Equity Research
June 7, 2016
BSE Sensex: 26777

Financials

Target price Rs835

Shareholding pattern

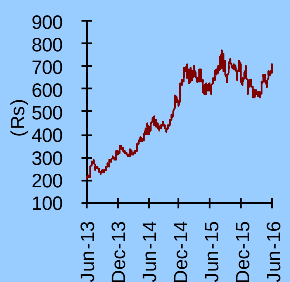
	Sep '15	Dec '15	Mar '16
Promoters	37.3	37.2	37.1
Institutional investors	47.1	47.7	47.6
MFs and UTI	16.2	17.1	18.8
Banks & FIs	0.6	0.5	0.4
FIIs	30.2	30.2	28.4
Others	15.7	15.2	15.2

I-Sec vs. Bbg* consensus

(%Var)	FY17E	FY18E
NII	0.3	1.1
PPP	0.9	0.0
PAT	6.1	2.8

*Bloomberg

Price chart



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INDIA

ICICI Securities

Repco Home Finance — BUY

Lots of steam remains — Rs702

Reason for report: Initiating coverage

Repco Home Finance has been able to create a credible business model in the high opportunity headroom but incredibly challenging, small ticket rural/ semi-urban housing loans space, catering majorly to self-employed customers. The play into policy focus/ endowment orientation towards the sector is obvious and execution track record reinforces confidence *(1.3% GNPA, 63bps of loans as peak credit costs in last 5 years and annual op cost at an impressive 94bps of average loans, despite 30% loan CAGR in last 5 years)*. We feel that existing dominant geographies (South, principally Tamil Nadu) remain low on penetration, assuring the opportunity to remain a high asset growth company. We build in 27.8% loan CAGR over FY16-18E and build up leverage to 9.3x from 8.1x, over the same period. We believe this should happen as credit rating agencies incrementally upgrade the company (AA- current Long Term rating from ICRA) and also allow it to operate with a lower capital buffer (current Tier-1 capital 20.7%). This should help it substitute its bank borrowings (~80% of liabilities) with incrementally cheaper NCDs, providing a further tailwind to growth (gains look likely to be passed on). All this combined, we expect ~20% RoE in FY18E and scope for further improvement will remain. Valuation at 3.9x FY17E P/BVPS may appear rich at first glance but a peer comparison and ~14.9% IRR possibility for any investor looking for a 5 year holding (3x 1-yr fwd P/BVPS exit multiple), convince us that valuations are not excessive. We set our target multiple at 3.5xFY18E P/BVPS *(adjusted for DTL, in line with what we practise for peers)* leading to a 12M target price of Rs835. We initiate coverage with a BUY recommendation. Key risks to watch out for are; (i) asset quality lumpiness that can come from high geographical concentration and (ii) any incremental weakening of underwriting standards as competitive dynamics evolves.

- **Multiple levers for enhancing capital productivity still remain.** As Repco maintains its high asset growth, we see multiple levers for its capital productivity (RoE) to inch up by ~300bps in next 2 years and by ~800bps to 25% in 5 years. Apart from bank borrowing substitution by NCDs as ratings improve, the primary driver of RoE will be financial leverage build-up (rating comfort willing) as asset growth far outstrips interim accruals, despite rather modest dividend payouts.
- **Credible business model in high growth phase.** Apart from the conservatism the company has displayed in the LAP segment (lower ticket size, low yields) and its core competence of underwriting self employed individual home loans, the most telling evidence of its efficiency is perhaps the fact that till FY15, loan losses amount to 0.06% of total disbursements. With asset prudence assured, the fact that in its core geography of Tamil Nadu (63% of loans), there are only 1,200-1,300 loans outstanding per district, convinces us that they have just scratched the surface of the growth opportunity. Diversification is seemingly not a pre-condition for high growth.
- **Affordable and rural housing opportunity huge.**We estimate the urban affordable housing opportunity at ~Rs10tn and that in rural housing ~Rs6.5tn at current prices - growing on the back of supportive socio-economics and policy focus.

Market Cap	Rs43.9bn/US$656mn
Reuters/Bloomberg	RHFL.BO/REPCO IN
Shares Outstanding (mn)	62.5
52-week Range (Rs)	773/566
Free Float (%)	62.9
FII (%)	28.4
Daily Volume (US$/'000)	736
Absolute Return 3m (%)	19.0
Absolute Return 12m (%)	13.1
Sensex Return 3m (%)	9.3
Sensex Return 12m (%)	1.4

Year to March	FY15	FY16P	FY17E	FY18E
NII (Rs mn)	2,373	3,039	3,789	4,731
Net Income (Rs mn)	1,231	1,501	2,006	2,453
EPS (Rs)	19.8	24.0	32.0	39.2
% Chg YoY	11.7	21.4	33.5	22.3
P/E (x)	35.5	29.2	21.9	17.9
P/BV (x)	5.4	4.6	3.9	3.2
Net NPA (%)	0.5	0.5	0.5	0.5
Dividend Yield (%)	0.2	0.3	0.3	0.3
RoA (%)	2.3	2.2	2.3	2.2
RoE (%)	15.9	17.0	19.2	19.6

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Multiple levers for enhancing capital productivity still remain

Somewhat surprisingly for a company of Repco's vintage, long term asset track record and size; multiple levers remain for further optimisation of capital productivity. The three major sources of this capital productivity headroom, with significant interplay between each other, are;

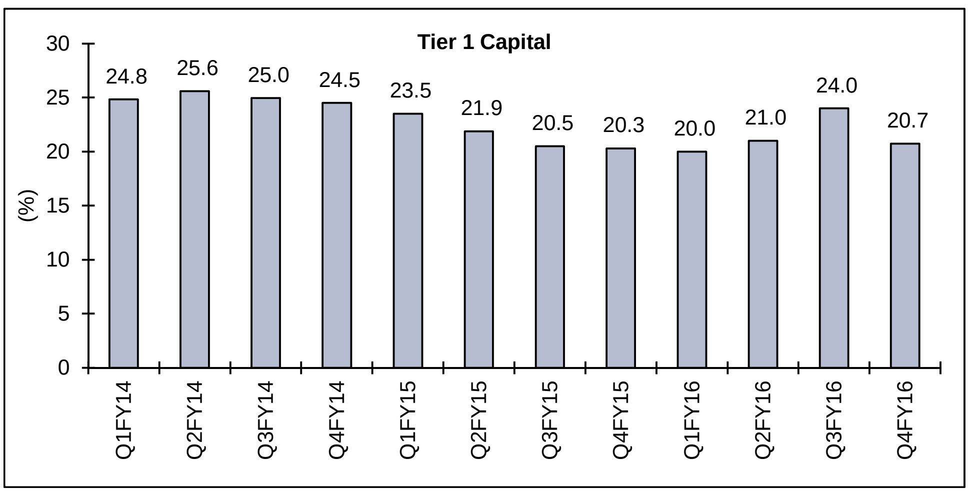
- Financial leverage
- Borrowing cost & mix
- Some amount of operating leverage

We elucidate below, how these factors (especially the first two) can provide significant aid to capital productivity in coming years.

Financial leverage headroom is significant

Repco Home Finance had one of the highest possible Tier-1 capital releases amongst the housing finance companies of ~400bps when NHB mandated that loans with ticket size of less than Rs3mn would attract a risk weight of 35% only (50% earlier). Back calculating from its Tier -1 capital disclosure and the fact that all LAP loans attract 75% risk weight, we estimate, as of end FY16 72.9% of its non-LAP loans were of ticket size less than Rs3mn.

Chart 1: A high Tier-1 capital leaves enough headroom for increasing leverage



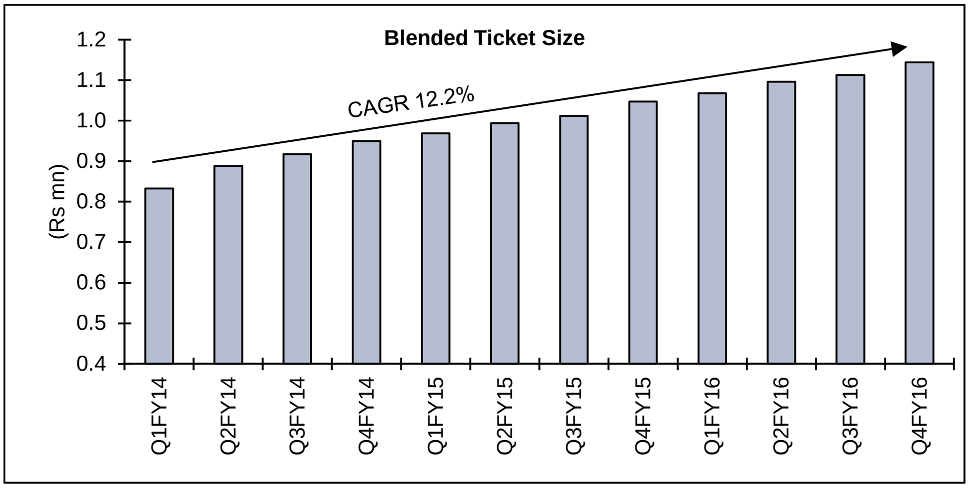
Source: Company data, I-Sec research

Table 1: We estimate that ~72.9% of non-LAP loans are below Rs3mn ticket size

(Rs mn)	**FY16**
Total Tier 1 Capital	**7,443**
Tier 1 (%)	20.7
Total Risk Weighted Asset	**35,958**
Non Loans RWA	443
Loan Related RWA	**35,515**
Less: Loan RWA for LAP Portion (Assuming 100% RW)	11,421
Individual Home Loan Related RWA	**24,093**
Total Balance Individual Home Loans o/s on FY15	61,683
Implied Risk Weight on Home Loan category	**39.06**
As on FY16, Risk Weights for loans upto Rs3mn was 35% (LTV<80%) and loans above Rs3mn upto Rs7.5mn is 50% (For LTV>75%)	
Hence, Proportion of non-LAP Loans below Rs3mn (%)	**72.9**

Source: Company data, I-Sec research

Chart 2: Average ticket size growth has been steady



Source: Company data, I-Sec research

Given that Repco Home Finance is unlikely to deviate significantly from its target customer segment in its medium term product strategy, we expect that a high proportion of loans will remain below the Rs3mn watermark. This implies that Tier-1 capital levels will remain far higher than the regulatory watermark of 6% and is getting capped due to other considerations.

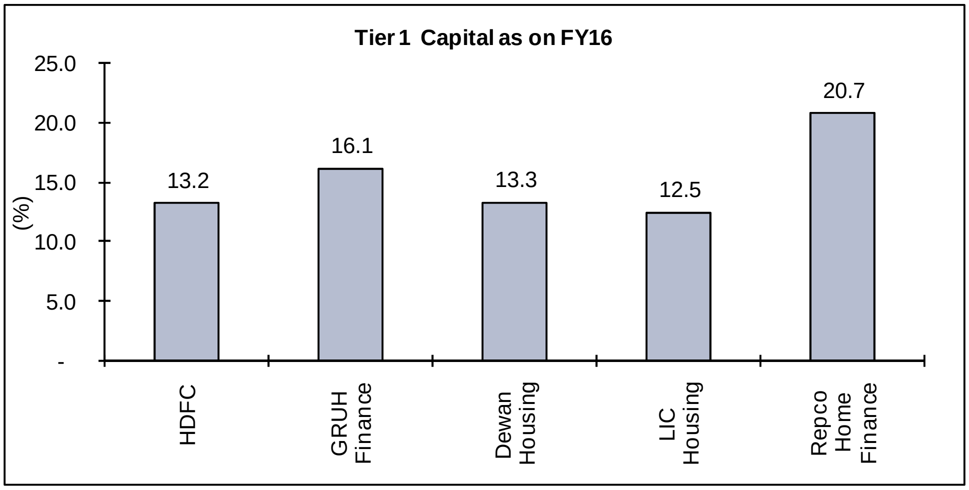
The chief of these other considerations seem to be its credit rating. Despite a recent slew of upgrades, the company's credit rating lags that of peers of similar vintage or success by 1-2 notches. Remember, this lag is despite the company maintaining a significantly higher capital buffer.

