Repco Home Finance – BUY

26 November 2015

Earnings downgrade

IIFL Institutional Equities

Robust outlook despite rising challenges

We reduce our earnings estimates for Repco Home Finance (RHL) by 2.4%/5.3% for FY16ii/17ii to reflect the impact of competition on growth and profitability. However, RHL's niche focus, successful ramp-up in new geographies, and contained cost ratios will likely help it sustain 28% EPS Cagr over FY15-18ii. Strong loan growth, robust profitability, and earnings trajectory would help sustain the premium valuations. RHL's key metrics stack up well against competition.

Growth drivers firmly in place. Geographical diversification and customer acquisition are fuelling growth for RHL. Loan growth in new geographies is robust and disbursements in Tamil Nadu (TN) and Karnataka (KTK) are still growing rapidly. RHL added nearly 50 of its 146 branches in FY14/15 and it is ramping existing branches. Loan growth is driven more by client acquisition than price escalation. The former has been trending at 16-19% YoY and the latter at c10% YoY.

Financial performance to remain robust. We estimate earnings Cagr of 28% over FY15-18ii driven by strong loan growth, margin expansion, and contained cost ratios. We have built in slightly higher loan loss provisions than earlier to reflect stress in the self-employed LAP category, stemming from increasing competition. Nevertheless, RoA and RoE are likely to trend towards c2.2% and c20% by FY18ii. Declining wholesale funding rates, potential rating upgrade, and contained cost ratios would support medium-term earnings performance.

Risks emerging, but outlook still robust. Risks from competition, especially in LAP, increasing repayment rates, and potential asset quality worsening have increased. However, RHL will overcome challenges backed by its disciplined lending approach and the ability to pass on the decline in interest costs thereby reducing the interest burden of the borrower, and achieve geographical diversification. Despite these risks, the strong earnings trajectory will help the valuation premium sustain. Re-iterate BUY.

Company update

CMP	**Rs678**
12-mth TP (Rs)	**753 (11%)**
Market cap (US$m)	**637**
Bloomberg	**REPCO IN**
Sector	**Banks**

Shareholding pattern (%)

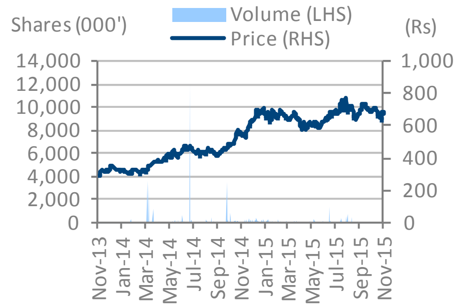
Promoters	37.3
FII	30.2
DII	16.9
Public	15.7

52Wk High/Low (Rs)	785/525
Shares o/s (m)	62
Daily volume (US$ m)	0.9
Dividend yield FY16ii (%)	0.4
Free float (%)	30.0

Price performance (%)

	1M	3M	1Y
Absolute (Rs)	-1.3	-2.8	20.7
Absolute (US$)	-3.6	-2.3	12.8
Rel. to Sensex	4.8	-3.0	30.3
Cagr (%)		**3 yrs**	**5 yrs**
EPS		14.3	15.6

Stock performance



Financial summary (Rs m)

Y/e 31 Mar, Parent	FY14A	FY15A	FY16ii	FY17ii	FY18ii
Pre prov. operating inc. (Rs m)	1,718	2,065	2,636	3,351	4,259
Pre-exceptional PAT (Rs m)	1,101	1,231	1,530	1,969	2,576
Reported PAT (Rs m)	1,101	1,231	1,530	1,969	2,576
Pre-exceptional EPS (Rs)	17.7	19.7	24.5	31.6	41.3
Growth (%)	37.6	11.4	24.3	28.7	30.8
IIFL vs consensus (%)			(0.6)	0.2	(0.9)
PER (x)	38.3	34.3	27.6	21.5	16.4
Book value (Rs)	119	130	152	179	215
PB (x)	**5.7**	**5.2**	**4.5**	**3.8**	**3.1**
CAR (%)	24.5	20.3	18.6	16.8	15.5
ROA (%)	2.6	2.3	2.2	2.1	2.2
ROE (%)	**16.0**	**15.8**	**17.4**	**19.1**	**20.9**

Source: Company, IIFL Research. Priced as on 24 November 2015

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Growth drivers firmly in place

RHL has been able to drive strong and consistent growth in disbursements and AUM in the past, which have increased at 30% and 34% Cagr over FY10-15 respectively. This is important to maintain a strong earnings growth trajectory. Increase in competitive intensity in the space has made it imperative for niche HFCs to grow rapidly and capture market share ahead of larger banks, NBFCs, and HFCs. We expect RHL to deliver 32% disbursements Cagr and 30% loan Cagr over FY15-18ii.

New geographies are ramping up, driving growth

RHL's geographic reach is limited and it has a long way to grow in the states where it is already well entrenched. RHL continues to add branches and satellite centres in States such as TN, KTK, and AP (including Telengana). However, the AUM growth from Maharashtra and Kerala, where credit penetration is high, has been encouraging; Repco has been a relatively late entrant though. TN and AP (including Telengana) account for 74% of loans and loan growth in these states (24-28% YoY). However, loan growth in Maharashtra, Kerala, and other geographies has been robust. Most of the growth in new geographies is driven by home loans and not LAP, which is concentrated in Tamil Nadu, accounting for ~90% of the total LAP portfolio. Since TN has been the home market for RHL, the probability of adverse selection in LAP would be relatively low.

