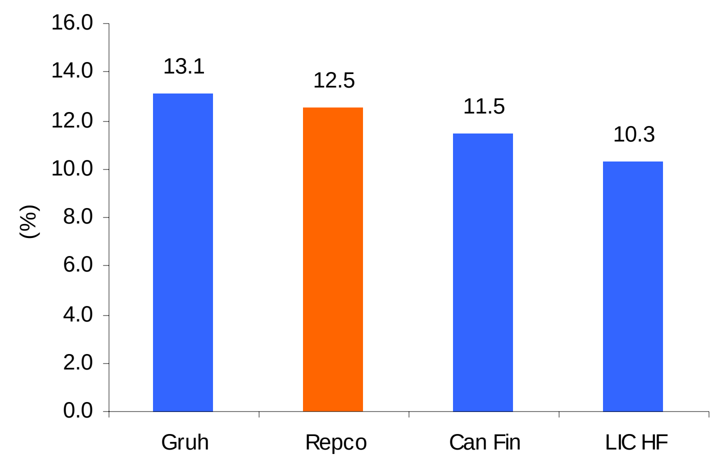
RHF's branch offices act as single points of contact for customers and are responsible for sourcing loans, assessing credit worthiness, providing assistance in documentation, disbursing loans and in monitoring repayments and collections. This enables it to provide personalized service and effectively communicate the product terms.

Low ticket size due to presence in under-served markets (FY12)



Source: Company, Antique

Yields are typically higher than large HFCs (FY12)



Source: Company, Antique

A typical salaried customer for RHF is either an employee of local government or related agencies or private companies including TCS, Cognizant, etc. Customers in the non-salaried segment include professionals such as doctors, lawyers and accountants; self-employed individuals such as hardware shop owners, garment shop owner, etc. RHF consciously avoids loans to real estate brokers, contractors, and any other professionals where ascertaining income is difficult.

Product matrix

	% of total loans	Base rate	Credit score based surcharge (max)	Avg yields
Home loans	85%	NA	NA	11.7%
Salaried	51%	10.9%	1.0%	11.2%
Non salaried	49%	11.4%	1.0%	12.2%
LAP	15%	NA	NA	15.9%
Salaried	21%	NA	NA	15.9%
Non salaried	79%	NA	NA	15.9%
Overall	100%	NA	NA	12.3%

Source: Company, Antique

Going ahead, ticket sizes are expected to trend upwards. However, we expect the company to maintain its yields at levels higher than that for banks and large HFCs given its niche focus. The Company also has some headroom for improving contribution from loan against property, which is generally a high yielding product. As such, we expect RHF to sustain the yield advantage over FY13-16e.

Stringent processes at the heart of asset quality control

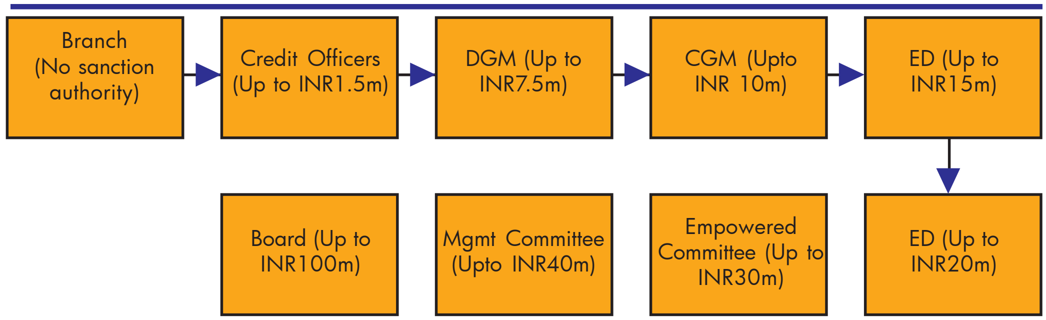
Given its presence in non-salaried segment in tier-2, tier-3 and peripheries of tier-1 cities, asset quality control has been implemented by RHF at multiple levels - employee policy, appraisal criterion and system level. GNPA and NNPA as on March 2013 stand at 1.5% and 1.0%, respectively. Although GNPAs have traditionally been at higher levels compared to its peer Gruh Finance, actual loss and frauds have been well contained. Of the INR49bn disbursed over the past thirteen years, losses have been contained INR0.39bn or 0.08% of disbursements, which best-in-class. These losses have emanated from 9 accounts of the total 42,000 accounts.