Table 2: Credit rating below peers

	CRISIL		ICRA		CARE	
	Long Term	**Short Term**	**Long Term**	**Short Term**	**Long Term**	**Short Term**
HDFC	AAA	A1+	AAA	A1+	AAA	A1+
GRUH Finance	AA+	A1+	AAA	A1+	-	-
Dewan Housing	-	A1+	-	A1+	AAA	-
LIC Housing	AAA	A1+	-	-	AAA	-
Repco Home Finance	**-**	**-**	**AA-**	**A1+**	**AA**	**A1+**

Source: Company data, I-Sec research

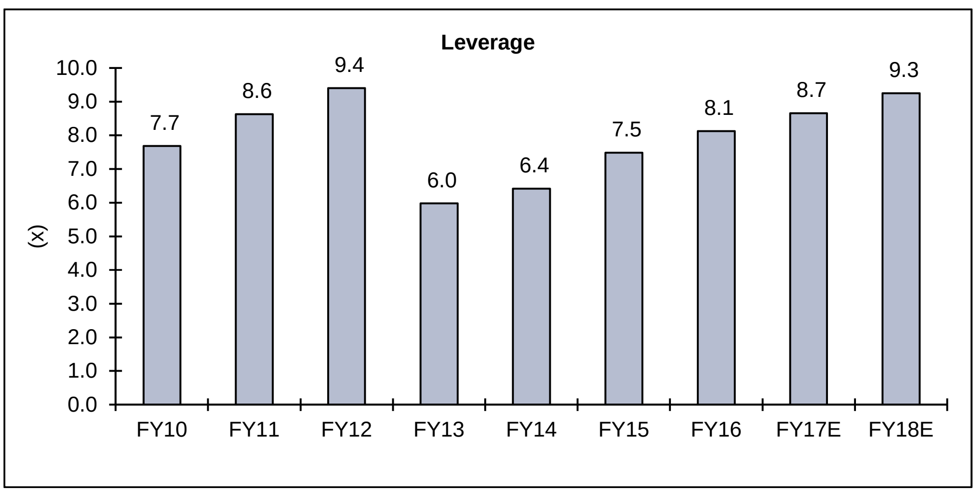
Chart 3: Relatively much higher Tier 1 capital than peers



Source: Company data, I-Sec research

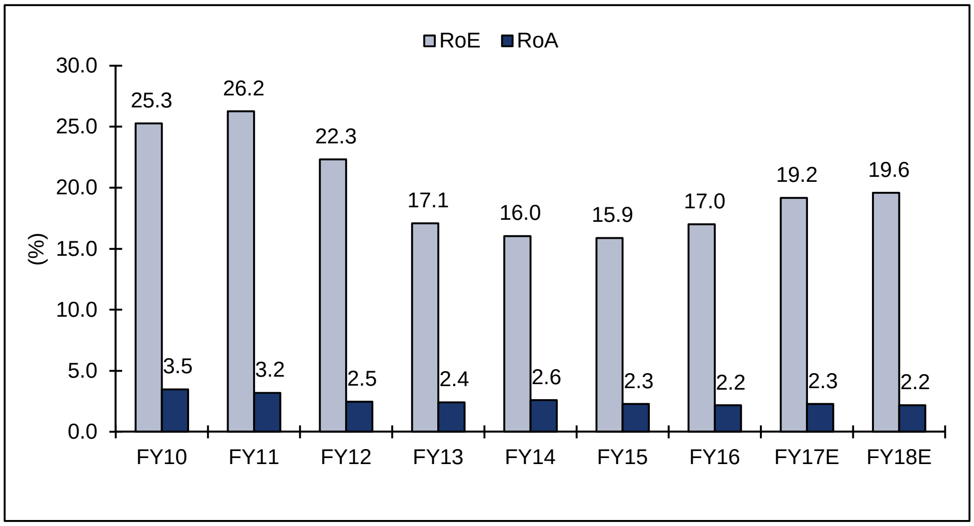
The chief worry of rating agencies seems to be that of the parentage of Repco Bank (which is a co-operative society and not a co-operative bank, with residual ownership stake of 37.14% and comprising 7.6% of Repco Home Finance's borrowings). We believe that in continuation of the current trend, this concern will gradually abate and the company's credit rating will catch up with peers and the leverage leeway that rating agencies are willing to offer it will also go up. While we build in some leverage headroom from current levels, the increase can be much more drastic and rating event driven.

Chart 4: Financial leverage should increase significantly



Source: Company data, I-Sec research

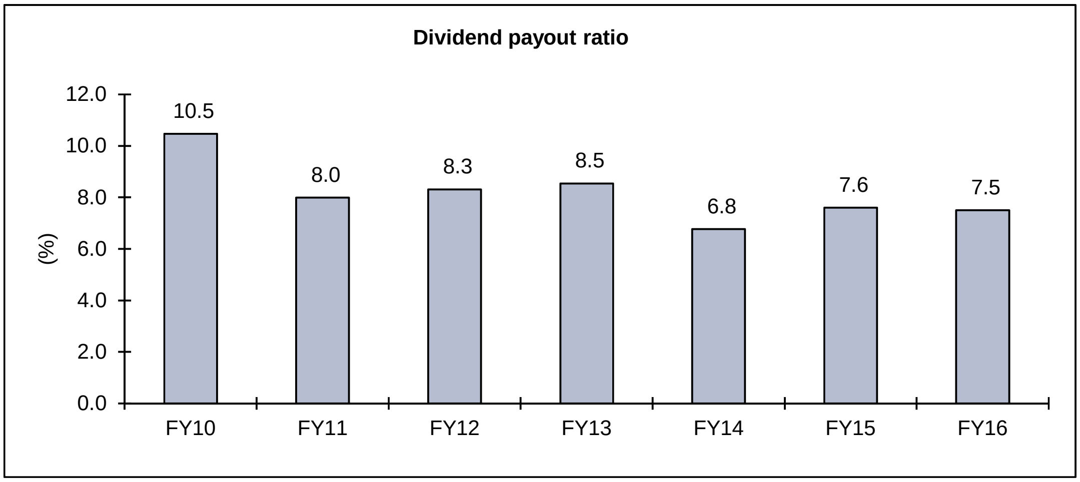
Chart 5: Multiple levers will support a ~20% RoE for the company by FY18



Source: Company data, I-Sec research

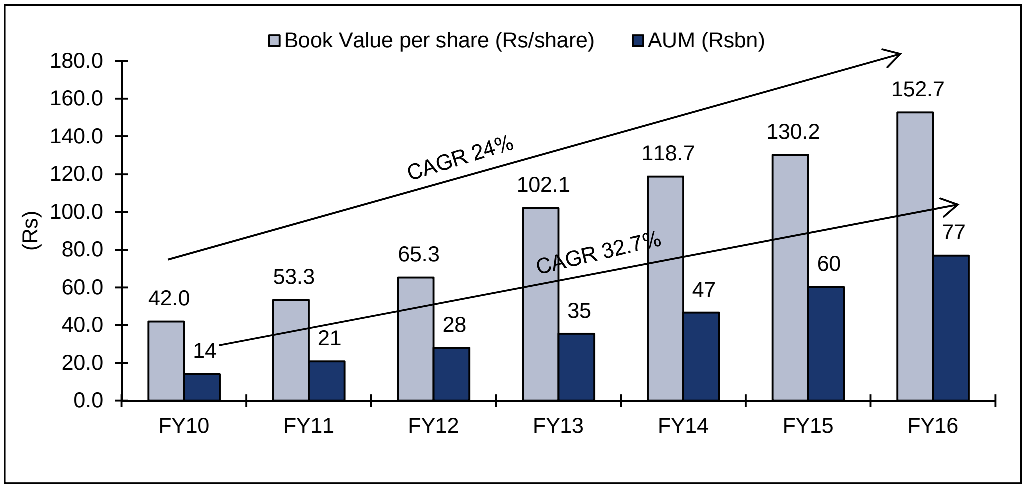
In the case of an easing on behalf of rating agencies, a strong case remains for the company to re-look at its dividend payouts. Even a one-time dividend can also be considered to lean out its capital structure. Of course, all this will be a function of its asset growth plans at that point.

Chart 6: Dividend payouts remain modest…



Source: Company data, I-Sec research

Chart 7:…but justified by asset growth has outpacing accruals

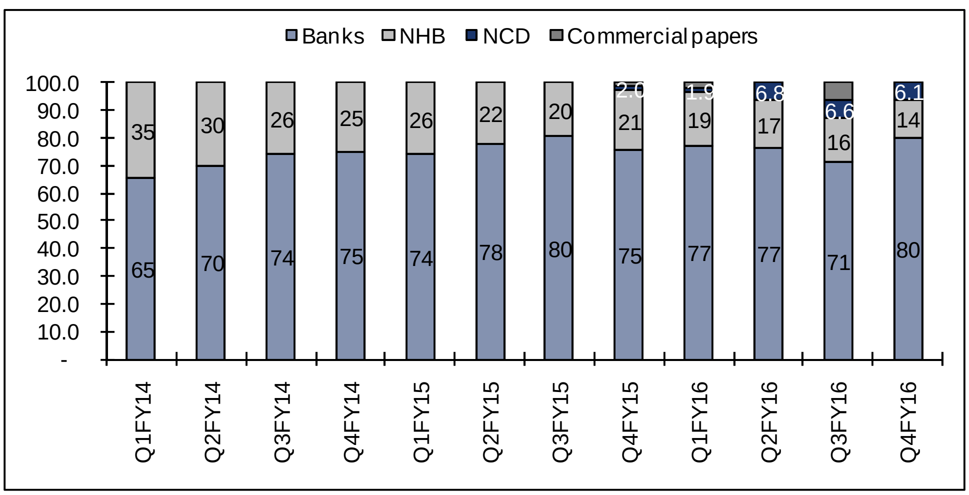


Source: Company data, I-Sec research

Borrowing mix – a lot of scope for optimisation remains

Another direct impact of the company's credit rating is its competitiveness in the bulk borrowing (NCD) markets. With its Long Term credit rating at AA- (by ICRA), bulk borrowing costs can indeed be higher than its bank borrowing costs with none of the flexibility that bank borrowings offer. This has meant that the company has remained largely bank financed.

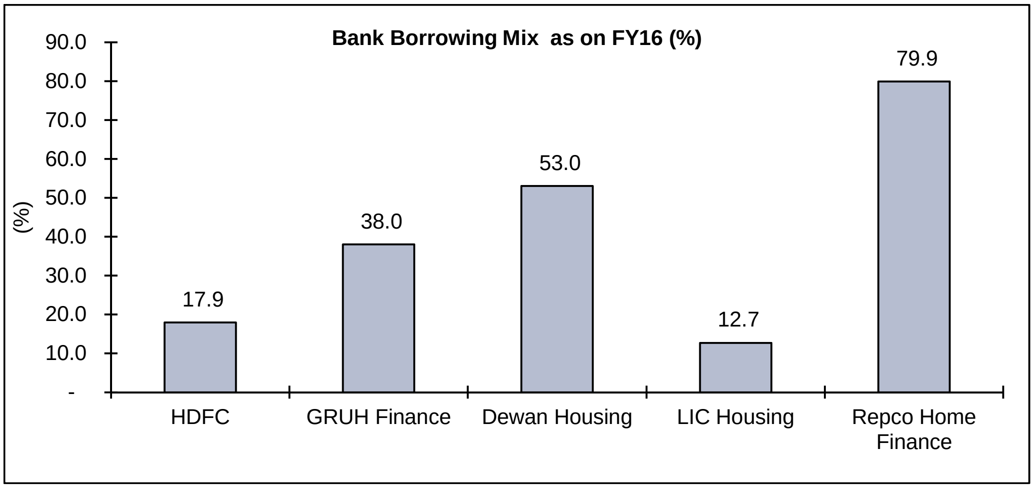
Chart 8: Proportion of NCD remains low mainly due to credit rating hurdle



Source: Company data, I-Sec research

With the recent upgrade, the company is testing the waters in the bulk borrowing market, a liability resource that we feel would be crucial to competitiveness in coming times. The fact remains that if the company can procure another notch of rating upgrade its borrowing costs in the bulk market will improve by 50-60bps while a two notch upgrade will improve the borrowing cost in the NCD market by 100bps. In both cases, these rates will be lower than bank borrowing costs by 10-20 and 50-60bps, respectively. **This will be a key boost to margins/ competitiveness, depending on the extent the company passes on the benefits of a structural borrowing cost reduction.** With NCDs at 6.1% of current borrowings, the headroom for substituting bank borrowings also remains high. The company's peers have all been actively working on reducing bank borrowing dependence.