Figure 1: State-wise loan mix and loan growth

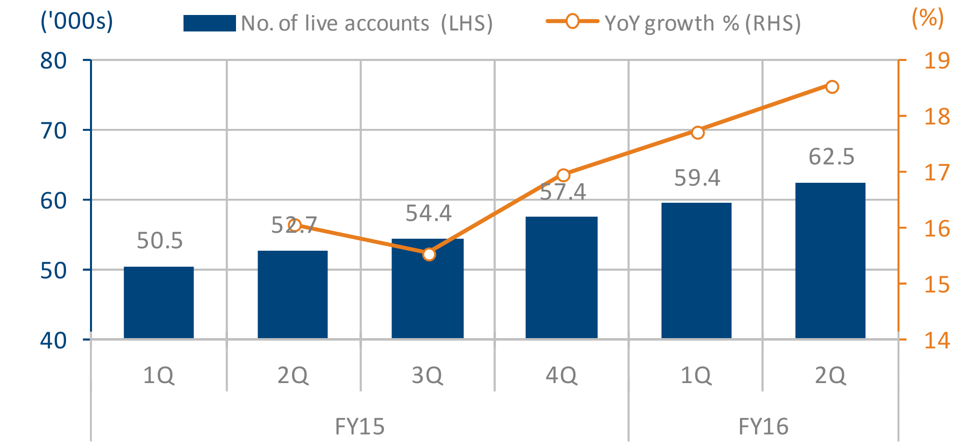
Region-wise loan book break-up	2QFY15	3QFY15	4QFY15	1QFY16	2QFY16
Tamil Nadu	64.0	63.5	62.9	62.5	62.5
Andhra Pradesh (incl. Telengana)	12.3	12.2	12.1	12.0	11.7
Karnataka	11.9	12.0	12.2	12.4	12.5
Maharashtra	5.1	5.2	5.3	5.4	5.4
Kerala	3.7	3.7	3.7	3.7	3.8
Others	3.0	3.4	3.8	4.0	4.1
(% YoY)					
Tamil Nadu	31	27	28	26	28
Andhra Pradesh (incl. Telengana)	22	20	12	24	24
Karnataka	30	28	31	36	37
Maharashtra	50	47	71	43	38
Kerala	30	27	29	30	34
Others	18	31	58	79	79

Source: Company, IIFL Research

Client acquisition has been a larger driver of loan growth

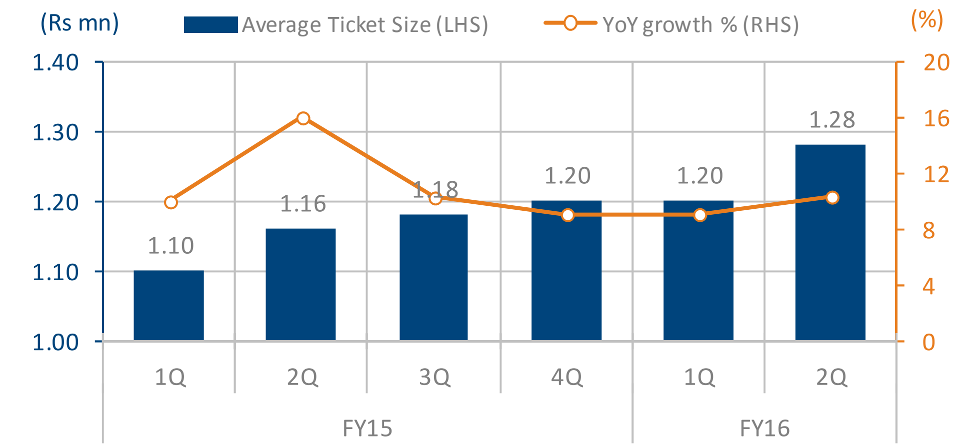
The penetration driven growth strategy has resulted in rapid growth in client acquisition. The number of client accounts has grown at 17% Cagr over the past two years whereas the average ticket size of loans has increased at 13% Cagr. However, growth in client acquisition has increased steadily from 16% YoY to 19% YoY over 3QFY15 to 2QFY16, driven by increasing penetration in both the existing geographies and new states. RHL relies purely on in-sourcing of loans for client acquisition and does not use direct sales agents. This is one way to check the quality of loans being sourced as well as reduce commissions. It does involve invest in fleet-on-street. RHL has partially offset the impact of muted price escalation and delivered robust loan growth with a focus on client acquisition.

Figure 2: Number of live accounts has increased at 17% Cagr over 2QFY14-2QFY16



Source: Company, IIFL Research

Figure 3: Movement in Average Ticket Size



Source: Company, IIFL Research

Has maintained discipline in growth

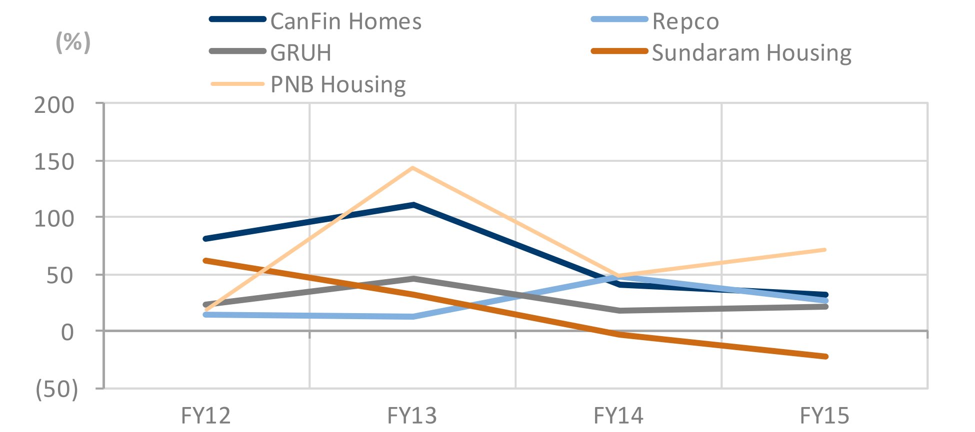
Despite competitive pressures, RHL has been able to maintain discipline in growth through a stable product mix of c20% in loan against property (LAP) and the remaining in mortgages. It has also steered clear of developer finance despite attractive yields in the segment. A comparison with peers reveals that Repco and GRUH have been the most disciplined in terms of growth. HFCs such as CanFin Homes and PNB Housing (much larger comparatively) have delivered disbursements Cagr of higher than 60% despite having larger loan portfolios. RHL, though, has taken some risk in terms of the mix of salaried versus self-employed through rapid growth in the latter. Competition would have pushed RHL to focus more on the non-salaried customer class where other financiers are shy to lend.