Employee policies, sanction matrix incentives strong asset quality control

RHF has a branch centric model where an employee is responsible for sourcing, credit appraisal, assessing credit worthiness, disbursing loans as well as in monitoring repayments and collections. The variable component of the salary structure prescribes equal importance to monitoring and collections as to the business sourcing. The Company has recently implemented the branch manager rotation policy where 1/5th of the branch managers would be transferred every year.

Sanction powers are only at the central office level. After the sourcing, documentation and appraise is carried out by the branch, it can recommend borrower to the central office. The central office has a team of 15 credit officer and 5 legal officers who have the sanctioning authority for loans up to Rs1.5mn. For higher ticket sizes, approvals from higher management such as DGMs, CGMs, etc is needed.

Power matrix for loan sanctions



Source: Company, Antique

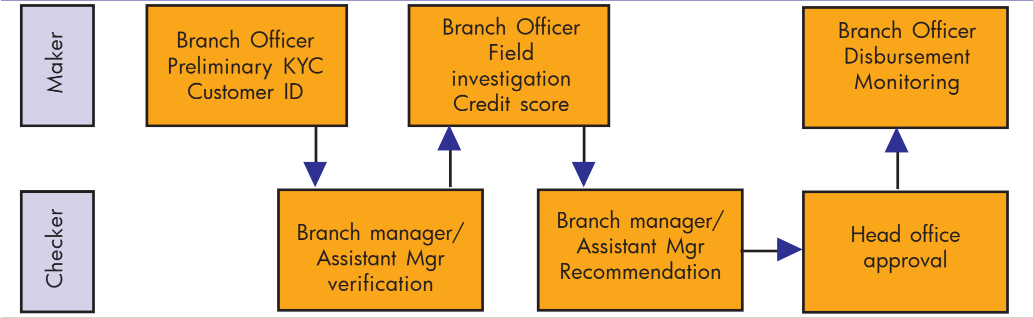
Appraisal process builds in adequate checks and balances

The appraisal process revolves around identifying the repayment capacity of the borrower, property valuation and ease in re-possessing the property. Unlike banks, where field investigation is largely outsourced, RHF's appraisal process is entirely driven by its employees. Legal and technical help is sought in cases where ticket sizes are large. It is mandatory for the branch employee to visit the business premise / employer place to ascertain the income level and inspect the property to be purchased for valuation and encumbrance's assessment. Some other thumb rules followed while conducting business are:

- Avoid loans to real estate brokers, contractors, etc where ascertaining the income is difficult.
- Legal opinion from external lawyers for property loans above INR1m.
- Personal interview by branch manager.
- Disbursements to under-construction houses should happen in a stage-wise manner, after examining progress at every stage.
- Loan against property (LAP) is extended mainly on self occupied homes; top-ups given only to customers with 24 months of repayment track record.

The implementation of these rules is ensured by a multi-level maker checker mechanism that involves the branch officer, branch manager and the head office. The only level where discretion is used is the head office, where there is a specialized team of 15 credit officers. This significantly mitigates judgment errors at employee level.

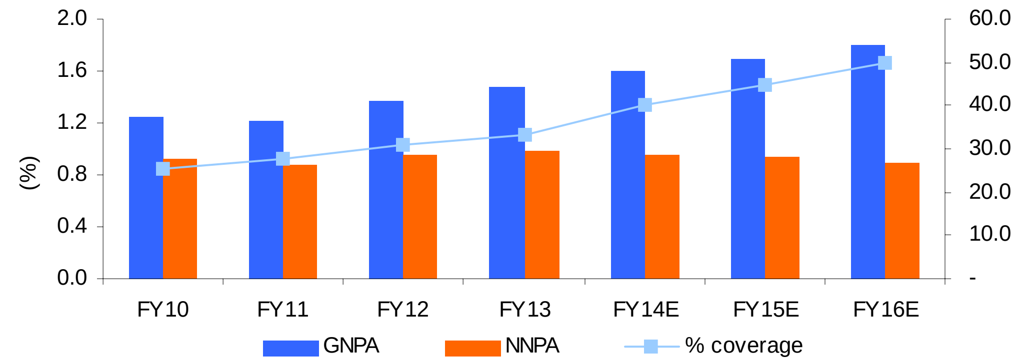
Multiple check-points prior to the final disbursement