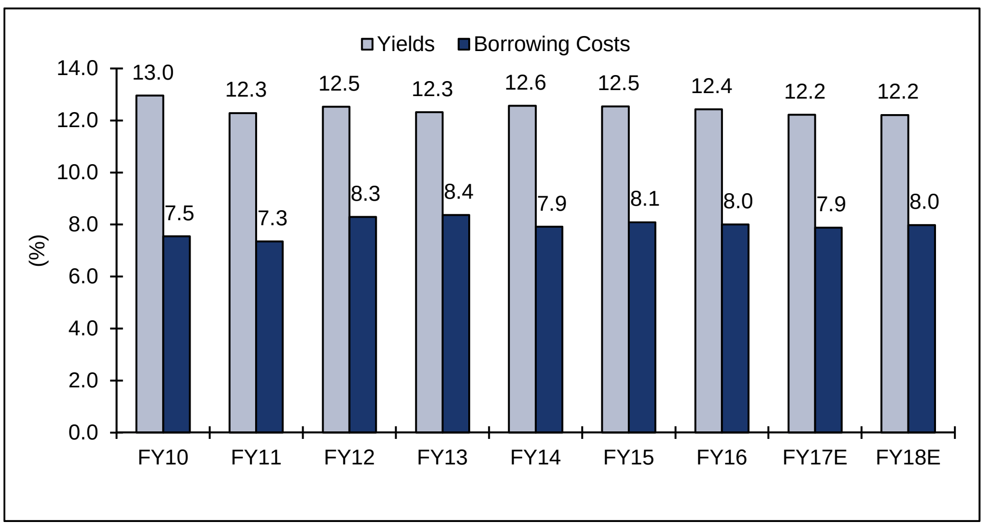
Chart 9: Proportion of bank borrowings remains very high compared to peers



Source: Company data, I-Sec research

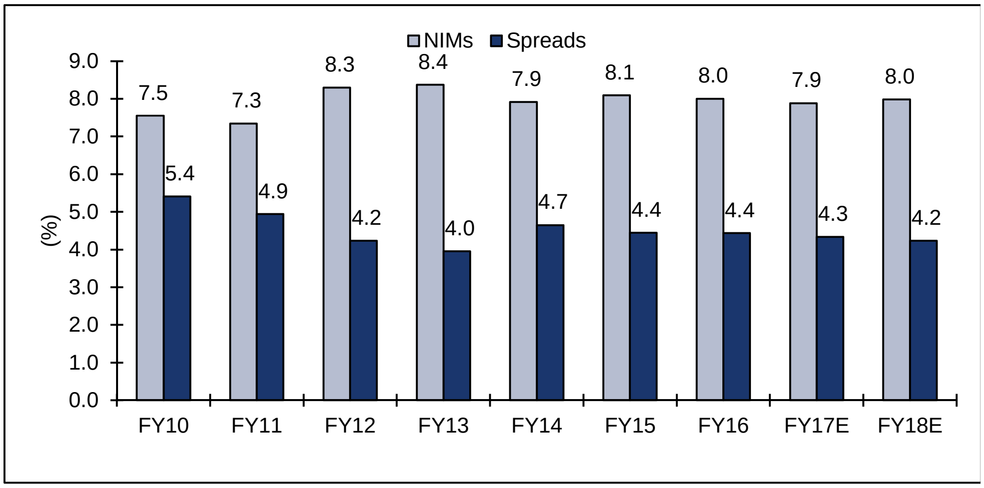
We do not build in too much margin boost from this avenue in the next 2 years, expecting gains to be passed along given high asset growth aspirations.

Chart 10: Cost advantage would likely have growth rather than margin ramification



Source: Company data, I-Sec research

Chart 11: NIMs to be supported by higher leverage

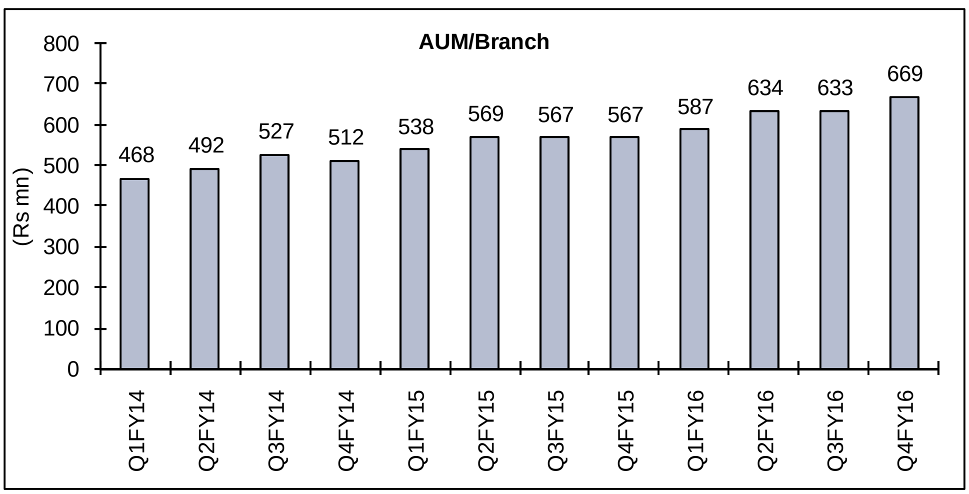


Source: Company data, I-Sec research

Operating leverage – some scope remains but not a lot

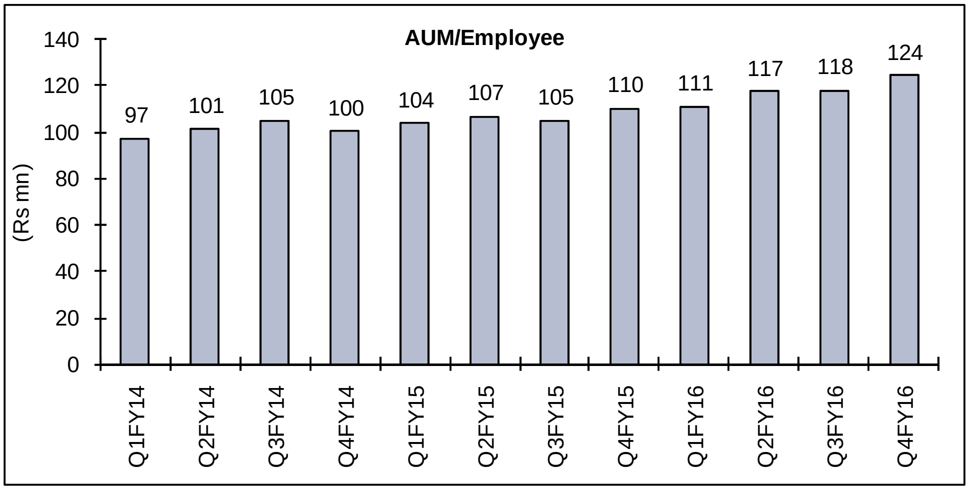
Much like the rural housing finance sector leader GRUH Finance, the company's reach expansion strategy has always been one of geographical contiguity. Also, branch expansion has generally not out-paced AUM growth *(even adjusting for build out of the larger ticket size LAP book)*.

Chart 12: AUM per branch has grown steadily



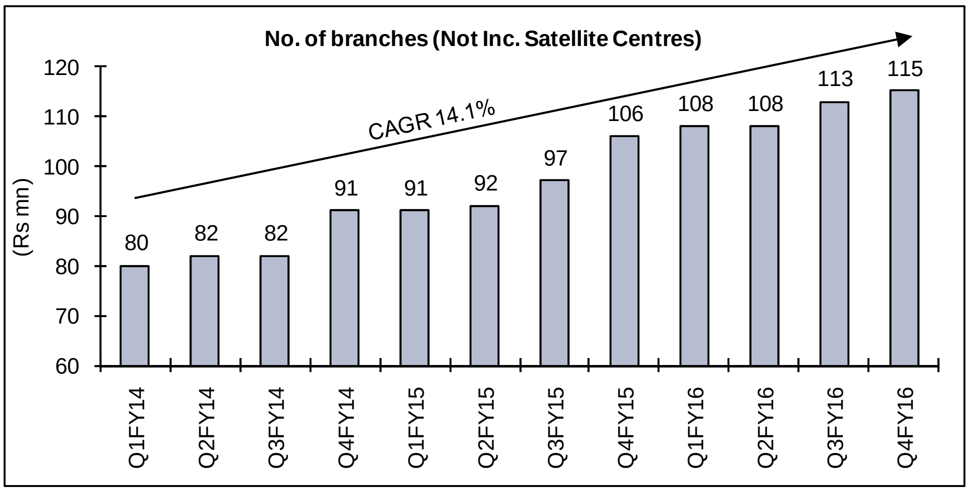
Source: Company data, I-Sec research

Chart 13: AUM/employee has grown at a good pace in FY16



Source: Company data, I-Sec research

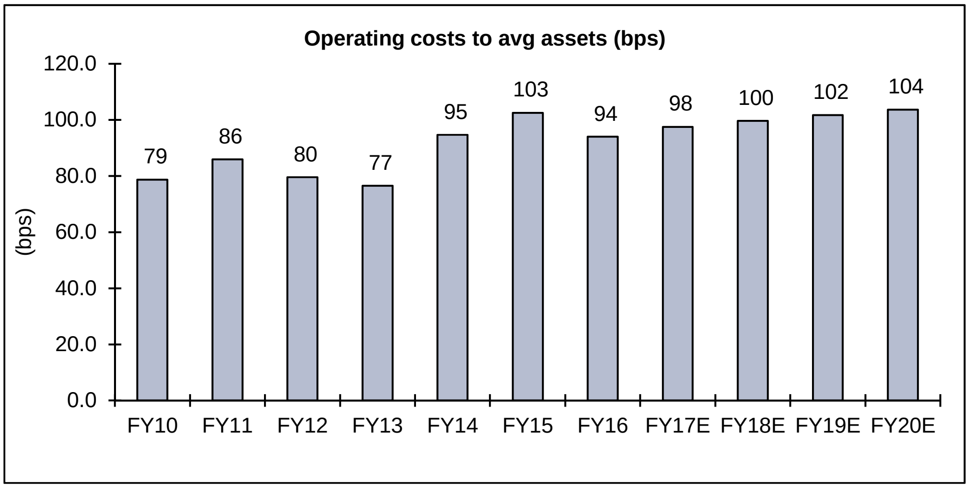
Chart 14: Branch expansion has been supporting the AUM growth



Source: Company data, I-Sec research

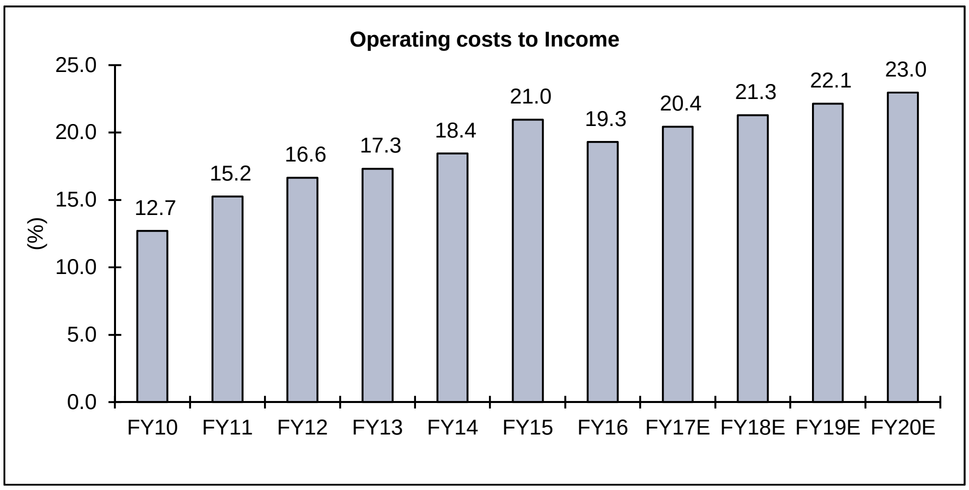
We expect that given the size of the business, its capital position and current margins, the company would in the medium term focus more on asset growth than focus on extracting the last bit of operating leverage juice from its existing distribution set up. Accordingly, while some operating leverage can be expected from overheads etc. getting shared over a larger base, it is unlikely to be very significant given regular employee and branch additions (albeit measured).

Chart 15: Operating costs have remained stable



Source: Company data, I-Sec research

Chart 16: Cost to Income has increased as the company expanded and margins shrunk slightly

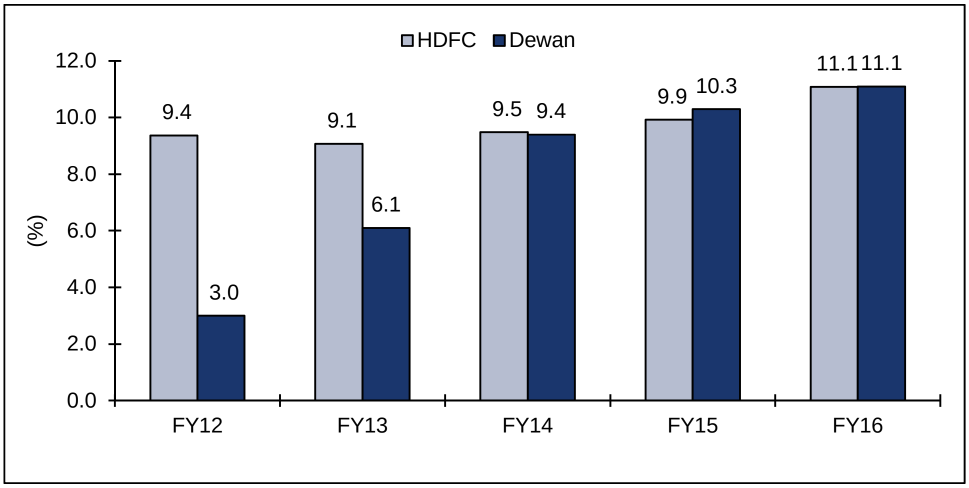


Source: Company data, I-Sec research

Securitisation can be a further fillip

The securitisation route has proved to be a growth and margin driver for many large NBFCs with the lead being taken by commercial vehicle financiers. The housing finance market is much larger than the commercial vehicle finance market and, being an asset class with much less cyclicality in delinquencies and longer duration of assets, RMBS (residential mortgage-based securities) issuance should have outpaced CV loans securitisation or any other similar asset class. The only drawback we can see is more prevalence of pre-payments, but the end security may be structured easily to take care of the same through accelerated principal repayments. The truth however remains that the RMBS market is still miniscule in India. Amongst our coverage companies, HDFC and Dewan remain the largest exponents.