Figure 4: Peer comparison: Growth in disbursements and loans

	Disbursements		Loans	
	FY15 (Rsmn)	Cagr FY11-15 (%)	FY15 (Rsmn)	Cagr FY11-15 (%)
HDFC	10,63,233	15	2,277,001	18
LICHF	3,03,273	11	1,083,607	21
IBHFL	203,040	NA	522,350	27
DHFL	198,215	32	510,397	36
CanFin Homes	33,464	63	82,313	39
Repco	21,812	24	60,129	31
GRUH	31,210	27	89,150	29
Sundaram Housing	19,390	13	68,050	27
PNB Housing	94,400	65	168,190	52

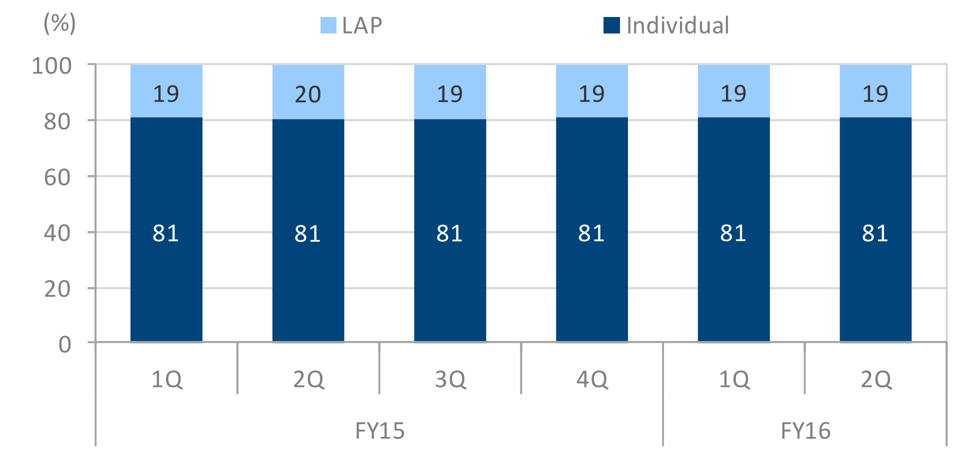
Source: Company, IIFL Research

Figure 5: Peer Comparison – Disbursements growth



Source: Company, IIFL Research

Figure 6: Disciplined approach to maintain a stable product mix without overtly relying on higher yielding product like LAP for growth



Source: Company, IIFL Research

Figure 7: Peer Comparison

	Risk	Retail	Salaried	ATS	Branches	Presence
HDFC	Low	73.0	NA	2.4	392	Pan India
LICHF	Low	97.0	85.0	1.2	257	Pan India
DHFL	Medium	78.0	58.0	1.2	361	Pan India
CanFin Homes	High	94.5	83.0	1.7	110	TN, AP, Kerala
REPCO	High	80.5	42.5	1.3	146	TN, AP, Maharashtra, Karnataka, Kerala
GRUH	Medium	96.4	92.5	0.7	171	Gujarat, Maharashtra, Karnataka, MP, TN, Chhattisgarh, Rajasthan
Sundaram Housing	Medium	97.4	NA	1.9	108	Kerala, Tamil Nadu, Karnataka, AP