Source: Company, Antique

Going ahead, we build in a marginal decline in asset quality, given the tough macro environment and that the state of Tamil Nadu continues to reel under acute power shortage. At the same time, we note that credit losses are not expected to increase give the huge margin of safety built in through strong appraisal practices and lower LTVs. We have also built in a proactive improvement in coverage ratio over FY13-16E, as the company migrates from a purely regulatory driven provisioning policy to a more conservative one. Faster than expected monetary easing could provide upside to our GNPA estimates.

Slight deterioration in asset quality, provision coverage to improve

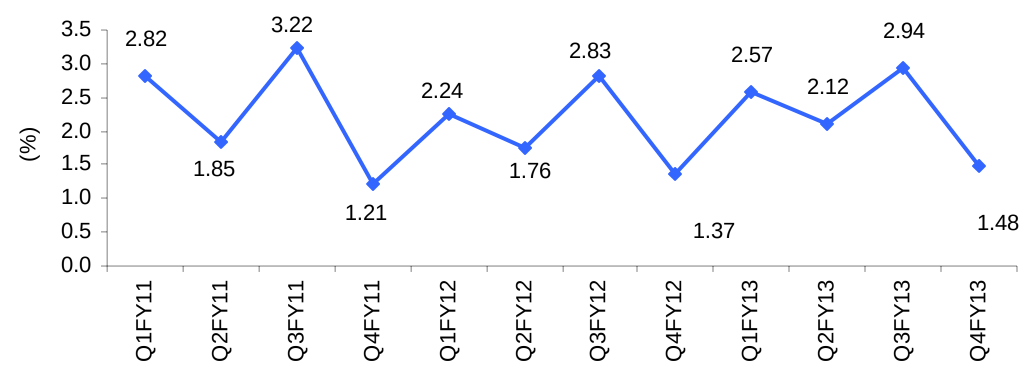


Source: Company, Antique

Seasonality variation in asset quality given RHF's target segment

Cashflow volatility is typical to RHF's self-employed borrowers and the same gets reflected in their quarterly GNPAs. Q1 will generally see highest GNPAs as its self-employed borrowers take a vacation from work or spend the money for meeting their children's school fees. Q2 would witness some recovery while Q3 being a festive season, results in a GNPA uptick again. Q4 witnesses a sharp recovery given the company's and borrower's focus on repayments. In the past, intermittent GNPAs have touched 2.5% on multiple occasions. However we take reprieve from the fact that these are technical in nature and actual losses are extremely low.

GNPA's have an element of seasonality



Source: Company, Antique

Low cost operating model ensures scalability

Despite having a branch-centric model, RHF has developed a low cost operating model through efficient employee utilization and implementation of centralized technology. This is reflected in its best-in-class operating ratios with average cost-to-income ratio at 15.5% and cost-to-assets at 0.8% over the past five years.

Lean branch structure

A typical RHF branch will start with three employees, mainly a branch manager and two executive assistants in a 300-500 sq.ft premise. Location in tier-2 cities and outskirts of metro areas ensure lower rentals as well. Technology requirements are limited to a few computers, scanner, internet connectivity and Thermpro loan management software. Employees are added as the branch business attains size.

RHF uses the satellite center approach to penetrate deeper around an existing branch. A typical satellite center consists of one or two employees and basic technology connectivity. On attaining size, it may be converted into a full-fledged branch.