Chart 17: Amongst our coverage HDFC and Dewan are biggest users of securitization/ sell-downs (as a proportion of total AUM)



Source: Company data, I-Sec research

The company has still not used the securitisation route and especially given unfavorable borrowing rates in the bulk debt markets, RMBS may be a lucrative and value enhancing opportunity.

Credible business model in high growth phase

Repco Home Finance,incorporated in April 2000 with Repco Bank (a co-operative based financial institution and not a co-operative bank) as promoter, is present in Tamil Nadu, Andhra Pradesh, Jharkhand, Kerala, Karnataka, Maharashtra, Madhya Pradesh, Gujarat, Odisha, West Bengal and Puducherry. Their presence is supported by 115 branches and 35 satellite centres.

Its two key products are home loans and loan against property (LAP). With a blended ticket size of Rs1.3mn, the focus is obviously on rural/ semi-urban locations and the self employed segment. The company has built considerable under-writing expertise in these relatively higher entry barrier segments and looks poised for high quality, profitable and robust asset growth in the medium term.

Table 3: Key products

Category	Name of Product	Purpose	Yields	Average Ticket Size	Customer category	Asset Book
Individual Home Loans	Dream Home Loan	Basic home loan for construction or purchase of home	Yields lie at ~11.5-12.3%	Average ticket size in the individual home loan category Rs1-1.2mn (As the company mainly focusses on Tier 2 & 3 cities and rural locations)	Around 50% of the customers are salaried class whereas other 50% are non-salaried, self-employed class.	~Rs61.7bn (Constituting ~80% of the book)
	Home Makeover Loan	Renovation & Repair of existing house				
	Plot Loans	To purchase the land for construction of home				
	Fifty Plus Loan	Home Loan to people above 50 years of age (Secured by their pension income stream)				
	Repco Rural	Home loans for affordable houses to weaker sections (In rural areas)				
	Repco Advantage	Limited period Home Loan scheme for a shorter period at attractive interest rates.				
LAP	Proprietary Loan	Basic product of loan against mortgage of immovable property	Yields lie at ~13 14%	Rs1.5-1.6mn (Incremental ticket size of Rs1.8-2.5mn)	Mostly Non-Salaried Self Employed	~Rs15.3bn (Constituting ~20% of the book)
	New Horizon Loan	Loan for purchase/construction of Non-Residential property				

Source: Company data, I-Sec research

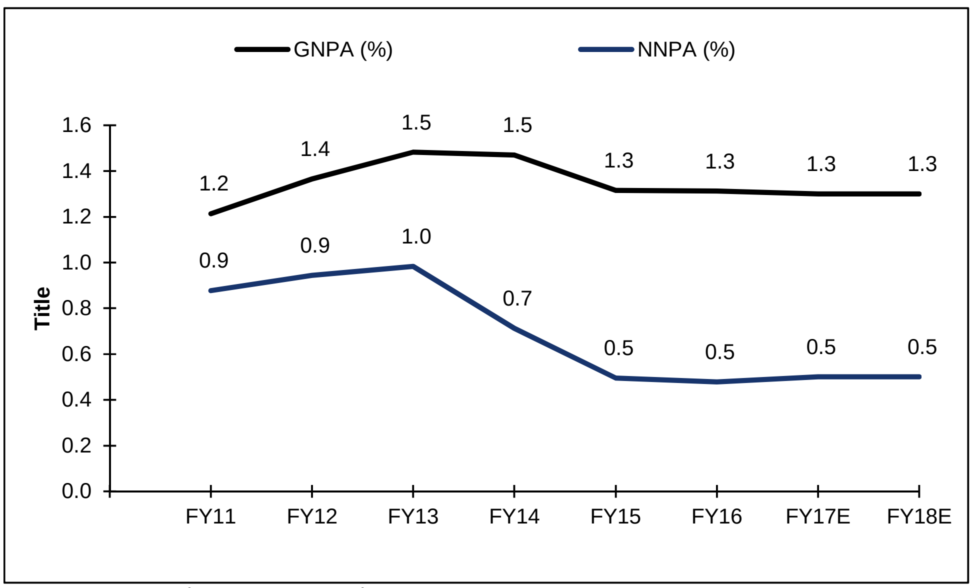
Asset quality stands testament to underwriting rigour

Repco Home Finance has almost no reliance on outsourcing for origination (only some LAP and individual loans in Maharashtra). This is income assessment based lending to the low ticket self employedsegment in the individual loans category and not merely based on collateral comfort. The proportion of loans to the self-employed segment stands at about 55% of all loans, with LAP being almost entirely a self-employed category product. On both its origination and underwriting processes, its 2015 Annual report states;

"…primary sources of customer acquisition are loan camps, customer walk-ins and referrals. Of these, loan camps contribute to about 70% of incremental originations. Manager of every branch conducts a loan camp once in every 2 months where, a primary assessment of customer documents is done and an in-principle sanction is given. The customer then approaches the branch for further processing of his/ her loan. The branch personnel act as single point of contact to customers and are responsible for sourcing loans, carrying out preliminary checks on the credit worthiness of potential customers, providing assistance in documentation, disbursing loans and monitoring repayments and collections. This way the company ensures that there is no conflict of interest and level of accountability is very high…"

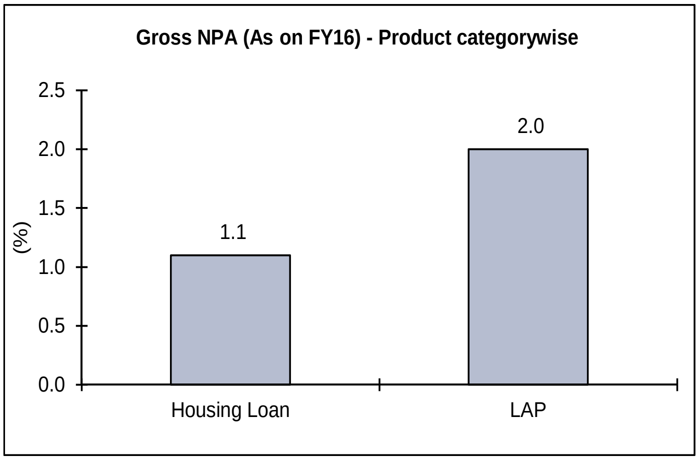
This model of both branch and hub based loan underwriting has stood the company in good stead and it has so far lost only 0.06% of loans disbursed over the last 15 years.We do not expect any major disruption, seasonal vagaries aside.

Chart 18: Asset Quality stands strong



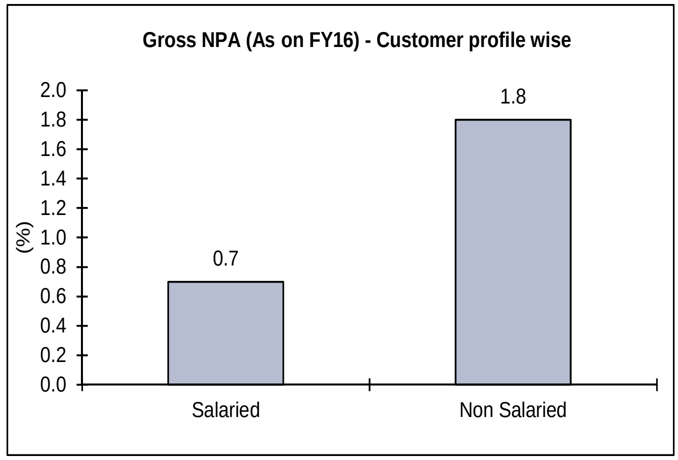
Source: Company data, I-Sec research

Chart 19: Product wise GNPA



Source:I-Sec Research

Chart 20: Customer profile wise GNPA



Source:I-Sec Research

As one can see, despite the ticket size related economies, LAP generally seems to do somewhat worse on asset quality. The company is focused on a LAP ticket size of Rs1.5-1.6mn (incremental ticket size of Rs2.5mn) which is a segment where we do not see as much froth as the higher end of the market. Its reasonable yields also provide the comfort of positive customer self selection. However, we do see some concerns with LAP business environment today from which no player can be 100% immune.

The LAP business eco-system raises some concerns for us

The home equity loans or LAP (Loan against Property) business as it is called in India has boomed in recent times and been a key growth driver for many NBFCs and housing finance companies. While Repco's deep distribution reach, significant on ground underwriting capabilities and reasonable loan ticket size/ pricing seem to indicate that it is at the low end of the risk spectrum in this product, we do have some concerns about the segment as a whole. Our interactions with credit appraisers and decision-makers at various HFCs/NBFCs suggest that they remain wary of the inherent credit risk in the segment due to the following reasons:

- Most lenders remain wary of customer's financial position when they avail this loan. With loan rates at 13-15%, apart from the cases where such borrowings are deployed by customers into their own business, the general suspicion remains that the borrower is in some sort of financial emergency.
- Lenders do not like the fact that the ultimate end use of the money is not under their direct control.
- While the collateral may be enforceable in the case of individual LAP loans through SARFAESI (not yet notified by RBI, although granted in the last Union Budget), our contacts in credit underwriting businesses feel that the pool defaults are likely to be higher than plain vanilla mortgages.

In order to mitigate the risks, the most prominent players are taking the following precautions:

- LTVs are much lower than the 80% maximum allowed for mortgage loans. For most players, it tops out at 70% with 50-60% being the usual range.

- Lenders try to gauge the cashflow pattern based repayment capacity of the borrower and not just rely on the adequacy of collateral.
- The exposure to this business line is capped to a limited portion of the overall asset portfolio.

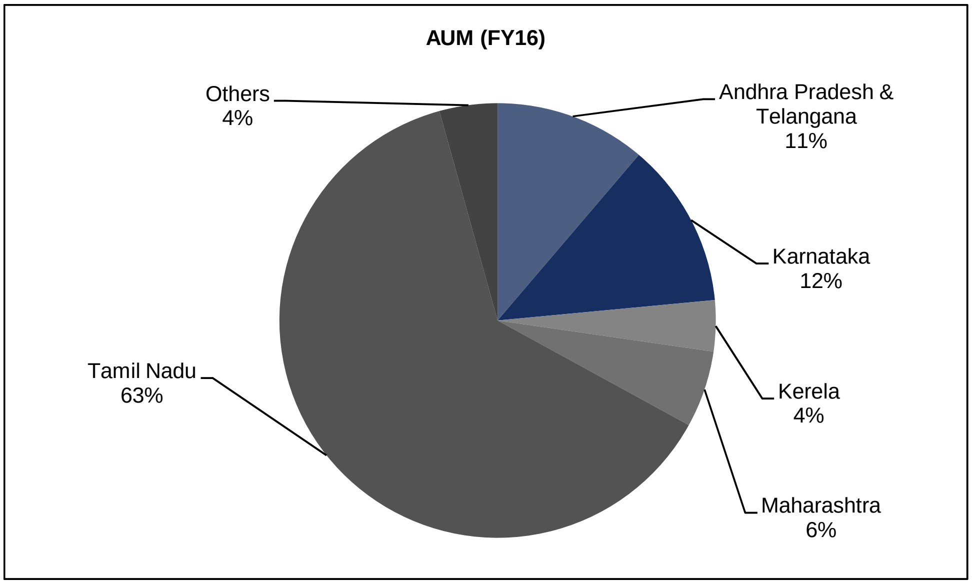
One rule of thumb we rely on, to gauge the risk inherent in a LAP portfolio, is to focus on ticket size and loan pricing. Obviously, all other things remaining equal, the smaller the better on both counts from a risk perspective. We also believe that LTV in the case of LAP loans is a subjective opinion and should not be accorded the same importance to analysis of portfolio risks, as one would give it for judging an auto or mortgage portfolio. The simple reason is that for the latter cases, valuation of asset is based on a transacted price of the asset and therefore more objective in nature.