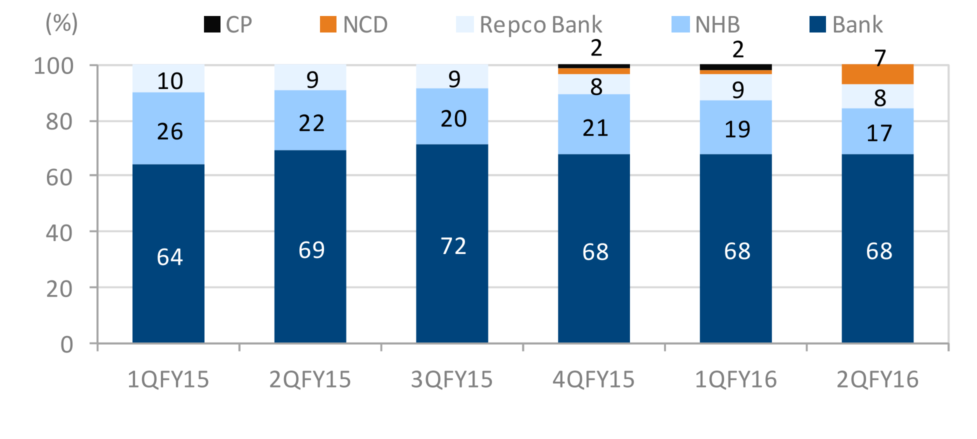
Source: Company, IIFL Research

Financial performance likely to remain robust

Funding flexibility and decline in wholesale costs to aid NIMs

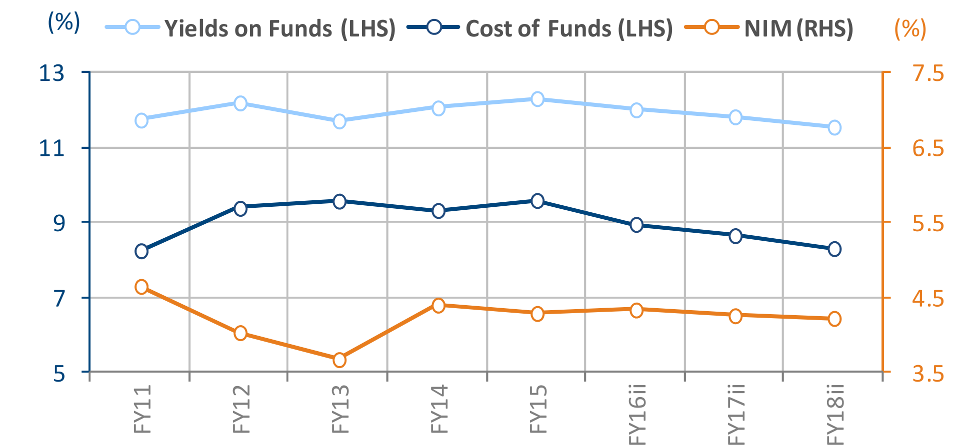
As RHL grows in scale, its funding flexibility is likely to improve. It has recently raised funds through non-convertible debentures (NCDs) that are used extensively by large HFCs to reduce their funding costs. NCDs cost at least 50-60bps lesser than bank loans for RHL. Commercial Paper (CP) was also utilised in the last two quarters to improve ALM and reduce funding costs. The funding profile is all set to diversify with more NCDs replacing bank borrowings. Bank loans themselves will reprice quicker once banks move to a margin cost based base-rate calculation regime. With scale, the probability of a rating upgrade in the medium term would increase, thereby reducing funding costs and improving the competitiveness of RHLs. Together, these would help offset pressure on margins.

Figure 8: Funding mix: new sources of funds will replace bank borrowings in the medium term, driving costs lower



Source: Company, IIFL Research

Figure 9: Decline in funding costs will offset the impact of falling yields, relieving the pressure on margins.



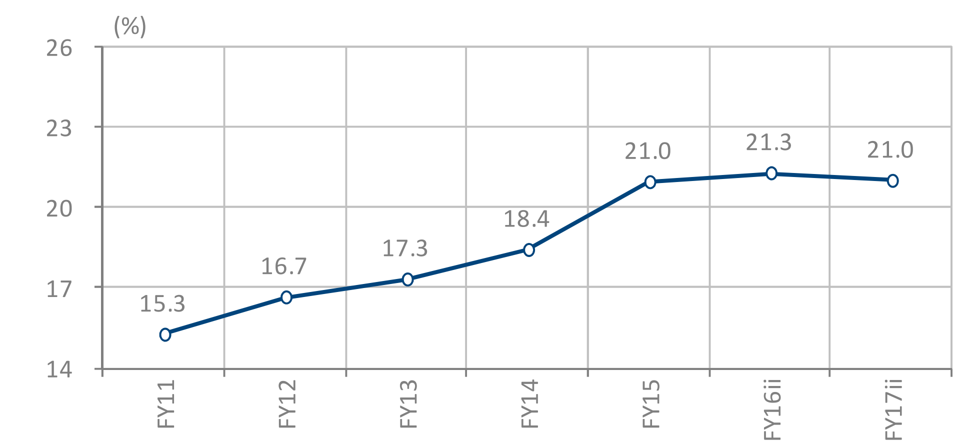
Source: Company, IIFL Research

Keen focus on cost ratios to continue

RHL's cost/income ratio has trended higher over FY11-15 but remains extremely competitive at 21% as of FY15. Rapid branch addition in FY14 and FY15 and introduction of an ESOP scheme for employees was the key reason for the increase in costs. Cost/income ratio should continue at the current pace as branch addition targets have since been calibrated and the company is focusing on ramping up existing branches, which should provide efficiency and productivity-related relief, and there is no significant investment into technology yet.

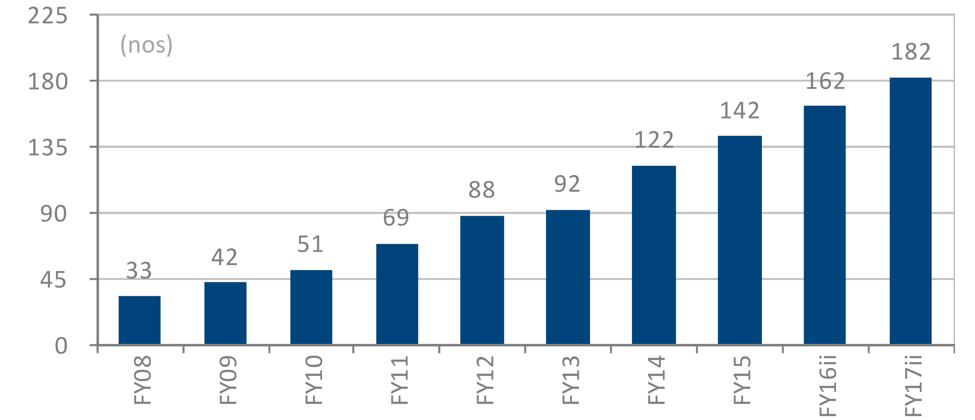
RHL's cost/income ratio is quite competitive versus peers. As it sources its loans in-house, and does not rely on DSAs or corporate agencies, it is able to keep commission payouts in check as well. We believe RHL will continue to maintain a cost/income ratio of 21-22% through FY18ii.

