INSTITUTIONAL EQUITY RESEARCH

Repco Home Finance (REPCO IN)

Play on the structural growth in underserved mortgage

INDIA | NBFCs | Initiating Coverage

7 January 2016

Focus on underserved self-employed segment

RHFL's focus on this segment, especially in small towns and cities will continue to fuel loan book CAGR of +27% (primarily driven by volume growth) over FY15-18, enabled by increasing geographical presence and strong demand in self-construction. Traction in recently opened branches and addition of new branch will add to the volume growth. Self - imposed ceiling of 20% in LAP portfolio to restrict growth in per unit average ticket size.

Re-pricing of liability will improve spreads

Due to the interest rate differential between bank loans and money market borrowings, RHFL will increase its reliance on NCDs and commercial paper to bring down its weighted average cost of borrowing. Change in liability mix and cut in base rate by banks will reduce its costs of funds by 50bps over FY15-18, translating into a 15bps improvement in spread.

Superior credit appraisal/monitoring to maintain asset quality; LAP risk amply priced

The company has maintained high asset quality, even in the self-employed segment because of granular loans, lower LTV, and superior credit appraisal and monitoring. Credit risk is higher on LAP (adequately priced in loans) and a 20% internal ceiling protects it from undue risk. RHFL is reasonably immune to systemic risk due to low inventory, stable property prices, and strong end-user property market in south India.

Increase in scale to bring operating efficiency

RHF follows a calibrated approach in branch and employee cost. To check costs, it adds one employee only after every additional Rs 100mn of business. A 2014 ESOP scheme has put some pressure on opex and will keep employee cost slightly high until it is fully amortised by H1FY18, after which we see these expenses (% of asset) falling 10bps.

Geographical concentration may pose a risk in terms of asset quality

RHFL has a 63% exposure to Tamil Nadu and the four southern states contribute 90% of total business. Any adverse impact from politics, economic downturn, or natural calamities poses a risk to its business growth and asset quality. Nevertheless, low inventory in residential mortgage in this region, stable property prices, and low LTVs suggest low risk.

Recommendation & Valuation

Repco is a play on the structural growth in the mortgage market with niche focus on the underserved self-employed segment in smaller towns and cities in India. Strong opportunity in less-competitive rural housing, underpinned by superior execution capability, will accelerate its loan book CAGR to +27% over FY15-18. Risk-based pricing model, strong underwriting standards and efficient monitoring will drive earnings CAGR of +25%. Re-pricing of liability and change in funding mix will add to spread and provide stability to returns on assets, despite increase in leverage. We expect return on equity to increase to 20% by FY18 from current 16.5%.

At CMP, the stock trades at 3.8x/3.2x FY17/18 ABVPS of Rs 173/207. Strong return ratios, sustainable growth in balance sheet and superior asset quality warrants a premium valuation. Based on the excess-return method, we ascribe per share value of Rs 800 (22% upside) and initiate coverage on RHFL with a Buy rating.

BUY

CMP RS 657

TARGET RS 800 (+22%)

COMPANY DATA

O/S SHARES (MN) :	62
MARKET CAP (RSBN) :	41
MARKET CAP (USDBN) :	0.6
52 - WK HI/LO (RS) :	785 / 570
LIQUIDITY 3M (USDMN) :	0.6
PAR VALUE (RS) :	10

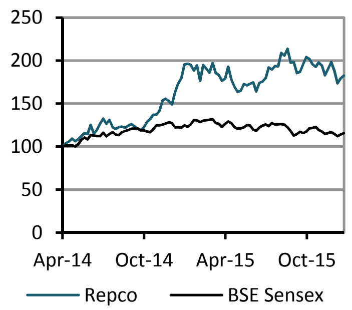
SHARE HOLDING PATTERN, %

	Jun 15	Mar 15	Dec 14
PROMOTERS :	37.3	37.3	37.3
FII / NRI :	31.7	30.4	30.9
FI / MF :	16.9	16.4	16.0
NON PRO :	5.0	5.5	5.2
PUBLIC & OTHERS :	10.7	12.1	12.2

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	1.9	-9.5	-2.7
REL TO BSE	4.6	-1.4	5.0

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

	FY16E	FY17E	FY18E
NII (Rs mn)	2,882	3,658	4,616
PAT (Rs mn)	1,492	1,889	2,435
% growth	21.2	26.6	28.9
EPS (Rs)	23.8	30.1	38.6
Adj BVPS (Rs)	146.5	173.2	207.4
ROA (%)	2.2	2.1	2.2
ROE (%)	17.0	18.3	19.8
P/E (x)	27.7	21.9	17.1
Adj. P/BV (x)	4.5	3.8	3.2

Source: PhillipCapital India Research Est.

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Investment thesis

- RHFL will have strong loan book growth driven by its focus on the underserved self-employed segment in smaller towns and cities.
- The benefit of liability repricing and avenues to expand liability mix will enable it to reduce its funding cost, thus aiding spreads.
- Superior underwriting skill, strong monitoring mechanism, and risk-based product pricing has enabled the company to enjoy superior return ratios.
- We expect loan book CAGR of 27% over FY15-18 translating into 25% CAGR in net profit. The increase in leverage will improve return on equity to 20% by FY18 from current 16%.
- At current market price of Rs 657 the stock trades at 3.8x FY17 ABVPS of Rs 173 & 3.2x FY18 ABVPS of Rs 207. A favourable operating environment, strong business and earnings, and superior return ratios warrant premium valuation.
- We initiate coverage with a BUY rating and price target of Rs 800 per share based on the excess-return method.

Most banks and larger HFCs have aggressively loaned to the salaried segment due to the ease in ascertaining cash flows and repayment capabilities. They have neglected the self-employed segment due to the risk perception and difficulty involved in credit appraisal and understanding cash flow. Taking cognizance of the funding void in non-metro cities, RHFL differentiated itself from larger HFCs and banks by creating a strong focus in tier-2, tier-3, and peripheries of tier-1 cities, to serve the underserved. RHFL has been able to manage credit risk associated with its target segment reasonably well and its cumulative write-off of just 0.06% bear testament to its superior underwriting skills.