Low cost branch structure

	CanFin	Repco	Gruh
Opex per branch (INR m)	1.7	0.8	1.4
Business per branch (INR m)	514.0	322.7	340.3

Source: Company, Antique

Robust technology platform

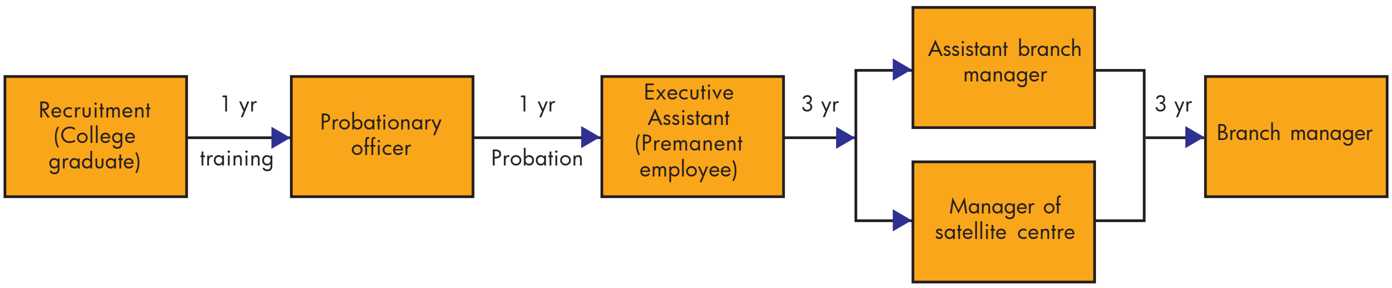
RHF uses the Thermpro loan management software (LMS) that provides real time connectivity between the branches and head office. As a part of the loan sanction process, KYC documents, field investigation report, inputs to the credit scoring model are all stored in the Thermpro LMS which can be viewed by the head office on a real-time basis. Thus, the sanction process, despite being centralized, is low cost and extremely quick.

Efficient employee utilization

A typical RHF branch would add an employee only when average business per employee touches Rs100mn. Marketing initiatives are limited to 4 or 5 loan melas per year. Since business sourcing is undertaken by RHF's own employees, commission expenses are negligible. Incentive structure are designed to encourage high performance - fixed salaries including dearness allowances are comparable to other market players while variable component is linked to sourcing, appraisal and subsequent loan performance.

Career progression opportunities ensure employee longevity. As an illustration, a graduate joins at a trainee level, becomes a confirmed employee (Executive Assistant) in 2 years. After 2 to 3 years of experience in that role, he has the option of becoming an assistant branch manager at a new branch or a manager at a satellite center.

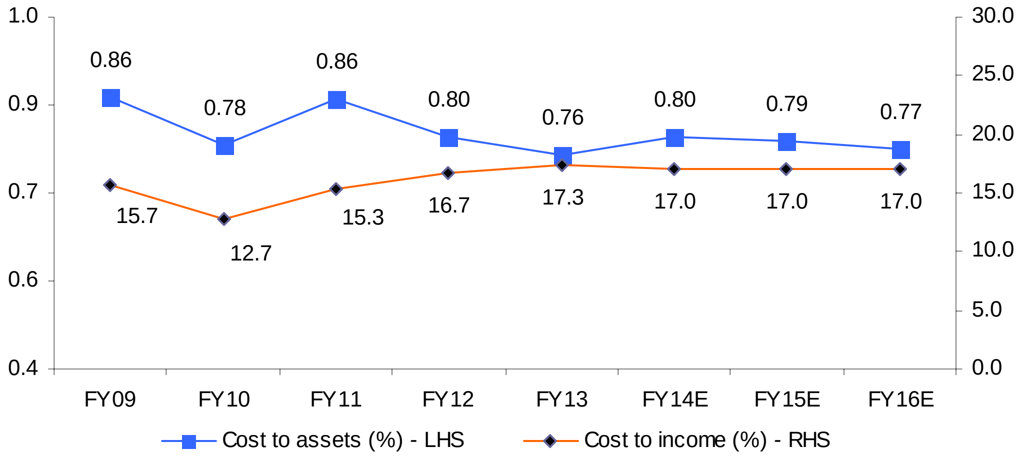
Employee career progression



Source: Company, Antique

The low cost operating structure ensures scalability, which is visible in stable cost ratios over FY09-13 even as its branch network doubled. Going ahead, RHF expects to open 15 branches a year. At the same time, it is also experimenting with the DST model to deepen its reach. Relentless focus on cost control will ensure average cost-to-income ratio at 17% and cost-to-assets at 0.8% over FY13-16E.