Figure 10: Cost To Income ratio trend: Increase over FY11-15 was due to branch addition and introduction of an ESOP program in FY14



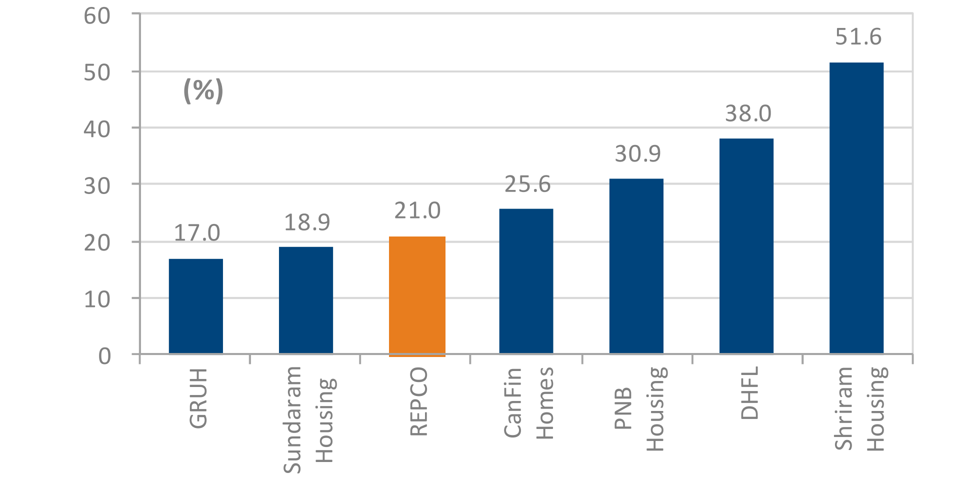
Source: Company, IIFL Research

Figure 11: Branch expansion trajectory has been relatively calibrated



Source: Company, IIFL Research

Figure 12: Peer Comparison –Cost To Income ratio (FY15)

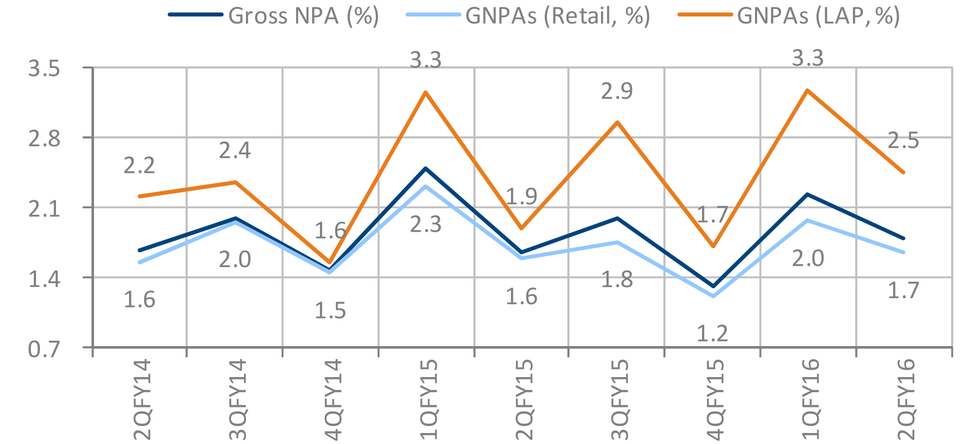


Source: Company, IIFL Research

Loan losses could be marginally higher going ahead

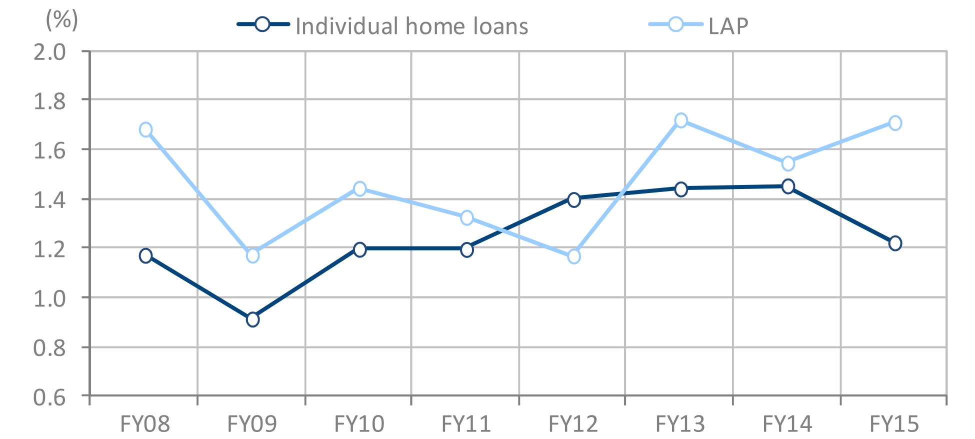
We note that both near-term and longer-term trends suggest that the GNPA in LAP have trended higher. Increase in LAP to self-employed category, muted growth in prices, and increasing stress in semi-urban and rural areas, especially in agriculture, could have led to such pressures. We believe risks in LAP are increasing for the industry as a whole due to increasing competition. We increase our loan loss assumptions for future marginally. This does not impact our earnings estimates materially going ahead, but it could, if asset quality worsens in the industry. Despite the increase in loan loss provisions, compared with earlier estimates, these are largely reasonable still.

Figure 13: Marginal increase in GNPAs for LAP and HL on a seasonal basis



Source: Company, IIFL Research

Figure 14: Longer term segmental GNPA data also shows a gradual increase in GNPAs in LAP