Valuation Methodology

DCF - Excess Return Valuation

	High growth stage	Stable growth Phase									
Return on Equity =	18.0%	16.0%									
Retention Ratio =	100.0%	50.0%									
Expected growth rate =	16.6%	8.0%									
Cost of equity =	13.0%	11.5%									
Year	***1***	***2***	***3***	***4***	***5***	***6***	***7***	***8***	***9***	***10***	***Terminal Year***
Net Income (Rs bn)	1.5	1.7	2.0	2.3	2.7	3.2	3.8	4.5	5.2	6.2	6.4
- Equity Cost (Rs bn)	1.1	1.2	1.4	1.7	2.0	2.3	2.7	3.2	3.8	4.5	4.6
Excess Equity Return (Rs bn)	0.4	0.5	0.6	0.7	0.8	0.9	1.1	1.2	1.5	1.7	1.8
Terminal Value of Excess Return (Rs bn)										119.3	
Cumulated Cost of Equity	1.1	1.2	1.4	1.5	1.7	2.0	2.2	2.5	2.8	3.2	
Present Value (Rs bn)	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	37.8	
Beginning BV of Equity (Rs bn)	8.1	9.5	11.1	13.0	15.3	17.9	21.1	24.8	29.1	34.3	39.8
Cost of Equity (%)	13.0	13.0	13.0	13.0	13.0	13.0	13.0	13.0	13.0	13.0	11.5
Equity Cost (Rs bn)	1.1	1.2	1.4	1.7	2.0	2.3	2.7	3.2	3.8	4.5	4.6
Return on Equity (%)	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	16.0
Net Income (Rs bn)	1.5	1.7	2.0	2.3	2.7	3.2	3.8	4.5	5.2	6.2	6.4
Dividend Pay-out Ratio (%)	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.5
Dividend Paid (Rs bn)	0.1	0.2	0.2	0.2	0.3	0.3	0.3	0.4	0.5	0.6	
Retained Earnings (Rs bn)	1.4	1.6	1.9	2.3	2.7	3.1	3.7	4.4	5.2	6.1	
Equity Invested (Rs bn)=	8.1										
PV of Equity Excess Return (Rs bn) =	41.8										
Value of Equity (Rs bn)=	49.9										
Number of shares (In bn) =	0.1										
Value Per Share =	**798**										

Source: Company, PhillipCapital India Research

Focus on underserved self-employed segment

- RHFL's loan book has been witnessing strong growth driven by volume and increasing ticket size.
- Loan Against Property (LAP) growth of ~48% vs. home-loan growth of ~27% contributed to overall loan book growth of 30% in FY13-15. With LAP growth moderating, loan book is likely to see some moderation over FY15-18.
- Increasing geographical presence, robust demand in the self-construction segment in tier-2/3 cities will drive loan book CAGR of +27% over FY15-18.

Systematic and well-planned growth strategy

RHFL has developed a robust business model based on opportunities in the affordable housing segment, which has lower penetration and is largely under-served, especially in smaller towns and cities. Most banks and larger HFCs have been aggressive in lending to the salaried segment (can easily ascertain cash flows and repayment capabilities), while neglecting the self-employed segment (high-risk perception, difficulty in credit appraisal and understanding cash flow streams).

Taking cognizance of this funding void, RHFL differentiated itself from larger HFCs and banks by strongly focusing on tier-2, tier-3, and peripheries of tier-1 cities. It distinguished itself by developing local expertise, maintaining high standards, quick turnaround time, and superior underwriting skills.

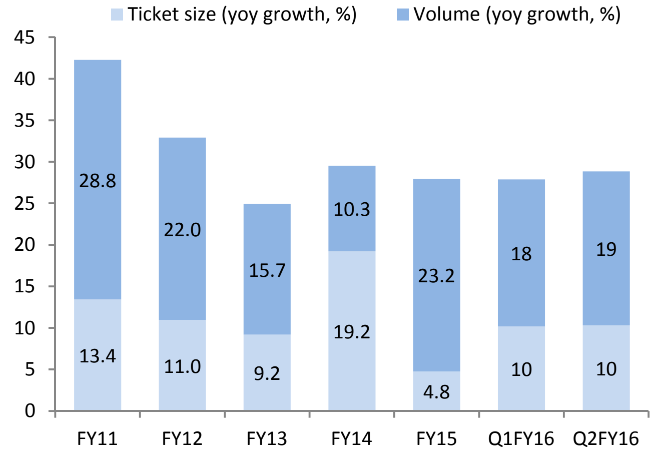
Initially, the company was a regional player (Tamil Nadu). However, over the past few years it diversified its geographical footprint. Its strategy is to deepen penetration in regions where it has strong presence while exploring untapped markets. Its branch network is concentrated in south India – Tamil Nadu alone houses 65 of its 146 total branches and commands 63% share of its loan book. Other southern states – AP, Karnataka, and Kerala – also hold a meaningful share of its branch network and the company is adding branches in these states.

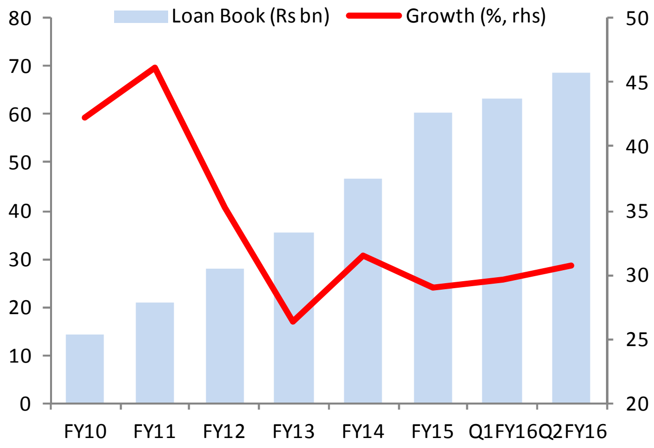
In the last few years, RHFL has tapped into Maharashtra, Odisha, Gujarat, and Ranchi where it wants to add branches in a calibrated manner – it plans to add 15 branches annually with 65% of incremental branches in south India.