Operating cost to remain under control

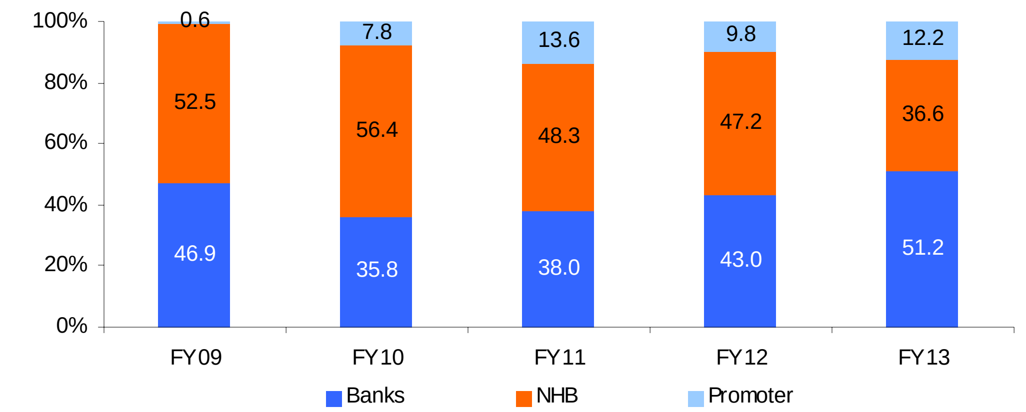


Source: Company, Antique

NHB refinance aids borrowing costs, scope for diversifying liability profile

Loans from commercial banks, refinance from NHB and short term credit facilities from its promoter are the key sources of funds. Given their small ticket sizes and presence in under-banked areas, RHF is eligible for refinance under various schemes of NHB. As on March 2013, NHB refinance constitutes 36% of total borrowings and has an average cost of 8.02%.

Scope for diversifying liability profile



Source: Company, Antique

RHF currently has a credit rating of A+ on its term loans, which is two notches below its peers. Key reasons cited by rating agencies for the lower rating prior to its IPO are i) Parent is a multi-state cooperative bank, not under ministry of finance, ii) Relatively higher leverage at 8x and iii) unlisted status. Post the IPO in March 2013, RHF's leverage stands reduced at 4x and rating agencies should soon upgrade its ratings.

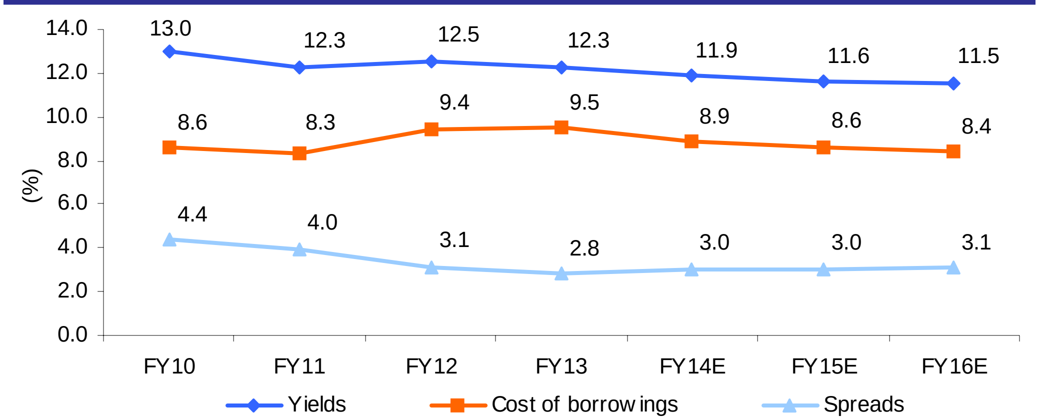
Credit ratings could be upgraded soon

	Ratings	Agency
Repco	A+	ICRA
CanFin	AA+	ICRA
Gruh	AA+	ICRA
GIC Housing	AA+	ICRA

Source: Company, Antique

Cost of borrowing from commercial banks is expected to come down by 25-30bps for FY14E on account of the rating upgrade. RHF could also tap into alternative sources of funds such as fixed deposits and NCDs to deepen its liability profile. Currently, 64% of liabilities are floating rate vs. 100% of assets that are floating in nature. Interest rates on the other 36% of liabilities i.e. NHB refinance are reviewed once in three years. Declining borrowing costs will aid in stabilizing spreads at 2.9% over FY13-16e.