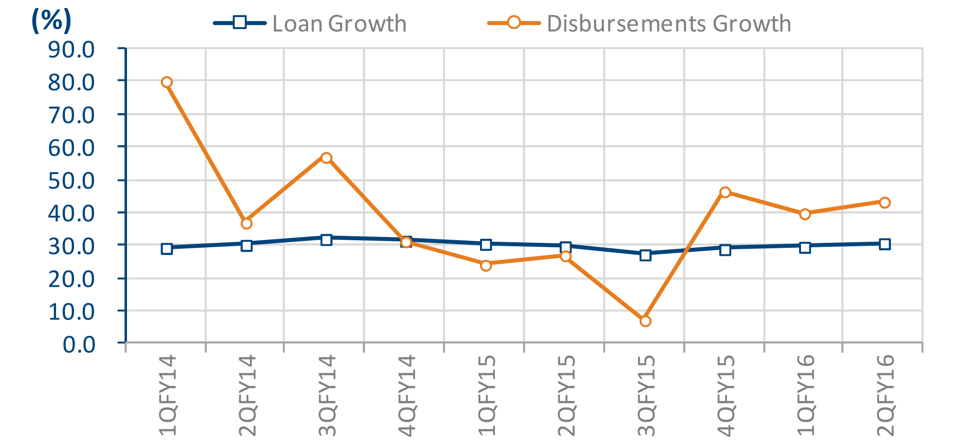
Source: Company, IIFL Research

Risks emerging, but outlook robust still

Key risks to RHL's earnings performance are from a slowdown in growth and a worsening in asset quality. In the last three quarters, we have noticed a sharp increase in disbursements, both in home loans and LAP. However, loan growth has remained broadly stable. This indicates increasing repayment rates in both the home loan and the LAP portfolios, and hence in the overall loan book. We believe a higher proportion of loans are being taken out by competitors due to RHL's 'sticky' lending rates. Hence, RHL has to increase disbursements to maintain the same level of growth. Should competitive pressures increase, RHL would have to decide between growth and profitability and sacrifice one for the other.

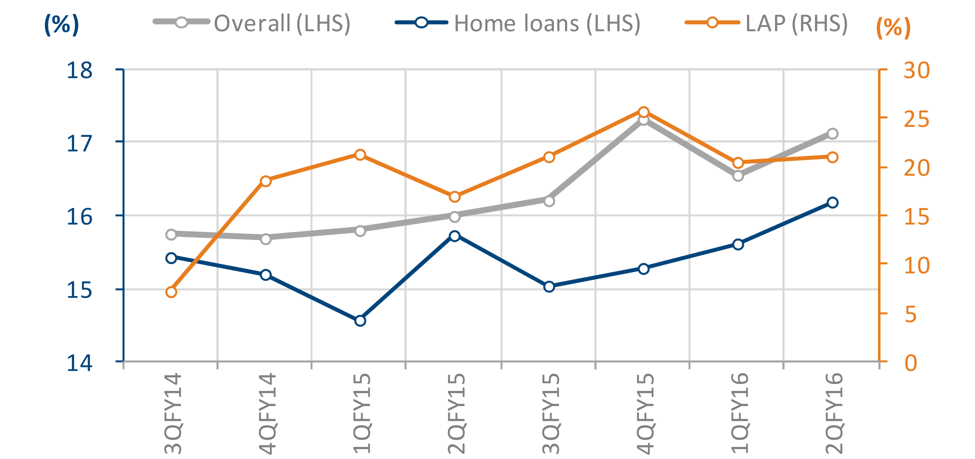
We have already accounted for potential asset quality risks by increasing the loan loss provisions going forward as well.

Figure 15: RHL's disbursements growth vs. loan growth (Overall)



Source: Company, IIFL Research

Figure 16: Repayment rates have been increasing steadily in home loans, but more rapidly in LAP. Concentration of LAP in TN and increasing competition could be leading to faster repayment.



Source: Company, IIFL Research

While there are risks on the anvil, RHL has successfully demonstrated its ability to grow organically, keep costs in check, and maintain healthy profitability. Management has been conservative in its approach to growth and has focused on profitability. For example, PNB Housing has delivered much higher growth rates as compared to RHL but its RoA of 1.28% as of FY15 is much lower than RHL's 2.2% RoA as of FY15.

There are several levers to growth and profitability as well. LAP is distributed predominantly in Tamil Nadu currently. Introduction and penetration of LAP in other regions should improve growth. Similarly, the funding profile is set to diversify further with more reliance on NCDs going forward. This would provide RHL some relief on costs and make its lending more competitive. A potential rating upgrade can drive costs lower too.

We believe RHL has a more sustainable growth trajectory, strong focus on profitability and is better placed as compared to competition on various metrics. Naturally, it receives premium valuations as compared to competition too. We believe RHL will continue to deliver growth in loans and earnings at 25-30% in the medium term. We maintain BUY with a target price of Rs753/share (4.2x FY17ii BV).

Figure 17: Comparison of profitability among various HFCs

FY15, %	ROA	ROE
HDFC	2.7	20.3
LICHF	1.3	18.1
REPCO	2.3	15.8
IBHFL	3.7	29.0
PNB Housing	1.3	15.6
DHFL	1.6	17.9
GRUH	2.5	31.0
CanFin	1.2	11.2

Source: Company, IIFL Research

Figure 18: Earnings revision summary

	FY16ii	FY17ii	FY18ii
Net profit (Rs m) - Old	1,567	2,078	2,639
Net profit (Rs m) - New	1,530	1,969	2,576
% change	(2.4)	(5.3)	(2.4)
EPS (Rs.) - Old	25.1	33.3	42.3
EPS (Rs.) - New	24.5	31.6	41.3
% change	(2.4)	(5.3)	(2.4)
ROE (%) - Old	17.8	19.9	21.1
ROE (%) - New	17.4	19.1	20.9
Change in bps	(39)	(88)	(21)

Source: Company, IIFL Research

Figure 19: RoE decomposition

Y/e 31 Mar	FY14	FY15	FY16ii	FY17ii	FY18ii
Interest income	12.0	12.3	12.0	11.8	11.5
Interest expense	7.6	8.0	7.7	7.5	7.3
Net interest income	**4.4**	**4.3**	**4.3**	**4.2**	**4.2**
Processing fees	0.4	0.4	0.3	0.3	0.2
Penal interest	0.1	0.1	0.1	0.1	0.1
Non-interest income	**0.6**	**0.6**	**0.4**	**0.4**	**0.3**
Total operating income	**4.9**	**4.8**	**4.8**	**4.6**	**4.5**
Total operating expenses	**0.9**	**1.0**	**1.0**	**1.0**	**1.0**
Pre provision operating profit	**4.0**	**3.8**	**3.8**	**3.7**	**3.6**
Provisions for loan losses	0.5	0.4	0.5	0.4	0.3
Other provisions	0.0	0.0	0.0	0.0	0.0
Profit before tax	**3.5**	**3.5**	**3.3**	**3.3**	**3.3**
Taxes	0.9	1.2	1.1	1.1	1.1
Net profit	**2.6**	**2.3**	**2.2**	**2.1**	**2.2**
Leverage	6.2	6.9	8.0	8.9	9.6
RoE	**16.0**	**15.8**	**17.4**	**19.1**	**20.9**