We expect RHFL's loan book CAGR at 27% over FY15-18 driven by further penetration in south India and expansion in average ticket size. In the longer term, growth momentum will continue with business kicking in from non-southern states.

So far, strong volume (18% CAGR over FY15-11) was aided by an increase in average ticket size (11% CAGR), which in turn drove loan book growth (30%+ CAGR). The increase in ticket size was due to higher proportion of LAP (now 19% of loan book vs. 15% in FY11) and the difference in incremental ticket size between LAP and home loan (Rs 2.3mn vs. Rs 1.6mn).

Break up of loan growth

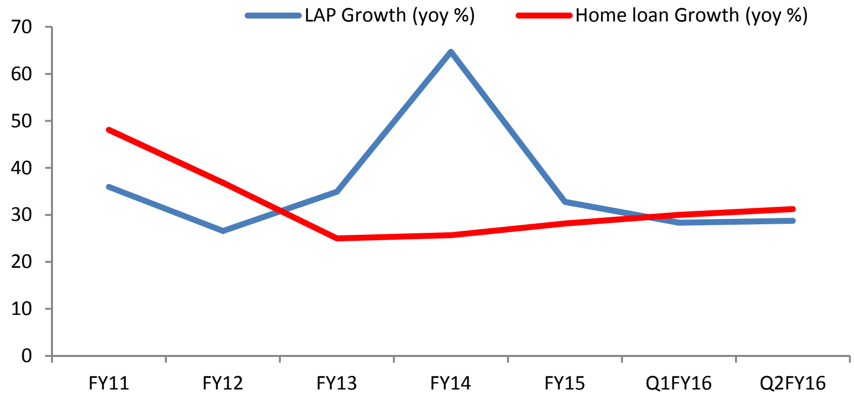




Source: company

RHFL's LAP business saw 39%+ CAGR over FY11-15 to reach 19% of loan book. The management does not expect its share to increase beyond 20%. Hence, this segment's growth from here should be in line with that of the home loan business.

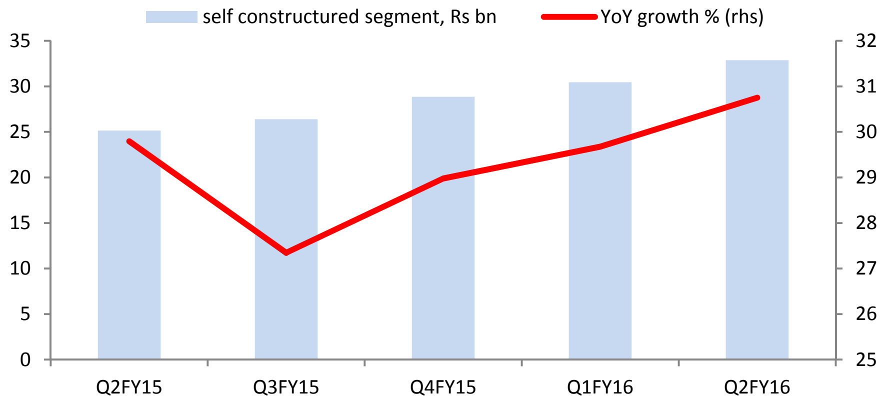
Product-wise loan growth



Source: company

RHFL has established a strong franchisee in the underpenetrated self-employed segment in tier 2/3 cities. Incrementally, 50% of its loans are towards self-construction of houses – this segment has been seeing strong traction, as people need loans for renovation, extension, or building new homes.

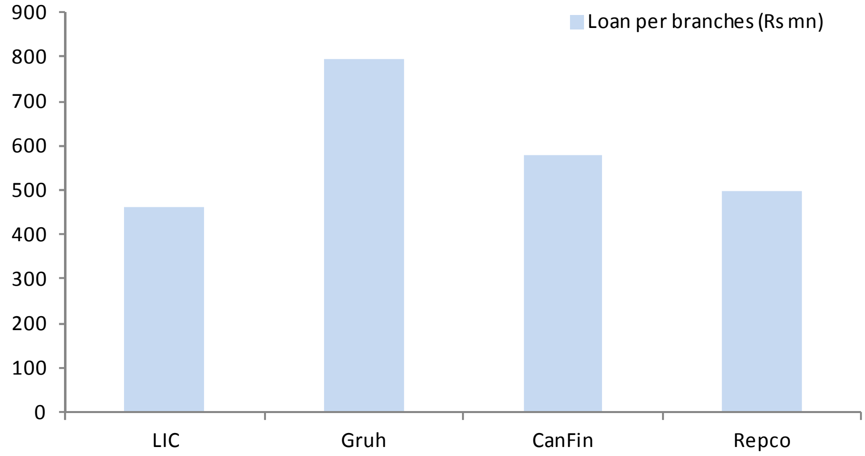
Loan book growth in self-constructed segment in last one year



Source: company

Over FY11-15, RHFL's volume grew at a CAGR was a strong 18%, driven by branch expansion, penetration, and new geographies. Volume of ~20% over the next three years is likely to be driven by continued expansion of branches (15-20 per annum) and tapping underutilised capacity of existing branches. Given the internal cap of 20% on LAP, this segment's growth will mirror RHFL's home-loan segment's growth. Factoring volume growth of 20% and small improvement in ticket size, we see loan growth at +27% over FY15-18.