On both these counts, Repco Home Finance checks out reasonably well.

Geographical distribution is South heavy – especially Tamil Nadu

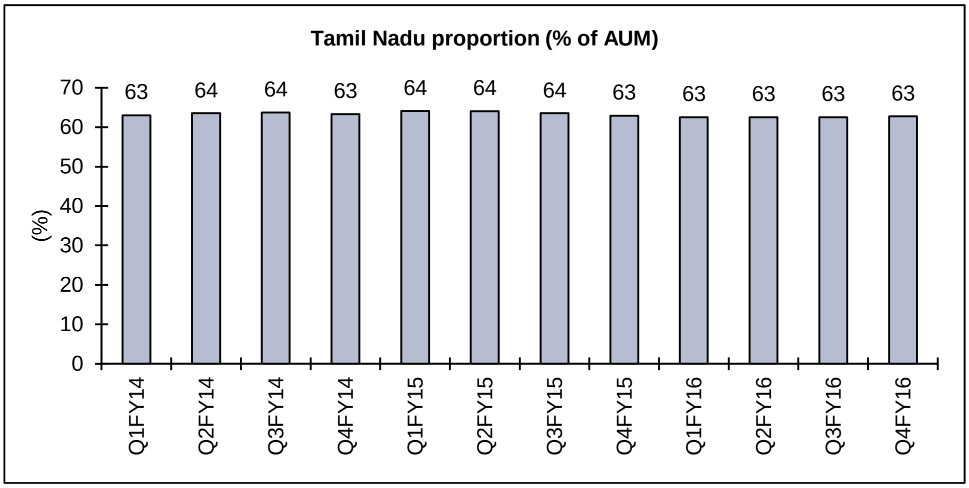
The dominant geography, without a shred of doubt remains Tamil Nadu, and despite high growth its overall contribution to the loan book has remained constant (in proportion).

Chart 21: A South heavy geographical distribution



Source: Company data, I-Sec research

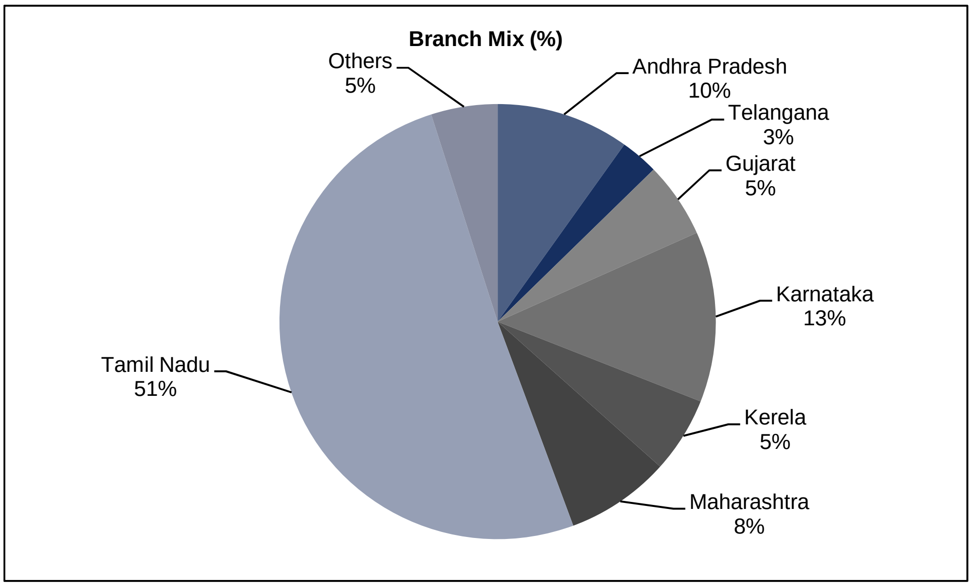
Chart 22: Proportion of Tamil Nadu has been constant ~63%



Source: Company data, I-Sec research

This pattern is reflected in its branch/ satellite centre distribution network as well.

Chart 23: Branch Mix as on FY16 (Total network of 142 branches)



Source: Company data, I-Sec research

We see a lot of growth headroom in existing geographies

While diversification efforts will remain regular and measured in the medium term, we expect that existing strong geographies still have much to contribute. The following analysis demonstrates how even the dominant geography of Tamil Nadu with FY15 AUM per branch of Rs525mn (24% above national average), has compounded overall AUM for the state at 27.8% over FY14-16. **However, the fact remains that even today total loans outstanding for the company per district of Tamil Nadu is still only ~Rs1.5bn (roughly 1,200-1,300 loans per district), a miniscule number in relation to the opportunity size in the space.**

Table 4: State-wise AUM/branch and growth rates for FY15

	FY14			FY15			AUM/Branch growth (%)
	AUM (Rsmn)	No. of Branches	AUM/Branch	AUM (Rsmn)	No. of Branches	AUM/Branch	FY14-15
Tamil Nadu	29,510	63	468	37,821	72	525	12.1
Karnataka	5,594	18	311	7,336	18	408	31.1
AP & Telangana	6,480	15	432	7,276	18	404	(6.4)
Others	5,035	26	194	7,697	34	226	16.9
Total	**46,619**	**122**	**382**	**60,129**	**142**	**423**	**10.8**

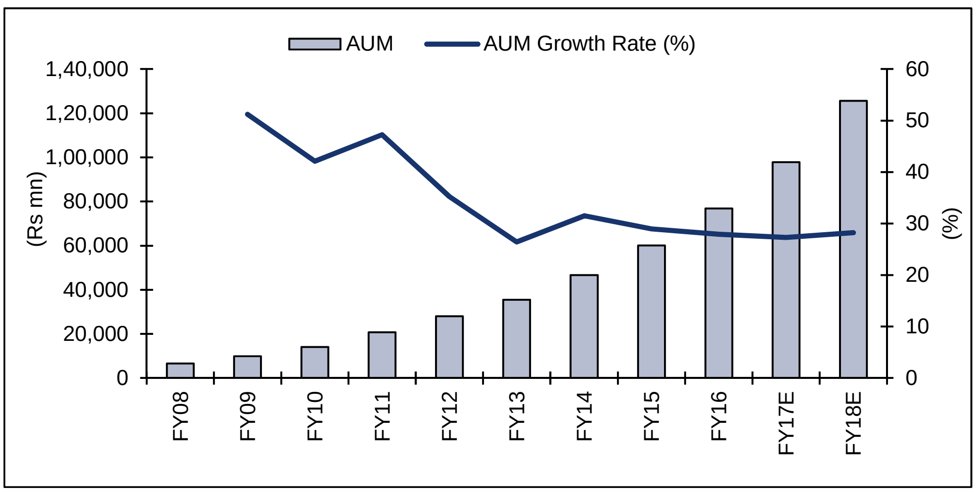
Source: Company data, I-Sec research

Table 5: State-wise AUM CAGR (FY14-16)

AUM CAGR (FY14-FY16)	AUM (FY14)	AUM (FY16)	CAGR (FY14-16) (%)
Andhra Pradesh & Telangana	6,480	8,614	15
Karnataka	5,594	9,460	30
Kerala	1,725	2,923	30
Maharashtra	1,865	4,384	53
Tamil Nadu	29,510	48,224	28
Others	1,445	3,307	51

Source: Company data, I-Sec research

Chart 24: We expect 27.8% AUM CAGR over FY16-18E, assuming 8% annual inflation in ticket size



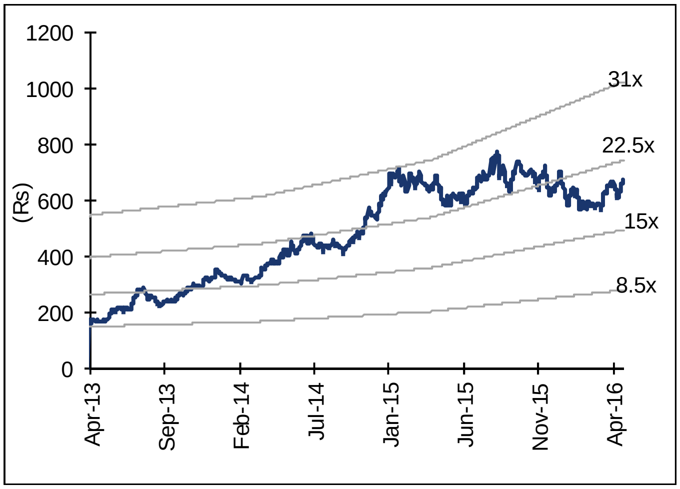
Source: Company data, I-Sec research

In context, valuations appear reasonable

No doubt, trading at higher than median levels…

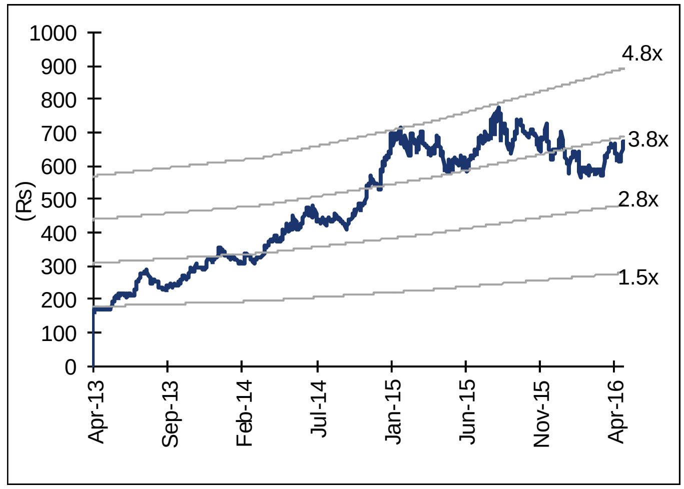
If we look at the trading range of the company in its listed history, these multiples are at the upper end of its band. In a market that seems generally positively inclined towards HFCs and even most other retail NBFCs, this is perhaps to be expected for a high growth small company with low asset quality risks like Repco Home Finance.

Chart 25: P/E band chart



Source:I-Sec Research

Chart 26: P/B band chart



Source:I-Sec Research

Table 6: Peer Valuation Table

	P/E (x)		P/B (x)		RoE (%)		EPS CAGR (%)
Company	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E	(FY16-18E)
Repco Home Finance	21.9	17.9	3.9	3.2	19.2	19.6	27.8
HDFC	27.3	22.1	4.8	4.3	19.4	20.4	13.6
GRUH Finance	34.0	27.7	10.1	8.4	32.2	32.9	21.4
LIC Housing Finance	12.0	10.1	2.2	1.9	19.8	20.1	18.4
Dewan Housing Finance	6.4	5.5	1.0	0.9	17.1	18.4	19.8

Source: Company data, I-Sec research

…the 'GRUH test' provides context though

We realize that Repco Home Finance is in a much earlier part of its growth life cycle than most peers and has multiple levers for capital productivity enhancement. In the meanwhile, leverage headroom ensures no need for dilutions and indeed some opportunity to thin out the capital base at some stage through raised payouts.

We use the same criterion we used on GRUH Finance, when we put our REDUCE recommendation on it 3 years back, to ensure that we capture long term value creation in our target multiple.

We assume that the typical investor in Repco Home Finance has a 5 year holding period, implying that current entry is at CMP and exit is at the end of FY21. We assume that the current 26-27% asset growth trajectory is maintained over the next 5 years while the company's RoE inches up to 25%, mainly through its leverage moving closer to its peers, as asset growth outpaces accruals. At this stage (FY21 end), we will have a 25% RoE company which can then look forward to 20% asset growth while paying out 20% of profits in the medium term. If we assume an exit multiple of 3x 1-yr fwd P/BVPS to such a company (rather conservative in our opinion), the investor will still make an IRR of 14.9% on the stock. We think our assumptions err on the side of caution.