Spreads to remain stable



Source: Company, Antique

Strong core earnings, return ratios make a strong BUY case

Presence in niche customer segment and strong branch expansion has ensured strong asset growth and robust margins over the past four years. This coupled with low operating expenses and best-in-class asset quality control has enabled strong profitability as well. Repco's loan book has grown at a CAGR of 41% over FY09-12 while its earnings has grown by 39% over the same period resulting in average RoAs of 2.8% and RoEs of 23%.

The company raised ~Rs270cr in Q4FY13 through its public offer and Tier-1 currently stands at 25%. As such, the return on equity declined from 25% in FY12 to 17% in FY13. Going ahead, leverage will improve as the company grows its loan book and we expect RoE's to trend at 20% only post FY15E. However, return on assets at 2.5% is expected to remain strong, second only to Gruh Finance in the housing finance space. Initiate with a BUY with a target price of Rs288/share, which discounts FY15E book value by 2.1x.

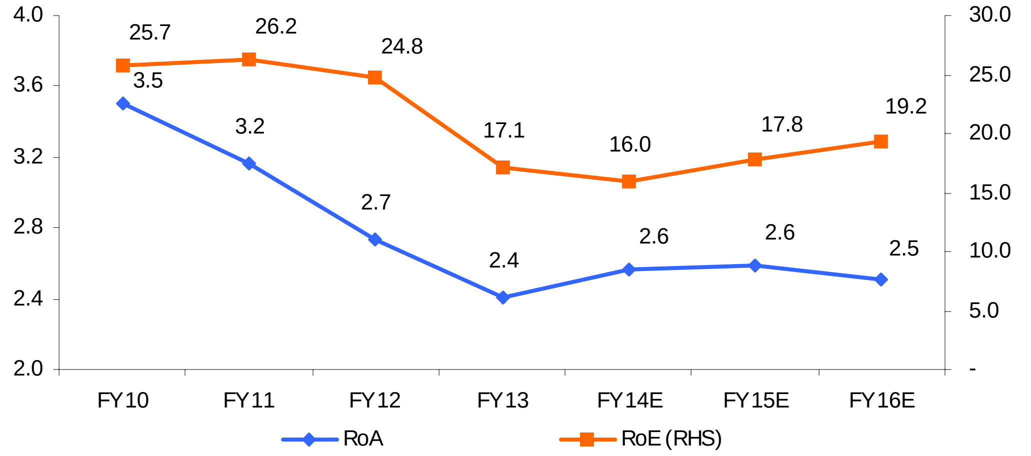
- We expect earnings growth to remain healthy - 29.9% over FY13-16E driven by strong loan book growth, steady cost ratios and stable asset quality.
- Cost benefit in the form of low cost NHB funding will continue to accrue given that average ticket sizes of new origination is still below INR1.5m, aiding stable spreads at 2.9%
- The management expects to open 12 to 15 branches annually. At the same time, it is also experimenting with the DST model for increasing its reach. Given its low cost branch model, we expect cost ratios to remain stable over FY13-16E.
- Asset quality has a seasonally pattern, with Q1 and Q3 typically being weaker quarters. Repco's 63% lending is in Tamil Nadu, which is reeling under power shortage since a long time. This could weigh on asset quality in near future and we expect GNPAs to increase by 30bps over FY13-16E. We also expect Repco to gradually improve its coverage ratio to 50% over the period.
- Return ratios are expected to remain healthy with RoAs at 2.6% over FY13-16E. However RoEs will remain below 20% until FY16E due to the strong capital adequacy position. We expect leverage to improve gradually and improve RoEs to +20% levels, which in our opinion are sustainable levels for Repco.