Loan per branch – peer comparison



Source: PhillipCapital India Research

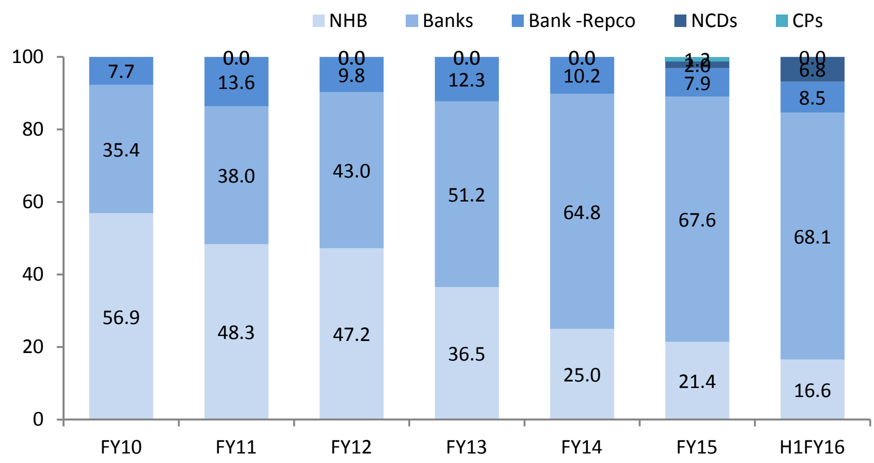
Re-pricing of liability to improve spreads

- When banks cut base rates, 76% of RHFL's total borrowings will re-price.
- Increased reliance on bonds and commercial paper will bring down its weighted average borrowing cost
- Lending cap will restrict the usage of the NHB-refinance window; RHFL's management is not comfortable doing business at a spread of 2%.
- Change in liability mix and cut in base rate by banks will reduce the company's costs of funds by 50bps over FY15-18, translating into 15bps improvement in spread.

Bank borrowings constitute the largest source of funds for RHFL. SBI's base rate is down 70bps YTD, with a major cut seen in Q3FY16. The benefit of cuts in the base rate is not yet visible in RHFL's costs of funds.

The company has diversified its sources of funding – refinance from NHB, bank loans, non-convertible debentures (NCDs), and commercial paper (CP). Due to cost difference between bank borrowing and prevailing NCD rates, RHFL is likely to rely more on NCDs and CPs going forward. Its cost of funds has remained stable at ~9.6% in H1FY16. It has a board approval to issue Rs 15bn NCDs and Rs 5bn CPs in FY16.

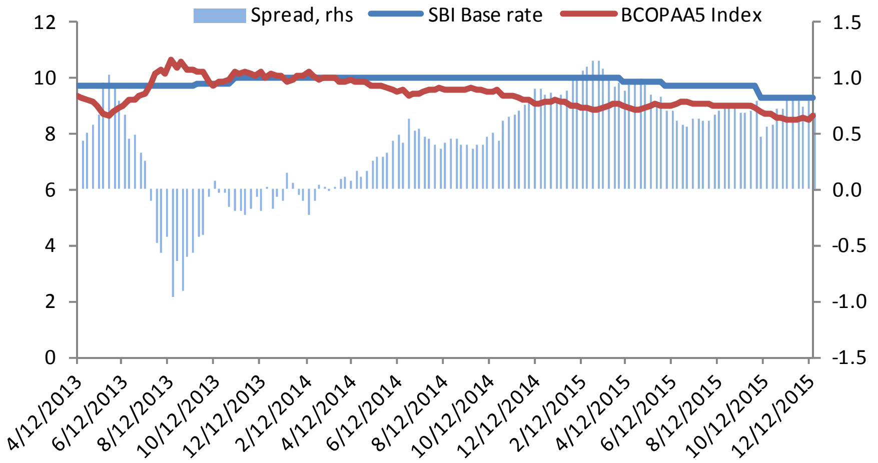
Borrowing mix (%)



Source: Company

The company's NCDs are rated AA by CARE and its commercial paper is rated A1+ by both ICRA and CARE. The average cost of bank loans in H1FY16 stood at 9.84% whereas the cost of NCDs was 9.33% (50bps difference). Expected increase in proportion of NCDs and CPs along with cut in costs of bank borrowings will lower overall costs of funds by 50-60bps over the next two years.

Widening gap between SBI base rate and AA bond yield (%)



Source: PhillipCapital India Research

Rating profile

Date	Instrument	Rating Agency	Rating	Rating Status
7-Dec-15	Proposed Non-Convertible Debentures	CARE	CARE AA	Assigned
19-Oct-15	Commercial Paper	ICRA	A1+	Reaffirmed
19-Oct-15	Non-Convertible Debenture	ICRA	AA-	Reaffirmed
30-Sep-15	Non-Convertible Debentures	CARE	CARE AA	Revised
30-Sep-15	Commercial Paper	CARE	CARE A1+	Reaffirmed
21-Oct-14	Commercial Paper	ICRA	A1+	Reaffirmed
21-Oct-14	Non-Convertible Debenture	ICRA	AA-	Reaffirmed
13-Aug-14	Commercial Paper	CARE	CARE A1+	Reaffirmed
13-Aug-14	Non-Convertible Debenture	CARE	CARE AA-	Reaffirmed
17-Oct-13	Commercial Paper	CARE	CARE A1+	Assigned
17-Oct-13	Non-Convertible Debenture	CARE	CARE AA-	Assigned
20-Sep-13	Commercial Paper	ICRA	A1+	Assigned
20-Sep-13	Non-Convertible Debenture	ICRA	AA-	Assigned

Source: Company

The proportion of its bank borrowings is likely to decline to 44% by FY18 vs. 76% currently. Further, NHB's interest cap of 2% (towards onward lending on some of its schemes) makes NHB borrowings as a source of funding unattractive. Thus, the re-pricing of bank loans to lower rates due to a cut in base rate and increased proportion of NCDs and CPs will reduce weighted average costs of funds by 50-60bps over the next few years. The decline in costs of funds would translate into an increase in spread by 15bps between FY15-18.