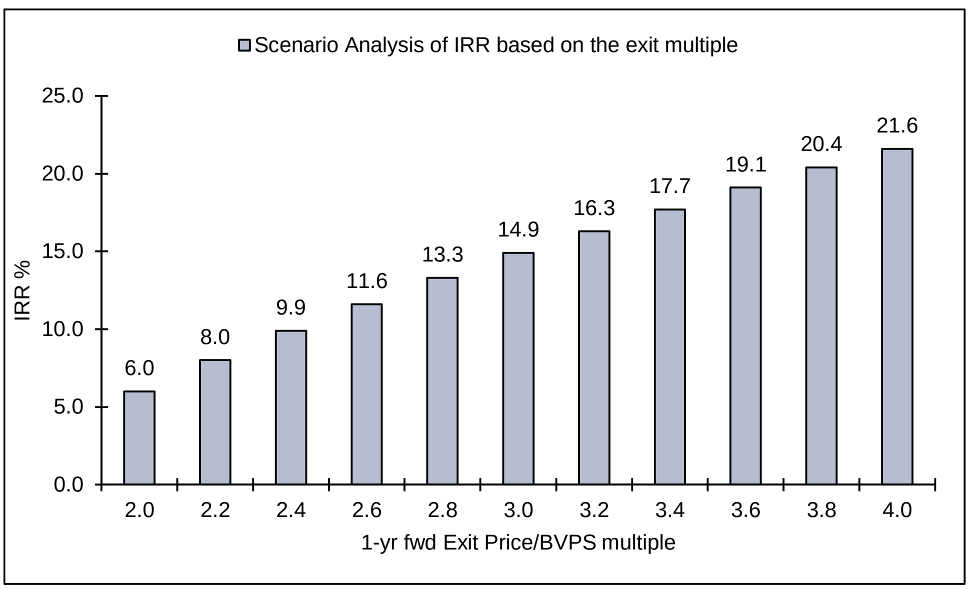
Table 7: IRR computation details

	FY16 Now	FY17 Year 1	FY18 Year 2	FY19 Year 3	FY20 Year 4	FY21 Year 5	FY22 Year 6
Stock price (Rs)	702.0					1384.4	
BVPS (Rs)	152.7	179.8	212.6	254.6	310.0	383.6	461.5
P/BVPS (1-yr fwd)	3.9					3.0	
RoE (%)	17.0	19.2	19.6	21.1	23.1	25.0	25.0
Dividends (Rs)	1.8	2.1	2.4	2.8	3.3	4.0	18.0
Cash flow to shareholder (Rs)	-702.0	2.1	2.4	2.8	3.3	1388.4	
Annualized total return of shareholder (%)	**14.9%**						

Source: Company data, I-Sec research

In order to assuage investor concerns, we provide the following sensitivity analysis which lists IRR for investors if exit multiples vary between a very unlikely 2x to a much more likely 4x.

Chart 27: Scenario analysis of IRR based on exit multiple



Source: Company data, I-Sec research

Target multiple is set 3.5x FY18E BVPS (adjusted for DTL)

We therefore set our target multiple at 3.5xFY18E P/BVPS (adding back DTL estimate, in line with other HFCs under coverage), yielding a 12M target price of Rs835, indicating 19% upside. We chose this multiple, as exit at 3x 1-yr fwd P/BVPS 5 years from FY17 end, will provide an IRR of 13% for an investor, which would be close to our estimate of the company's cost of equity. **We initiate coverage with a BUY recommendation.**

Affordable and rural housing opportunity makes growth headroom in the medium term a non-issue

In the affordable and rural housing segment, we see no risk of growth saturation in the medium term, from an opportunity point of view. There are many socio-economic factors that drive this opportunity.

- Population growth
- India's demographic dividend – growing proportion of people in an economically productive age group
- High savings rates
- Rising income levels leading to better affordability
- Rural prosperity and consumption
- Trend of formation of nuclear families
- Urbanization

Policy thrust on affordable housing

In recent years, the Government of India and regulators (NHB and RBI) have stressed upon the need for easier and cheaper financing options especially in the affordable housing segment. Typically, banks and housing finance companies (HFCs) offer interest rate discount of 25bps for purchase of relatively cheaper housing units (normally loans less than Rs3mn per unit) primarily catering to customers in non-metro cities. During the past decade, there has been a secular rise in the quantum of housing units across the country on the back of a rising middle class, growing trend of nuclear families and aggressive foray by companies in the retail housing sector. This has meant that housing mortgages have become an important growth driver for NBFCs and banks alike. While the private sector banks were traditionally active in this segment, of late most PSU banks too have identified it as an important growth driver going forward (especially with SME and corporate financing plagued with rising NPAs and slowing growth). However, as we estimate in the following table the opportunity size remains large at Rs10tn at current prices.

Table 8: Potential financing opportunity in affordable housing pan-India

Housing finance opportunity calculation	
Housing shortfall (million units)	18.95
Average cost of an affordable house (Rs mn)	0.8
Loan-to-value ratio	70.0
Average loan per house (Rs mn)	0.5
Total financing requirement (Rs bn)	**9,974**

Source: Technical group on Urban Housing Shortage (2012-17), MoHUPA, RBI, I-Sec research

While there is no uniform definition of affordable housing in India, houses ranging from about 300sqft for Economically Weaker Sections (EWS), 500sqft for Low Income Group (LIG) and 600-1200sqft for Middle Income Group (MIG). EMIs at 30% to 40% of the monthly income of the buyer are generally considered as affordable houses in the country. The Ministry of Housing and Urban Poverty Alleviation (MoHUPA), uses the following household income criteria to define EWS and LIG:

- For EWS: Rs100,000 as household income per annum
- For LIG: Rs100,001 to Rs200,000 as household income per annum

Multiple central initiatives to support growth

In the past decade or so, the central and state governments have taken a plethora of initiatives to promote housing and housing finance in the country. Some of the key schemes being implemented by the GoI are as follows:

- **PradhanMantri Awas Yojana (PMAY) – Housing for All by 2022:**The implementation of this scheme spans from 2015 to 2022. It aims at undertaking the construction of ~20mn houses by 2022. The scheme will be implemented through four verticals –

    i. **In Situ Slum Redevelopment**: To utilize the lands in the slum areas and provide the slum dwellers with houses in the form of a formal urban settlement with private participation. A slum rehabilitation grant of Rs0.1mn/house will be admissible for all houses built for eligible slum dweller.

    ii. **Affordable Housing through credit linked subsidy:**Beneficiaries of Economically Weaker section (EWS) and Low Income Group (LIG) seeking housing loans from Banks, HFCs and other such institutions would be eligible for an interest subsidy totalling to 6.5% of the loan value on a NPV basis (upto a principal amount of Rs0.6mn) for a tenure of 15 years or during tenure of loan whichever is lower. The NPV of the interest subsidy @ 9% discounting rate will be credited upfront to the loan account of the beneficiary with the lending institution.

    iii. **Affordable Housing in partnership**: Partnership with private or public sector for affordable housing projects with at least 35% of houses constructed for EWS. A central assistance of Rs0.15mn/house will be available for all EWS houses in the project.

    iv. **Beneficiary led individual house construction or enhancement**: Individuals eligible for benefits to EWS will get a central assistance of Rs0.15mn for construction of new house or enhancement of the existing one. However, the individual must prove the availability of owned land and finance (including his own contribution) for the construction. Further, the subsidy will be made available in 3-4 instalments with the final instalment beinga minimum of Rs30,000, released post completion of the construction/ enhancement.

- **Indira Awas Yojana (IAY):** This scheme is targeted at BPL families by providing them cash subsidy to build low-cost houses. Funding is jointly provided by the central and state governments in the ratio of 75:25. Since inception, ~23mn houses have been constructed under this scheme.
- **Golden Jubilee Rural Housing Finance Scheme (GJRHFS):** This scheme was announced in 1997 to improve access to housing finance in rural areas. During 1997-2013, a total of ~3.9mn housing units were financed by HFCs, banks and cooperative sector institutions achieving 95% of the targeted 4.1mn units. The scheme has been instrumental in providing increased access to institutional credit in rural areas at the pan-India level.

Apart from these some other major schemes/policies implemented by the GoI are as follows:

- **The National Urban Housing & Habitat Policy, 2007:** This policy aims to achieve affordable housing for all by promoting public-private partnerships.
- **Affordable Housing Partnership**: This scheme introduced by the GoI to increase affordable housing stock by providing central support of Rs75000/dwelling -unit constructed for EWS/LIG given a minimum project size of 250 dwelling units.Till date, 24,141 projects have been sanctioned of which 8,968 are completed.
- **Rajiv Awas Yojana (RAY):** This scheme has been introduced with the objective of providing basic housing facilities to the urban poor and provides for funding assistance to states for implementing slum re-development and affordable housing projects. This scheme has been discontinued and the outstanding projects have been subsumed in “Housing for All by 2022” mission. .

State-level initiatives in housing are also helping

Recently, many state governments have also taken steps to make affordable housing a reality especially amongst the weaker sections of the society. Some of the initiatives taken by the major states are as follows:

- **Andhra Pradesh**: As per the Andhra Pradesh State Affordable Housing Policy, 2015, the government targets to construct 1mn affordable houses for EWS/LIG sections over a 10 year period. The housing shortage in the state has been estimated at 1.27mn units based on NHB survey. All group housing projects over a plot size of more than 5 acres are mandatorily required to ear mark 10% of the built up area or 25% of total units built for EWS/LIG sections. Another mode of incentivizing the private developers is by giving them benefits for constructing projects with minimum 250 dwelling units and having units of less than 60sqmt on at least 60% of the total built up area (where 35% of the total units constructed to be for EWS/LIG sections).
- **Gujarat**: The MukhyaMantri Gujarat Rural Urban Housing Yojana 2014 envisages to make Gujarat slum-free within 5 years. It aims at construction of 5mn houses in 5 years of which 2.2mn houses are planned in urban areas. It involves providing financial assistance of Rs0.15mn to EWS (annual income upto Rs0.1mn) and Rs0.1mn to LIG (annual income from Rs0.1mn to Rs0.25mn). It also has provisions for capping the maximum price charged for house (Rs0.3mn for EWS and Rs0.75mn/Rs1.1mn for LIG). The scheme also contains incentives for private developers in form of higher Floor Space Index in those properties or permissions for setting up commercial establishments on a part of that land, etc.
- **Maharashtra:** Under the Maharashtra State New Housing Policy& Action Plan 2015, government has undertaken the action plan to resolve the 1.94mn housing shortage in the state as revealed by a NHB survey. The action plan targets construction of 1.1mn houses in MMR and 0.8mn houses outside MMR by 2022. The action plan takes cares of key hurdles in affordable housing space in the following manner –
    - **Preparation of government land bank**
    - **Creation of housing fund** (A fund where the private or government employees will park a fixed percentage of salary which will be invested in government securities. After 10 years of contribution, members can apply for a house in any government scheme and the amount standing to their credit in the fund can be utilized as his share of cost towards the house while the member needs to pay only the balancing amount.)
    - **Interest only Housing Loan for LIG/EWS category –** In this scheme, the government will create a fund to provide the financial support for constructing the affordable houses for the mentioned categories. The fund will grant loans to developers for 15 years at SBI PLR for an amount upto Rs100mn per borrower. The loan will carry a bullet repayment structure where principal will have to be paid at the end of 15 years. Meanwhile flats will have to be sold to LIG/EWS sections worth the loan taken where the developer can take a maximum of 10% of the cost upfront and the balance 90% will be recovered post completion of the project. Meanwhile, the applicants for the flat will pay an interest to the developer. Thus this financing structure in a way incentivizes the developer for undertaking such projects.

- **Rajasthan:** Under the Chief Minister's Jan Awas Yojna, the government targets to resolve the urban housing shortage of 1.05mn as revealed by a NHB survey by undertaking the construction of additional houses by 2022. Of these, ~85% will be constructed for the EWS and LIG sections. The scheme mandates reservation of 10% of land in a government or private housing project and 7.5% in a developer township project for LIG and EWS sections.
- **Kerala:** The Kerala State Housing Policy 2011 focuses on treating housing need as a fundamental human right and aims to address the housing stock gap of the vulnerable and poor sections of the society (with particular focus on EWS and LIG sections). The policy also focuses on upgrading of decaying housing stock and facilitating the dwellings with the basic amenities of power, sanitation, drinking water, etc. Some of the initiatives taken by the state government in respect of Housing for All are funding of houses for BPL homeless people (75,000 houses target for FY16), subsidizing 75% of the annual principal repayment and interest on home loans taken by landless BPL people for a period of 20 years, etc.
- **Uttar Pradesh**: The UP Urban Housing Policy aims at encouraging cost-effective measures to make affordable housing a reality for EWS/LIG families. Under the policy, every EWS/LIG plot would also include the provision to set up a shop or a business unit.
- **Madhya Pradesh**: As per the Madhya Pradesh State Housing and Habitat Policy 2007, 30% of the developed land is to be reserved for EWS/LIG segments if the land has been provided by the government at concessional rates. Also, in case the land has been purchased by private/cooperative sector developers, 15% of it is earmarked for EWS/LIG housing.

Shortfall in rural housing is another opportunity

Despite increasing urbanisation, rural population at over 68% of India's total population continues to be huge with significant housing requirements. As per the working group on rural housing for the 12th FYP, total shortfall in rural India stands at 43.7mn units, out of which 90% is on account of the Below the Poverty Line Population (BPL families). One of the main reasons behind this shortfall (apart from high poverty levels) is the lack of formal institutional financing mechanism and framework. As per the Planning Commission, about 66% of the new construction financing is sourced through own resources, 27% through non institutional agencies and only 9% through sourced institutional finance. We estimate the rural housing finance opportunity at Rs6.5tn at current prices.