Source: Company, IIFL Research

Figure 20: Key earnings drivers

(%)	FY14	FY15	FY16ii	FY17ii	FY18ii
Loan growth	31.5	29.0	31.1	30.3	29.4
Net interest margin	4.4	4.3	4.3	4.3	4.2
Net int income growth	53.6	23.8	31.4	28.2	28.4
Core fee income growth	53.0	21.8	3.0	10.0	10.0
Non-int inc as % of total	11.2	11.4	9.2	8.2	7.2
Operating costs growth	59.6	41.1	30.2	25.0	27.2
Cost/income ratio	18.4	21.0	21.3	21.0	21.0
Gross NPAs as % of loans	1.5	1.3	1.4	1.3	1.3
Total provision charges as % of loans	0.6	0.4	0.5	0.4	0.3
Tax rate	26.2	33.9	34.0	34.0	34.0
Net NPL % of net worth	4.5	3.7	4.0	3.4	3.7

Source: Company, IIFL Research

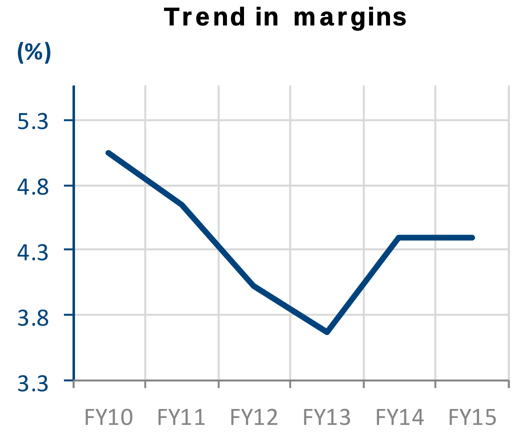
Figure 21: P/BV multiple trend

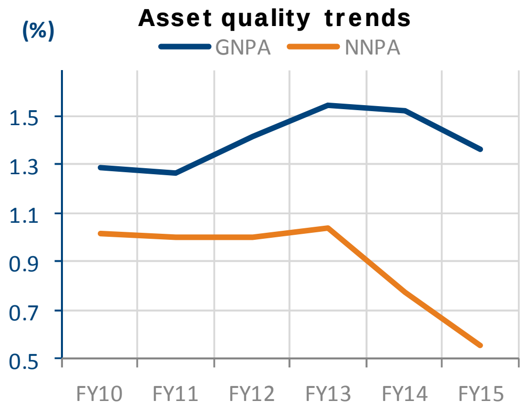
Source: Company, IIFL Research

Background: Repco Home Finance Ltd (RHFL) promoted by Repco Bank is a housing finance company headquartered in Chennai. It provides individual home loans and LAP in Tier II/III cities and peripheral areas of Tier I cities. Of the Rs68bn outstanding loan portfolio as on September 2015, 80.8% is accounted by individual home loans and balance 19.2% by LAP. Loans to salaried and non-salaried borrowers constitute 42% and 58% of loan book. It has a distribution network of 146 branches and 37 satellite centres with ~85% of them located in Southern India. However, it is gradually expanding its footprint in other states like Maharashtra, Gujarat, Odisha and West Bengal. It operates at relatively lower cost owing to its lean branch model, centralized credit appraisal system and direct business sourcing.

Management

Name	Designation
T. S. Krishna Murthy	Chairman
R Varadarajan	Managing Director
V. Raghu	Executive Director