Changing funding mix to reduce cost of fund

(figures in per cent)	FY13	FY14	FY15	FY16e	FY17e	FY18e
NHB Borrowing	36.5	25.0	21.4	18.2	15.5	13.2
cost of NHB fund	8.2	7.6	7.9	7.9	7.9	7.9
Loan from banks	51.2	64.8	67.6	55.4	48.1	40.0
cost of bank borrowing	10.6	10.1	10.1	9.9	9.7	9.6
Loan from Repco bank	12.3	10.2	7.9	6.1	5.0	3.9
cost of fund from Repco bank	10.6	10.1	10.1	9.9	9.7	9.6
NCDs	0.0	0.0	2.0	16.6	25.8	36.3
cost of NCD			9.6	9.3	9.2	9.0
CPs	0.0	0.0	1.2	3.6	5.6	6.5
cost of CP			8.5	8.3	8.3	8.3
overall cost of fund	9.6	9.3	9.6	9.4	9.2	9.1
Spread	**2.8**	**3.3**	**3.0**	**2.9**	**3.0**	**3.0**

Source: Company and PhillipCapital India Research

Asset quality under control; LAP risk adequately priced

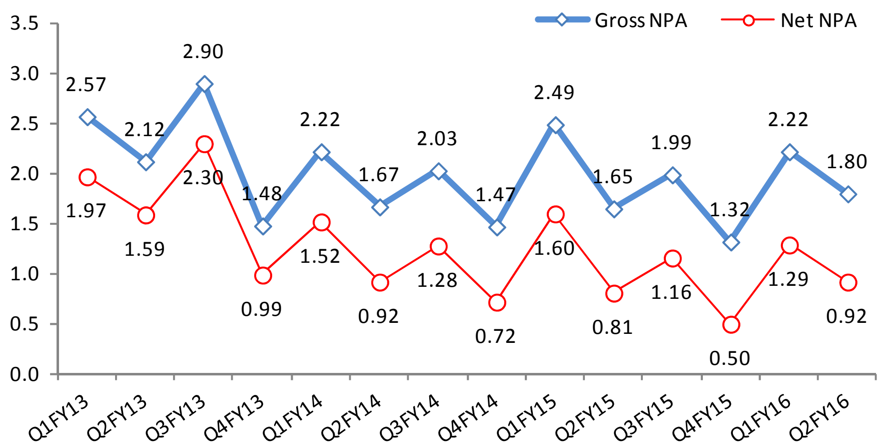
- The company has been able to maintain high asset quality, even while catering to the self-employed segment – this is due to granular loans, lower LTVs, superior credit appraisal, and monitoring.
- The credit risk is higher on LAP, which is well priced in; its own 20% limit on LAP restricts risk.
- Asset quality in Andhra Pradesh, Telangana, and Kerala has been under stress for some time. With the political impasse settled and with a focus on economic development, the real estate segment has started improving in Andhra Pradesh and Telangana.
- Low inventory, stable property prices, and strong end-user markets in south India reduce systemic risk for RHFL.

GNPA and NNPA ratios have been falling since FY13. Although quarterly volatility persists due to erratic nature of cash flows in the self-employed segment, historical trends suggest that the increase in GNPA (in the first and third quarters of a financial year) is primarily due to delayed payments by borrowers. These slippages are subsequently upgraded on repayment of overdue balances. The cumulative write-off of Rs 44mn since inception (0.06% of cumulative disbursement) suggests that quarterly movements of NPAs are temporary. RHFL's asset quality trend has been improving since FY13.

Despite being in the self-employed segment (57.5% of its loan book), its asset quality has been continuously improving. The management aspires to reach 0% NNPA in the next 8-10 quarters.

RHFL's superior credit quality is largely due to granular loan book with low ticket size, conservative loan to value ratio (LTV) of 62% in home loan and 50% in LAP, and strong credit appraisal and monitoring. The ticket size (at origination) for home loans is Rs 1.6mn and Rs 2.4mn for LAP.

Asset quality trend

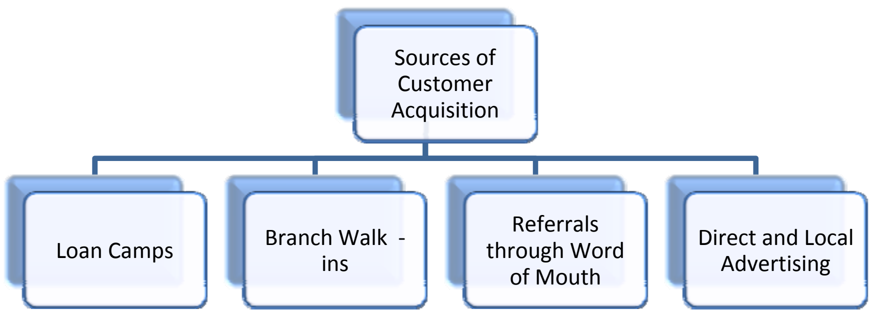


Source: Company

Business sourcing

RHFL's marketing strategy is built around loan camps, local advertising, and word of mouth referrals. Its primary modes of publicity are advertisements through local media, including advertisements in regional newspapers, magazines, and cable channels, hoardings at prominent locations in cinema halls, bus terminals, and railway stations, and distribution of pamphlets and banners. RHFL conducts loan camps in most of its branches once every 2-3 months within a 20-25km radius of the branch location. Almost 50% of its business originates from loan camps.