Table 9: Rural housing shortage (2012 -2017)

Factors	Shortage (million)
No. of households without houses - 2012	4.2
No. of temporary houses - 2012	20.2
Shortage due to congestion - 2012	11.3
Shortage due to obsolescence - 2012	7.5
Additional housing shortage arising between 2012-17	0.6
Total housing shortage - 2012 to 2017	**43.7**

Source: Planning Commission, I-Sec Research

Table 10: Estimated financing requirement in rural housing

Total housing shortage (mn)	43.7
Average cost of rural house (Rs mn)	0.20
Loan-to-value ratio	75%
Average loan per house (Rs mn)	0.15
Total financing requirement (Rs bn)	**6,555**

Source: Planning Commission, I-Sec Research

State government schemes for rural housing are aplenty

More than 15 states have separate rural housing schemes and during the 11th FYP period (2007-12), 3mn houses were built under the various state governments' schemes. Some of the important schemes run at the state levels are as follows:

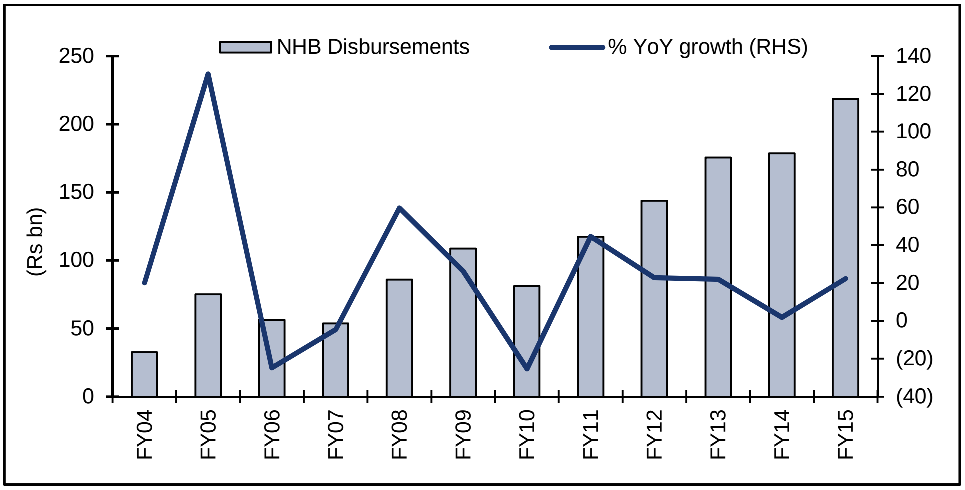
- **Tamil Nadu**: Under the solar Powered Greenhouse Scheme all the BPL rural people are eligible for free housing. Each house built is within a 300sqft area (land shall belong to the person) at a cost of Rs0.18mn fully funded by government with solar powered lighting implemented. The TEDA will be in turn eligible for claiming the subsidy from Ministry of Renewable Energy.
- **Kerala**: Under the EMS housing scheme, financial assistance of upto Rs125,000 is provided to poor families from the backward communities.
- **Gujarat**:The Gujarat government had introduced nine housing schemes complementing the IAY. In 2009, the local government decided to bring all the different schemes under one fold with uniform financial assistance of Rs55000.
- **Karnataka:** The government runs two different schemes ("BasavaVasathiYojane" and "Ambedkar Housing Scheme") targeted at special occupational groups and economically weaker sections. Under both the schemes, the total financial assistance is capped at Rs63500.

- **Rajasthan:** As a complementary scheme to IAY, in 2011 the *"MukhyaMantriGramin BPL Awaas Yojana"* was launched with the objective of providing 1.0mn houses to rural BPL families over a course of four years. The state government has arranged a loan of Rs34bn from HUDCO to finance the scheme.

Refinancing from National Housing Bank (NHB) is an enabler

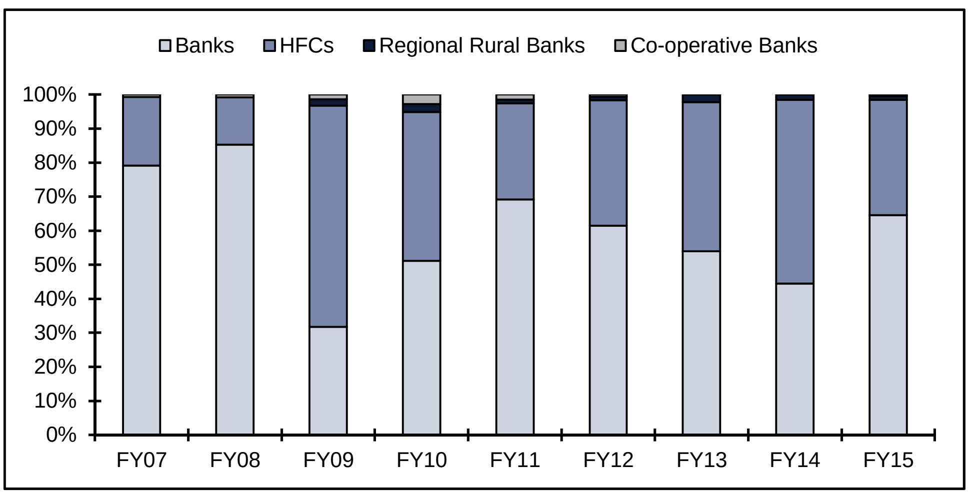
Banks and the larger HFCs have been the biggest beneficiaries of NHB's refinance facility. Recently, the smaller niche-focused HFCs have also started tapping the facility given their strong growth trend and healthy operating profile. On the other hand, disbursements to the cooperative sector has witnessed a declining trend given the losses experienced by individual institutions making them ineligible for NHB refinance.

Chart 28: NHB refinance has been growing at ~20%



Source: NHB, I-Sec research

Chart 29: NHB refinance – disbursement mix (%)

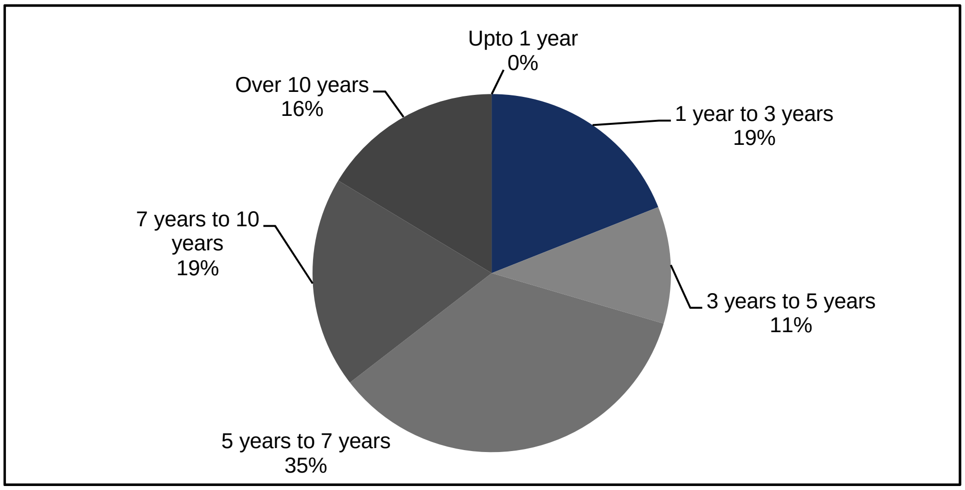


Source: NHB, I-Sec research

Nature and key features of NHB disbursements

NHB refinance remains pretty lucrative for HFCs in cost terms (~200bps advantage for an average institutional borrower). Refinance available from NHB is primarily of medium term duration with approximately ~65% of disbursements in FY15 falling under the 1 to 7 year maturity bucket. However, it is to be noted that majority of the incremental housing loans disbursed by banks and HFCs are floating rate based, leading to some ALM mismatch on an overall basis. Given that interest rates are expected to decline in India going forward, this ALM structure may lead to some spread compression as loans re-price at lower interest rates while NHB refinance is tied up at a fixed rate of interest. However, the major mitigating factor is that housing loans disbursed in the rural areas can be refinanced at significantly lower interest rates.

Chart 30: Tenure wise break-up of NHB refinance disbursements (FY15)

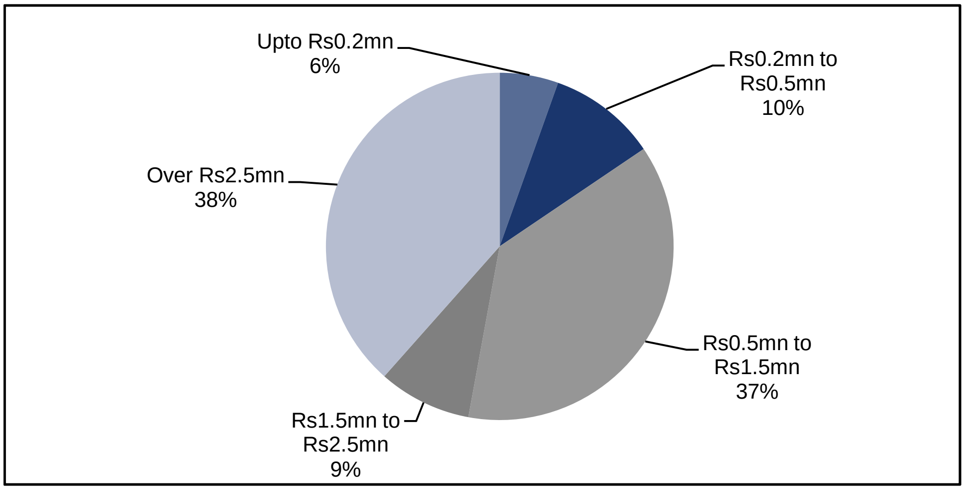


Source: NHB, I-Sec research

Still a significant portion of refinance available against small-ticket loans

In FY15, ~16% of the NHB refinance disbursements were for loans with ticket-size of less than Rs0.5mn while loans with ticket-size of Rs0.5mn to Rs2.5mn contributed 46%. The proportion of loans below Rs2.5mn ticket size disbursed has reduced to 62% in FY15 from 82% in FY14. Considering the general inflation level in the cost of construction, still a significant portion of the refinance is available against small-ticket loans, mainly in the non-metro areas.

Chart 31: Breakdown of NHB disbursements –ticket-size (FY15)

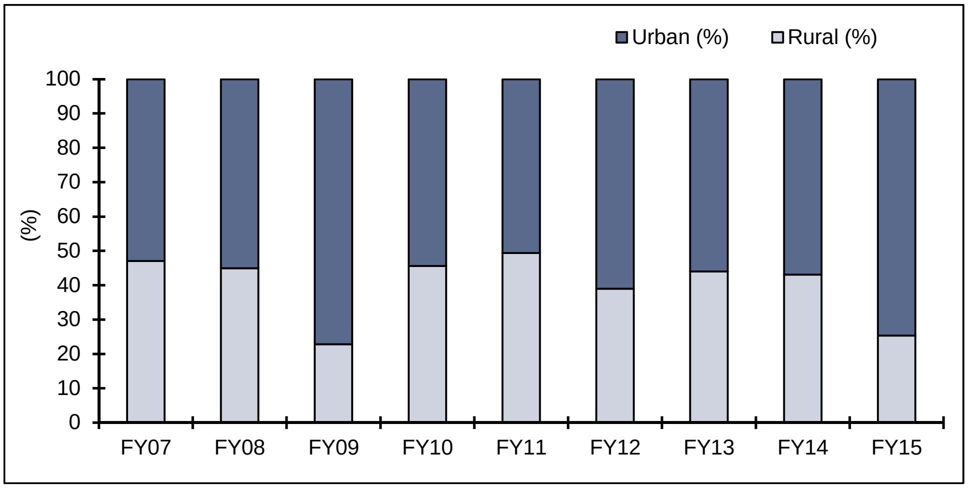


Source: NHB, I-Sec research

Urban areas have started dominating NHB refinance disbursements in FY15

In FY08, urban areas constituted ~55% of total disbursements and in FY15, it increased to ~75%. One reason behind this increase could be the change in classification of the earlier rural areas to urban areas during the period. However, the mix has not been so steady over the years (share of urban areas was 55% in FY08, increased to 77% in FY09, remained stable at 50-60% in FY10-14 and jumped to 75% in FY15).Hence drawing any conclusion on the same may be far-fetched at present.