Repco – ROA decomposition

	FY10	FY11	FY12	FY13	FY14E	FY15E	FY16E
Interest earned	12.4	12.0	12.4	11.8	11.5	11.5	11.4
Interest expended	7.2	7.1	8.2	8.0	7.4	7.3	7.2
Gross interest spread	5.2	4.8	4.2	3.8	4.1	4.2	4.1
Other income	0.7	0.7	0.5	0.4	0.4	0.4	0.4
Total income	5.9	5.5	4.7	4.2	4.5	4.6	4.5
Employee expenses	0.4	0.4	0.4	0.4	0.8	0.8	0.8
Other expenses	0.4	0.4	0.4	0.3	-	-	-
Operating income	5.1	4.6	3.9	3.5	3.7	3.8	3.7
Provisions	0.3	0.3	0.4	0.3	0.3	0.3	0.4
Pre-tax earnings	4.8	4.3	3.5	3.2	3.4	3.5	3.3
Tax	1.3	1.2	0.8	0.8	0.9	0.9	0.8
RoA	3.5	3.2	2.7	2.4	2.6	2.6	2.5
Leverage	7.3	8.3	9.1	7.1	6.2	6.9	7.7
RoE	25.7	26.2	24.8	17.1	16.0	17.8	19.2

Source: Company, Antique

Return ratios to improve with leverage



Source: Company, Antique

Key risks

Protracted slowdown leading to stress in broader economy

The broader economy has been relatively resilient despite the macro weakness. However, prolonged slowdown could result in stress in the broader economy as well which could moderate housing demand in Repco's target market. Given Repco's small loan book size and expanding geographic reach, the risks to growth are relatively low.

Inability to diversify its borrowing profile

NHB refinance constitutes ~36% of Repco's total borrowings. The remaining borrowing needs are fulfilled by banks, including the promoter bank. Strong future growth would require higher borrowings and proportion of NHB refinancing may decline, forcing Repco to tap other sources of borrowings such as NCDs and public deposits.

Increasing ticket sizes leading to lower yields

In its endeavor to grow fast, Repco may have to increase ticket sizes in addition to acquiring new customers. A customer with large ticket size is generally served by banks and other housing finance companies as well and could result in lower yields for Repco. However, Repco is far away from saturation point and major decline in yields is unlikely.

About Repco Home Finance

Repco Home Finance is a professionally managed housing finance company headquartered in Chennai, Tamil Nadu and registered with the NHB. It was established by Repco Bank Limited, a Government of India owned enterprise, in April 2000 to tap the growth potential in the housing finance space. It focuses on self-employed people in the underserved markets like tier-2 and tier-3 towns and peripheries of Tier-1 cities.

As of December 31, 2012, it has a network of 73 branches and 19 satellite centers, 90% of which are located in South India. Further, 77 of these branches and satellite centers were located in tier 2 & tier 3 cities, and at the peripheries of tier 1 cities, based on its belief that they are underserved by larger HFCs and banks.

Management profile

Mr. R. Varadarajan, Managing Director, has approximately 35 years of work experience in the banking industry. Prior to joining Repco Home Finance in 2010, he was associated with Syndicate Bank in various capacities for a period of 23 years and with Repco Bank since 2001.

Mr. P. Natarajan, Executive Director, has around 30 years of experience in banking and financial services. Prior to joining Repco Home Finance, he was a general manager at Repco Bank.

Mr. V. Raghu, Executive Director, holds a master's degree in economics from Birla Institute of Technology & Science and an MBA degree as well. His prior work experience includes a stint at NHB as a General Manager and stint with RBI as Research Officer.

Note on Repco Bank

The Repatriates Co-operative Finance and Development Bank Limited (Repco Bank) was registered as a cooperative society on September 9, 1969 under the Madras Cooperative Societies Act, 1961. With the enactment of the Multi-State Cooperative Societies Act, 2002 and in accordance with the relevant provisions thereof, it was registered under the Multi-State Cooperative Societies Act, 2002. Government of India owns 76.8% in the bank.

The bank currently operates in the states of Tamil Nadu, Andhra Pradesh, Karnataka and Kerala and the Union Territory of Puducherry through a network of 85 branches. It largely caters to the retail and the trader segment through its products, the list of which is summarized below.