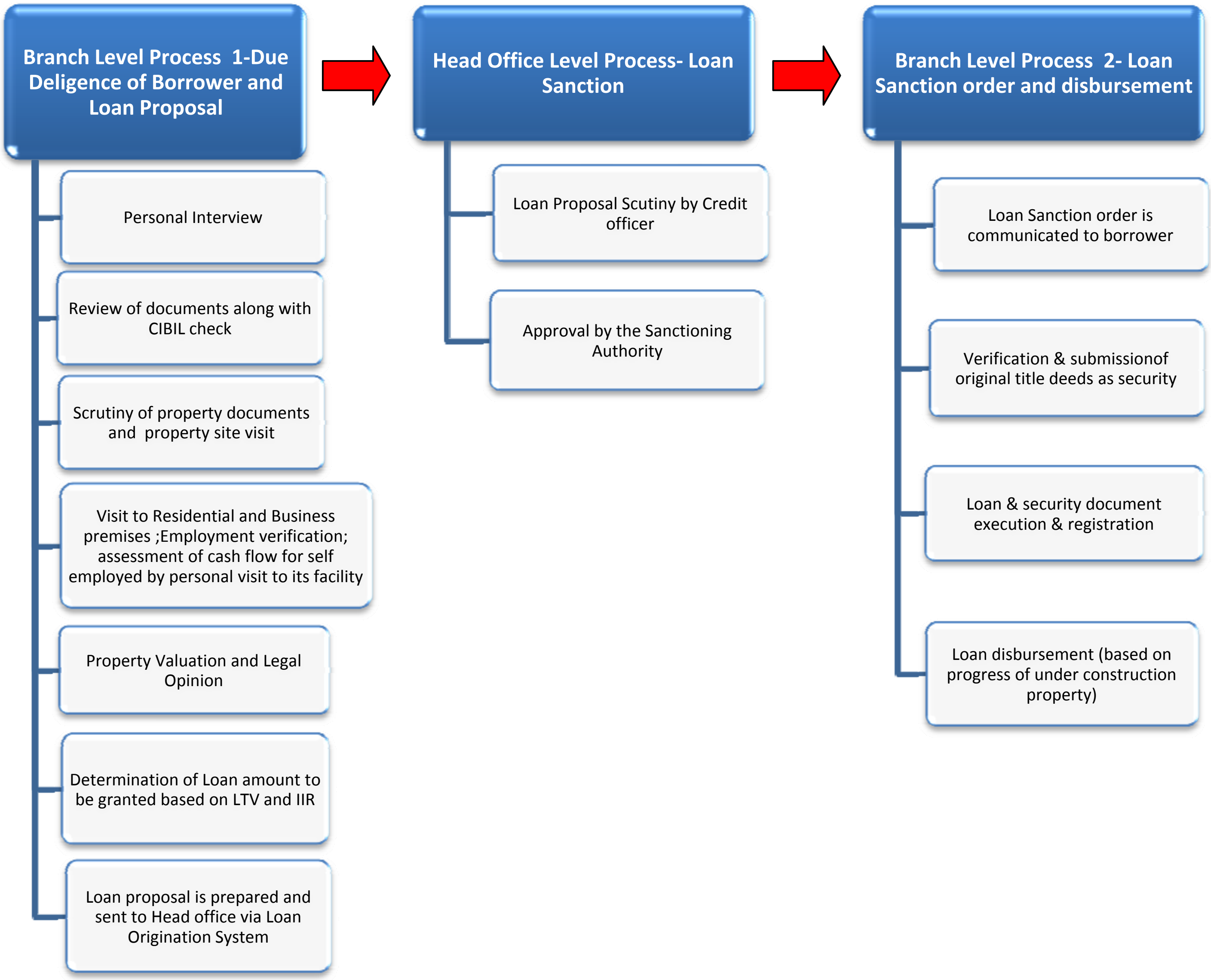
RHFL does not engage marketing intermediaries, as this reduces transparency of operations and direct interaction with customers. As a result, most borrowers are walk-ins or referred by existing borrowers.



At loan camps, the company evaluates loan documents and conducts on-the-spot assessments about the credit-worthiness of prospective borrowers. It grants in-principle approvals to some – these borrowers then approach the branch office for final approval after which the loan is sanctioned in accordance with internal policies. Branch personnel conduct loan camps with support personnel from its head office who not only assist in credit evaluation but also oversee the general loan-camp operation.

Credit appraisal process

RHFL carries out credit appraisal at two levels – one at the branch level and the other at the head office. Once the credit appraisal at the branch level is complete and such borrowers meet the basic eligibility criteria, the application is considered for processing at the head office. In order to ensure uniformity, RHFL has centralised the credit approval and sanctioning functions at the head office. The following is a set of activities carried out at branch offices and head office during the credit appraisal process.



Monitoring of operations

RHFL has both formal and informal mechanisms for on-going monitoring of the branch operations and activities. The company has put in place measures to ensure that there is co-ordination between branches and the head office. Some of the key interactions are: monthly performance scoring of branches based on performance (both lending and recovery), monthly MIS report and branch manager report, half-yearly and annual review meetings to assess performance and market situation, and periodic departmental meetings at the head office.

Its various inspection and audit practices are:

- Annual inspection: A dedicated inspection team visits branches and carries out inspection of records on an annual basis. All loans above Rs 1mn are reviewed by this team.
- Internal audit: By external chartered accountant firms that carry out regular audits on a half yearly basis and such an internal audit typically covers 75% of branch business on an annual basis.
- Head office visits: Head office personnel periodically visit branches, including during loan camps, and conduct informal checks on branch operations.
- Property inspection: Periodical inspections of the secured properties, both before and after disbursements.

- Inspection by statutory audit: The auditor of the company also carries out an audit of strategic branches (random) each year to check the efficacy of the credit appraisal and lending process and other internal controls.

Recovery and collection

The branch disbursing loans is also responsible for recovery. NPAs impact the branch performance / scoring and ultimately the incentive payment to the branch personnel. RHFL has a dedicated recovery team at the head office, which tracks and monitors branch-level NPAs. This team also assists branch personnel sometimes in various collection and recovery efforts, including conducting focused recovery camps when needed.