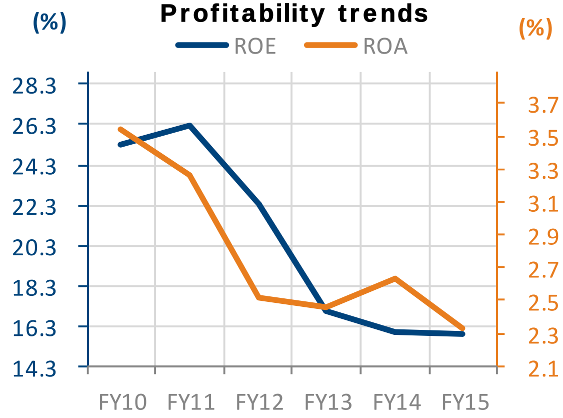


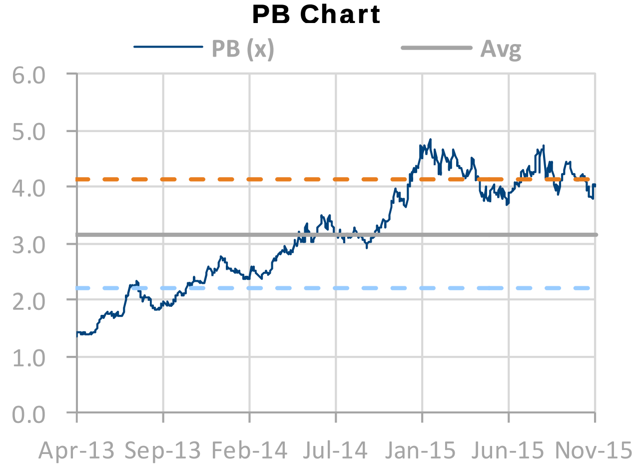


Key earnings drivers

Y/e 31 Mar, Parent	FY11	FY12	FY13	FY14	FY15
Loan Growth (%)	47.2	35.3	26.4	31.5	29.0
Net Interest Margin (%)	4.7	4.0	3.7	4.4	4.3
Net int income growth (%)	31.0	19.2	21.4	53.6	23.8
Core fee income growth (%)	45.0	12.9	6.2	53.0	21.8
Non-int inc/total inc (%)	14.3	14.0	13.3	11.2	11.4
Operating costs growth (%)	58.4	29.7	25.2	59.6	41.1
Cost/income ratio (%)	15.3	16.7	17.3	18.4	21.0
Gross NPLs ratio (%)	1.2	1.4	1.5	1.5	1.3
Total Prov/avg loans (%)	0.2	0.6	0.3	0.6	0.4

Source: Company data, IIFL Research





Financial summary

Income statement summary (Rs m)

Y/e 31 Mar, Parent	FY14A	FY15A	FY16ii	FY17ii	FY18ii
Net interest income	1,869	2,313	3,039	3,895	5,002
Fee Income	182	221	228	251	276
Portfolio gains	0	0	0	0	0
Others	55	78	81	96	114
Non-interest income	237	299	309	347	390
Total operating income	2,106	2,613	3,348	4,241	5,392
Total operating expenses	388	547	713	891	1,133
Pre provision operating profit	**1,718**	**2,065**	**2,636**	**3,351**	**4,259**
Provisions for loan losses	226	203	318	368	356
Other provisions	1	0	0	0	0
Profit before tax	1,491	1,862	2,318	2,983	3,903
Taxes	390	631	788	1,014	1,327
Net profit	**1,101**	**1,231**	**1,530**	**1,969**	**2,576**

Balance sheet summary (Rs m)

Y/e 31 Mar, Parent	FY14A	FY15A	FY16ii	FY17ii	FY18ii
Net loans & advances	46,619	60,129	78,805	102,660	132,856
Placements to other banks	62	100	150	165	82
Cash & equivalents	350	314	364	375	315
Other interest-earning assets	124	124	143	157	157
Total interest-earning assets	**47,154**	**60,668**	**79,461**	**103,358**	**133,410**
Fixed assets	50	89	116	139	139
Other assets	187	(342)	137	137	137
Total assets	**47,390**	**60,414**	**79,714**	**103,634**	**133,686**
Customer deposits	0	0	0	0	0
Other interest-bearing liabilities	39,020	51,044	68,895	90,722	117,747
Total interest-bearing liabilities	39,020	51,044	68,895	90,722	117,747
Non-interest-bearing liabilities	959	1,249	1,349	1,727	2,504
Total liabilities	**39,980**	**52,293**	**70,244**	**92,449**	**120,251**
Total Shareholder's equity	**7,411**	**8,121**	**9,470**	**11,185**	**13,435**
Total liabilities & equity	**47,390**	**60,414**	**79,714**	**103,634**	**133,686**

Source: Company data, IIFL Research

Ratio analysis - I

Y/e 31 Mar, Parent	FY14A	FY15A	FY16ii	FY17ii	FY18ii
Balance Sheet Structure Ratios (%)					
Loans / Deposits	0.0	0.0	0.0	0.0	0.0
Loan Growth	31.5	29.0	31.1	30.3	29.4
Growth in Deposits	0.0	0.0	0.0	0.0	0.0
Growth in Total Assets (%)	25.0	27.5	31.9	30.0	29.0
Profitability Ratios					
Net Interest Margin	4.4	4.3	4.3	4.3	4.2
ROA	2.6	2.3	2.2	2.1	2.2
ROE	16.0	15.8	17.4	19.1	20.9
Non-Int Income as % of Total Income	11.2	11.4	9.2	8.2	7.2
Net Profit Growth	37.6	11.8	24.3	28.7	30.8
FDEPS Growth	37.6	11.4	24.3	28.7	30.8
Efficiency Ratios (%)					
Cost to Income Ratio	18.4	21.0	21.3	21.0	21.0
Salaries as % of Non-Interest costs	54.3	61.2	61.8	61.8	61.7

Ratio analysis - II

Y/e 31 Mar, Parent	FY14A	FY15A	FY16ii	FY17ii	FY18ii
Credit Quality Ratios (%)					
Gross NPLs as % of loans	1.5	1.3	1.4	1.3	1.3
NPL coverage ratio	51.0	62.4	66.0	72.1	71.0
Total prov charges as % avg loans	0.6	0.4	0.5	0.4	0.3
Net NPLs as % of net loans	0.7	0.5	0.5	0.4	0.4
Capital Adequacy Ratios (%)					
Total CAR	24.5	20.3	18.6	16.8	15.5
Tier I capital ratio	24.5	20.3	18.6	16.8	15.5

Source: Company data, IIFL Research

Disclosure : Published in 2015, © India Infoline Ltd 2015

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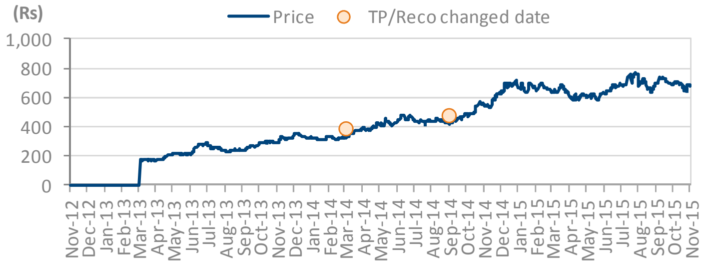
Repco Home Finance: 3 year price and rating history



Date	Close price (Rs)	Target price (Rs)	Rating
25 Mar 2014	323	390	BUY
23 Sep 2014	425	480	BUY