Chart 32: Significant proportion of NHB refinance remains rural



Source: NHB, I-Sec research

Refinance disbursements under the Rural Housing Fund (RHF) has been increasing

In FY09, the GoI announced the setting-up of Rural Housing Fund (RHF) so as to enable the lending institutions to on-lend to the targeted groups in the rural areas at concessional rates of interest. The financing can be for purchase/construction/repair and upgradation of housing units. Launched with an initial allocation of Rs17.8bn in FY09, the fund has seen allocation increased to Rs80bn in the (FY15) Union Budget.

Key features of the refinance scheme under the RHF (For HFCs)

Purpose – To provide refinance assistance in respect of housing loans extended byHFCs to weaker sections of the society for construction, purchase or renovation

Eligible Loans

- Loan Size upto Rs1.5mn
- Location of property in rural area (Areas with population less than 50000 as per 1991 census)
- Loan to weaker sections of society including:
    - Farmers with land-holdings of less than 5-acres, landless labourers, tenant farmers and share croppers
    - Women
    - Scheduled Castes and Scheduled Tribes, minority community persons
    - Individuals classified under 'Below poverty Line' (BPL) or marginally above it, i.e. eligible for loans under the Swarnjayanti Gram Swarozgar Yojana (SGSY) and Differential Rate of Interest (DRI)
    - Rural population with income upto Rs0.2mn

Tenure of loans – 3 to 10 years

Refinancing under the RHF scheme is for fixed rates and the applicable rates of interest (as ofFY16) are as follows:

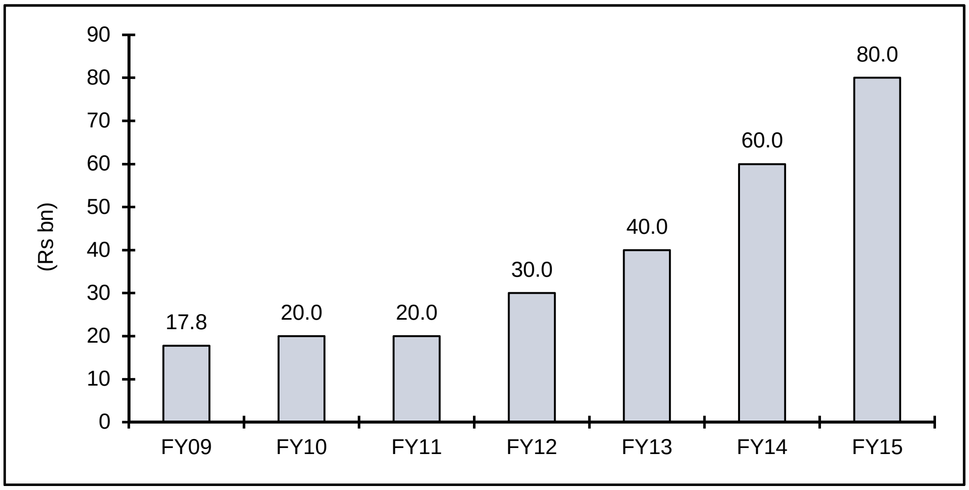
Table 11: RHF refinance rates

		Interest Rates	On-Lending Cap
Funds	HFCs and RRB	6.12% pa	9.62% pa
	SCBs	6.12% pa	Base rate

*Rates are for Loan size of Rs1mn (for urban cooperative banks) and Rs1.5mn for others
Source: NHB, I-Sec research

The RHF scheme has been a success with steady increase in allocation and utilisation. Allocations to the fund from the Union Budget have steadily risen from Rs17.8bn in FY09 to Rs80bn in FY15.

Chart 33: Allocation to the Rural Housing Fund has been steadily increasing



Source: NHB, I-Sec research

Utilisation from the fund has been ~100% since inception with HFCs having been the major beneficiaries. However, for FY15, the actual amount disbursed till June'15 was Rs23.6bn as against the allocated amount of Rs80bn.

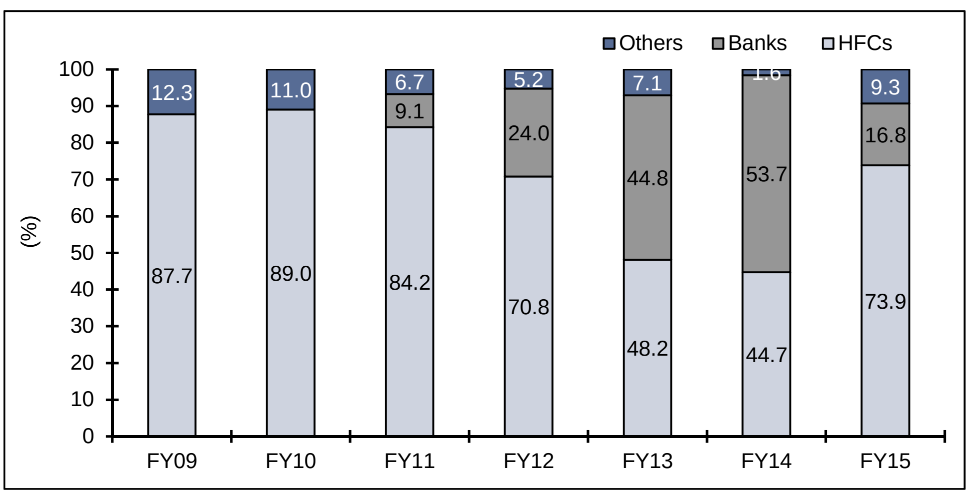
Table 12: NHF – Utilisation

(Rs bn)

		Utilisation					
Fiscal Year	**Allocation (Rs bn)**	**Housing Finance Cos.**	**Commercial Banks**	**Urban Co-operative Banks**	**Regional Rural Banks**	**Others**	**Total**
2009	17.8	15.4	0.0	0.2	2.0	0.0	17.6
2010	20.0	17.9	0.0	0.0	1.8	0.3	20.2
2011	20.0	16.9	1.8	0.0	1.3	0.0	20.0
2012	30.0	21.3	7.2	0.1	1.4	0.0	30.0
2013	40.0	19.4	18.0	0.0	2.9	0.0	40.3
2014	60.0	26.8	32.2	0.0	0.9	0.0	60.0
2015	80.0	17.5	4.0	0.0	2.2	0.0	23.6
Total	**267.8**	**135.2**	**63.3**	**0.3**	**12.6**	**0.3**	**211.7**

Source: NHB, I-Sec research

Chart 34: NHF – Utilisation Mix (%)



Source: NHB, I-Sec research

Annexure 1: Financials

Table 13: Profit and Loss Statement

(Rs mn, year ending March 31)

	FY14	FY15	FY16	FY17E	FY18E
Interest earned	5,156	6,691	8,521	10,678	13,646
Interest expended	3,247	4,318	5,482	6,889	8,915
Net interest income	**1,908**	**2,373**	**3,039**	**3,789**	**4,731**
Other income	**198**	**239**	**297**	**386**	**501**
Staff cost	211	335	399	525	704
Depreciation	24	29	41	51	56
Other operating expenses	154	183	204	277	353
Total operating cost	**388**	**547**	**644**	**853**	**1,113**
Pre-provisioning op profit	**1,718**	**2,065**	**2,692**	**3,322**	**4,118**
Provisions & contingencies	226	203	391	235	345
Profit before tax	**1,491**	**1,862**	**2,301**	**3,086**	**3,773**
Income taxes	390	631	800	1,080	1,321
PAT	**1,101**	**1,231**	**1,501**	**2,006**	**2,453**

Source: Company data, I-Sec research

Table 14: Balance Sheet

(Rs mn, year ending March 31)

	FY14	FY15	FY16	FY17E	FY18E
Capital	622	624	625	626	626
Reserves & surplus	6,760	7,497	8,923	10,771	13,044
Networth	**7,381**	**8,121**	**9,548**	**11,397**	**13,670**
Total borrowings	**39,020**	**51,044**	**65,379**	**84,257**	**109,349**
Provisions	550	748	967	1,197	1,536
Other Liabilities	409	843	1,737	1,847	1,891
Total liabilities & stockholders' equity	**47,361**	**60,757**	**77,632**	**98,699**	**126,444**
Loans & advances	**46,619**	**60,129**	**76,912**	**97,888**	**125,532**
Investments	124	124	124	140	157
Fixed Assets	50	89	93	105	118
Current & other assets (Including Cash & Bank)	568	414	503	566	637
Total Assets	**47,361**	**60,757**	**77,632**	**98,699**	**126,444**

Source: Company data, I-Sec research

Table 15: Key Ratios

(Year ending March 31)

	FY14	FY15	FY16E	FY17E	FY18E
Growth (%):					
AUM	31.5	29.0	27.9	27.3	28.2
Disbursements	47.0	27.2	30.7	30.0	30.0
Loan book (on balance sheet)	31.5	29.0	27.9	27.3	28.2
Net Interest Income (NII)	52.0	24.4	28.0	24.7	24.9
Non-interest income	33.8	21.1	24.2	29.9	29.8
Pre provisioning operating profits (PPoP)	48.0	20.2	30.4	23.4	24.0
PAT	37.6	11.8	22.0	33.6	22.3
EPS	3.8	11.7	21.4	33.5	22.3
Yields, interest costs and spreads (%)					
NIM	7.9	8.1	8.0	7.9	8.0
Yield on loan assets (on -book)	12.6	12.5	12.4	12.2	12.2
Average cost of funds	7.9	8.1	8.0	7.9	8.0
Interest Spread on loan assets (on -book)	4.7	4.4	4.4	4.3	4.2
Operating efficiencies					
Non-interest income as % of net income	9.4	9.2	8.9	9.2	9.6
Cost to income ratio (%)	18.4	21.0	19.3	20.4	21.3
Op.costs/avg AUM (%)	0.9	1.0	0.9	1.0	1.0
No of employees (including off rolls)	465	545	619	721	841
Average annual salary (Rsmn)	0.5	0.6	0.6	0.7	0.8
Annual inflation in average salary(%)	22.7	35.8	4.9	13.0	14.9
Salaries as % of non-interest costs (%)	54.2	61.2	62.0	61.6	63.2
NII /employee (Rsmn)	4.1	4.4	4.9	5.3	5.6
AUM/employee(Rsmn)	100.3	110.3	124.3	135.8	149.3
Capital Structure					
Debt-Equity ratio	5.3	6.3	6.8	7.4	8.0
Leverage (x)	6.4	7.5	8.1	8.7	9.3
CAR (%)	24.5	20.3	20.7	18.5	17.6
Tier 1 CAR (%)	24.5	20.3	20.7	18.5	17.6
Tier 2 CAR (%)	-	-	-	-	-
Asset quality and provisioning					
GNPA (% of AUM)	1.5	1.3	1.3	1.3	1.3
NNPA (% of AUM)	0.7	0.5	0.5	0.5	0.5
GNPA (Rsmn)	685	791	1,009	1,273	1,632
NNPA (Rsmn)	332	298	368	489	628
Coverage ratio (%)	51.5	62.4	63.5	61.5	61.5
Credit costs as % of average AUM	0.6	0.4	0.6	0.3	0.3
Return ratios & capital management					
RoAA (%)	2.6	2.3	2.2	2.3	2.2
RoAE (%)	16.0	15.9	17.0	19.2	19.6
Payout ratio (%)	6.8	7.6	7.5	6.6	6.1
Valuation Ratios					
EPS (Rs)	17.7	19.8	24.0	32.0	39.2
Price to Earnings	39.6	35.5	29.2	21.9	17.9
BVPS (Rs)	118.7	130.2	152.7	182.1	218.3
Price to Book	5.9	5.4	4.6	3.9	3.2
Dividend yield (%)	0.2	0.2	0.3	0.3	0.3

Source: Company data, I-Sec research

Table 16: Du Pont Analysis

	FY14	FY15	FY16E	FY17E	FY18E
Interest earned	12.6	12.5	12.4	12.2	12.2
Interest expended	7.9	8.1	8.0	7.9	8.0
Gross Interest Spread	**4.7**	**4.4**	**4.4**	**4.3**	**4.2**
Credit cost	0.2	0.4	0.3	0.4	0.2
Net Interest Spread	**4.4**	**4.0**	**4.1**	**3.9**	**4.0**
Operating cost	0.9	1.0	0.9	1.0	1.0
Lending spread	**3.5**	**3.0**	**3.2**	**2.9**	**3.0**
Non- interest income	0.5	0.4	0.4	0.4	0.4
Final spread	**4.0**	**3.4**	**3.6**	**3.4**	**3.5**
Tax rate (%)	*26.2*	*33.9*	*34.8*	*35.0*	*35.0*
ROAAUM	**2.9**	**2.3**	**2.4**	**2.2**	**2.3**
Effective leverage (AAUM/ AE)	6.0	6.9	7.8	8.3	8.9
RoAE	**17.5**	**15.7**	**18.4**	**18.2**	**20.1**

Source: Company data, I-Sec research

Annexure 2: Index of Tables and Charts

Tables

Charts

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