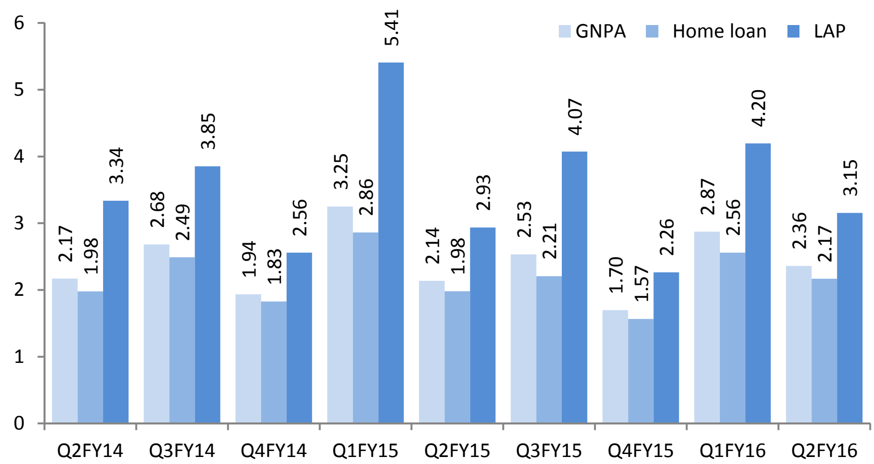
The key recovery and collection processes are listed below:

- Instalments are paid through ECS / post-dated cheques. Branches send text messages to borrowers to notify them of an impending payment so that they are able to maintain or deposit sufficient funds in their bank accounts to honour their payments.
- In case of non-payment of dues, borrowers are sent telephonic reminders.
- If the payments are still pending, branch heads and other staff members visit the premises and residences of borrowers, supplemented by periodic visits by recovery officers from head office.
- Branch personnel visit the borrower at the first instance of default to understand the reason. At this stage, RHFL either collects the dues or obtains a commitment letter from the borrower for timely repayment going forward. At this stage, branch personnel also inform the guarantor of the status of the account.
- Reminder notices are issued to borrowers/guarantors in case of default, after which proceedings are initiated against the borrower in accordance with the provisions of the Negotiable Instruments Act, 1881.
- Chronic defaulters are proceeded against under the provisions of the SARFAESI Act.

Credit risk in LAP is adequately priced

RHFL's LAP asset quality is improving. However, there is a quarterly fluctuation due to the erratic nature of cash flows in the self-employed segment. Within the various categories of loan products, LAP has higher delinquencies compared to home loans. The risk in its LAP portfolio is fairly priced in the yield that RHFL charges for the segment. Hence, the risk-adjusted return in LAP is superior to its home loan product.

Segment wise GNPA



Source: Company

Superior yield in LAP adequately prices the risk. RHFL charges a yield of 15.8% on LAP compared to 11.8% on home loans. Based on FY15 asset quality, credit cost in home loans is around 20bps while it is 130bps for LAP. LAP's higher margin of 7.6% adequately captures the risk. RHFL has an internal cap of 20% on LAP, which protects it from any undue risk.

Segment-wise return as % to total asset based on FY15 financials

	Home loan - Salaried	Home loan - self employed	LAP	Overall
Yield on asset	11.1	11.8	15.6	12.2
cost of fund (including equity)	8.0	8.0	8.0	8.0
Spread	3.1	3.8	7.6	4.2
noninterest income to loan book	0.4	0.4	0.4	0.4
operating cost	1.0	1.0	1.0	1.0
operating profit	2.5	3.2	7.0	3.6
credit cost	0.2	0.2	1.1	0.4
PBT	2.3	3.0	5.9	3.2
Tax	0.8	1.0	2.0	1.1
PAT	1.5	2.0	3.9	2.1
Return on capital	14.0	17.3	17.5	16.0

Source: Company and PhillipCapital India Research

RHFL has created a niche in LAP segment catering to the small-ticket segment. This makes its portfolio more granular and less competitive. Being a player in niche LAP segment, competitive pressure on yield is relatively lower.

LAP – peer comparison

Rs mn	Advances	LAP	Ticket Size	Tenure (Years)	LTV%	Interest Rate%
Cholamandalam	2,68,641	80,902	5.3	4	50	14.3
Bajaj Finance	3,79,640	89,850	17.5	4 to 6	60	12.3
HDB	2,31,480	81,018	na	4 to 6	60	16.8
Fullerton India	1,00,690	37,888	na	4 to 6	60	14.3
Capital First	1,36,042	94,834	10.0	6	42	12.8
Repco	68,487	13,150	2.3	6	50	15.8

na: not available

Source: PhillipCapital India Research

Low inventory and stable real estate price in south India shields systemic risk

Asset quality in Andhra Pradesh, Telangana, and Kerala has been under stress for some time. Settlement of political impasse and focus on economic development has started improving real estate in Andhra Pradesh and Telangana. Kerala still remains a grey area due to suppressed rubber prices and moderation in expatriate income from Middle East. Nevertheless low inventory, stable property prices, and strong end-user market makes south Indian real estate stable.

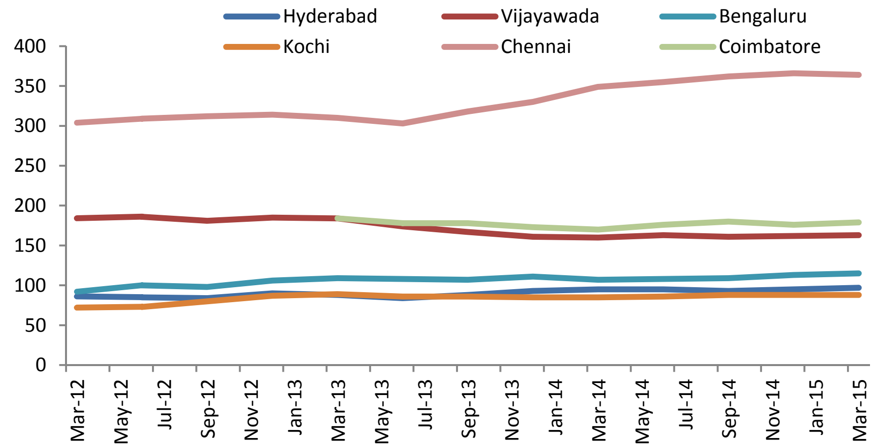
Geographical mix of asset quality

States	Loan portfolio, Rs mn	GNPA, Rs mn	GNPA %	RHFL Loan book growth in last one years
Tamil Nadu	42,805	642	1.50	28%
Andhra Pradesh (undivided)	8,013	208	2.59	24%
Karnataka	8,561	163	1.90	37%
Kerala	2,603	107	4.10	34%
Maharashtra	3,698	37	1.00	38%
Gujarat	1,301	20	1.50	148%
Others	1,507	60	4.00	44%

Source: Company

The state of real estate in the southern market is relatively better than northern India. Data points such as unsold stocks and price movement of property do not suggest any unwarranted stress on the portfolio. Moreover, most of RHFL's customer base is in tier 2/3, where the property slowdown is relatively lower than tier-1 cities.