Products and services

Asset products	Liability products
Jewel loan	Savings deposits
Jewel overdraft	Daily deposits
Trader plus - Working capital	Recurring deposits
Doctor plus	Fixed deposit
Rent plus - receivables discounting	Cash certificate
Salary loan	Monthly payment scheme
Corporate loan	Repco money back deposit
Hypothecation loan - CV, CE, etc	

Source: Company, Antique

As a multi-state cooperative bank, Repco Bank cannot offer products which have repayment tenure of more than 7 years. As a result, housing loans are not done by them. Home loans are done through its subsidiary, Repco Home Finance. As on March 2013, the loan book stands at INR39bn while its net NPAs are zero.

Key financials

	FY10	FY11	FY12	FY13
Deposits	22,940	29,750	40,350	50,880
Advances	16,140	22,640	30,260	39,170
Total Business	39,080	52,390	70,610	90,050
Profit After Tax (PAT)	440	560	730	860
Number of Branches	63	74	75	85
Gross NPA	641	747	489	609
Gross NPA %	3.9	3.3	1.6	1.6
Net NPA	-	-	-	-
Net NPA %	-	-	-	-

Source: Company, Antique

Transactions with Repco Home Finance

- Provides cash credit facilities, which constitute 12% of RHF's total liabilities.
- Customers referred by Repco Bank account for 5% of overall originations; No concept of referral fees.
- Provides daily deposit accounts for customers who wish to opt for the same.

Financials

Income statement (INRm)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Interest income	3,056	3,912	4,858	6,156	7,934
Interest expenses	2,023	2,656	3,123	3,907	5,052
NII	**1,033**	**1,255**	**1,735**	**2,249**	**2,883**
Other income	133	148	177	213	256
Total income	1,166	1,403	1,913	2,462	3,139
Operating expenses	194	243	325	419	534
PPP	**972**	**1,160**	**1,588**	**2,044**	**2,605**
Provisions	94	92	137	186	266
Pre-tax profit	**877**	**1,068**	**1,450**	**1,858**	**2,339**
Tax expense	202	268	363	464	585
PAT	**676**	**800**	**1,088**	**1,393**	**1,754**

Balance sheet (INRm)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Share capital	464	622	622	622	622
Reserves & Surplus	2,568	5,724	6,620	7,769	9,215
Networth	3,033	6,345	7,242	8,391	9,837
Borrowings	24,860	31,132	39,048	51,814	68,460
Other liabilities	615	447	492	541	595
Total liabilities	**28,508**	**37,924**	**46,782**	**60,746**	**78,892**
Fixed assets	33	45	49	54	59
Investments	81	81	89	97	107
Cash & Bank Balances	175	2,101	277	360	468
Advances	28,071	35,501	46,151	59,996	77,995
Other current assets	148	197	217	239	263
Total assets	**28,508**	**37,924**	**46,782**	**60,746**	**78,892**

Per share data

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
No. of shares	46.4	62.2	62.2	62.2	62.2
EPS	14.5	12.9	17.5	22.4	28.2
BV	65.3	102.1	116.5	135.0	158.2

Source: Company, Antique

Growth indicators (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Advances	35.2	26.5	30.0	30.0	30.0
Borrowings	37.4	25.2	25.4	32.7	32.1
NII	19.6	21.6	38.2	29.6	28.2
PPP	16.9	19.4	36.8	28.7	27.5
PAT	19.4	18.5	35.9	28.1	25.9

Cost ratios (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
Cost to income	16.7	17.3	17.0	17.0	17.0
Cost to average assets	0.8	0.8	0.8	0.8	0.8

Valuation (x)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
P/E	14.5	16.4	12.1	9.4	7.5
P/BV	3.2	2.1	1.8	1.6	1.3

Return ratios (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
RoA	2.7	2.4	2.6	2.6	2.5
RoE	24.8	17.1	16.0	17.8	19.2

Asset quality & adequacy (%)

Year ended 31 Mar	2012	2013	2014e	2015e	2016e
GNPA	1.4	1.5	1.6	1.7	1.8
NNPA	1.0	1.0	1.0	0.9	0.9
Tier 1	16.5	25.5	22.4	20.0	18.0

Source: Company, Antique

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Analyst ownership in stock	No
Company ownership in Repco Home Finance	Yes

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