Residential property price



Source: RBI residex

Increase in scale to bring operating efficiency

- Increase in business to result in 10bps decline in cost-to-asset ratio in FY15-18. However, ESOP expenses would negate this in the medium term.
- Calibrated branch addition of 15 per year will contain the cost-to-asset ratio.
- Maximum leverage level at 9x to maintain credit rating (NHB permits 16x).

RHF follows a very cost-efficient business model. Its approach towards branch and employee addition has been much calibrated. It has a network of 108 branches and 38 satellite centres manned by 584 employees. To keep a check on employee cost, it adds one employee for incremental business of Rs 100mn. However, recently, its operating expenses escalated due to employee stock option scheme initiated in FY14. This will keep employee cost slightly high until it is fully amortised by H1FY18. From H2FY18, we expect employee expenses as percentage of assets to decline.

RHFL's branches are primarily in tier-2 and 3 cities, where rents and cost of running operations are relatively lower than in metros. Usually, each RHFL branch is run by 3-4 local employees that understand the geography and are therefore well placed to anticipate the needs of customers. RHFL follows a branch-satellite business model (opening a satellite centre near the branch) – its satellite office is usually operated by 1-2 officers. The purpose of this model is to penetrate and serve areas adjoining a full-fledged branch. Once these satellites centres reach a specified milestone, they may be converted into branches.

We see the operating-cost-to-asset ratio remaining stable in FY15-17 (declining in FY18) due to amortisation of ESOP cost. Incrementally, it adds 60-65% of its branches in southern states. Excluding ESOP cost, operating cost is likely to decline as balance sheet growth will surpass opex growth.

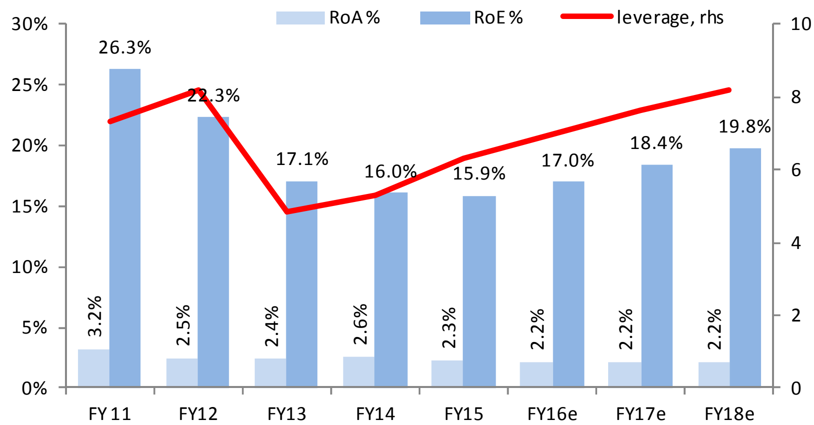
Operating cost-to-asset breakup

	FY14	FY15	FY16e	FY17e	FY18e
Employee cost (excluding ESOP expenses)	0.44	0.50	0.49	0.50	0.51
Esop expenses	0.07	0.15	0.16	0.17	0.08
other operating cost	0.42	0.39	0.37	0.34	0.32
Total	**0.92**	**1.04**	**1.02**	**1.01**	**0.91**
opex (ex-ESOP cost)	0.86	0.89	0.86	0.84	0.83

Source: company and PhillipCapital India Research

NHB allows a leverage level of 16x net owned fund. RHFL's current level stands at 6.5x, which it can increase to 9x (due to reservation from rating agencies, RHFL may not increase its leverage beyond 9x). Based on current CRAR of 19.4% and leverage ratio of 6.5x, it will not require capital up to FY18.

Return ratio trajectory



Source: Company and PhillipCapital India Research

DuPont Analysis

	FY13	FY14	FY15	FY16e	FY17e	FY18e
Interest earned	11.8	12.1	12.4	12.2	12.0	12.0
Interest expended	8.0	7.6	8.0	8.0	7.8	7.9
Gross interest spread	3.8	4.5	4.4	4.2	4.2	4.1
Non- Interest income	0.4	0.4	0.4	0.4	0.4	0.4
Total income	4.2	4.9	4.8	4.6	4.6	4.5
Employee expenses	0.4	0.5	0.6	0.6	0.6	0.6
Other expenses	0.3	0.4	0.4	0.4	0.3	0.3
Operating income	3.5	4.0	3.8	3.6	3.6	3.7
Provisions	0.3	0.5	0.4	0.4	0.4	0.4
Pre-tax earnings	3.2	3.5	3.4	3.3	3.3	3.3
Tax	0.8	0.9	1.2	1.1	1.1	1.1
RoA	2.4	2.6	2.3	2.2	2.2	2.2
Leverage	7.1	6.2	7.0	7.8	8.5	9.1
RoE	17.1	16.0	15.9	17.0	18.3	19.7

Source: Company, PhillipCapital India Research Estimates

Comparative valuation

	CMP	MCAP	Loan Book	RoE			RoA			EPS			ABV			PE			P/ABV		
		Rs bn	Rs bn	FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17
Gruh*	268.5	98	99	30.9	32.2	32.5	2.6	2.6	2.6	6	7	8	20	26	30	47.9	39.5	32.3	13.7	10.3	9.0
RHFL	**661**	**41**	**68**	**17.0**	**18.3**	**19.7**	**2.2**	**2.2**	**2.2**	**24**	**30**	**39**	**146**	**173**	**207**	**27.7**	**21.9**	**17.2**	**4.5**	**3.8**	**3.2**
CanFin*	1067	28	93	14.1	16.0	18.0	1.2	1.4	1.4	42	50	65	290	331	381	25.7	21.2	16.5	3.7	3.2	2.8
LIC	500	252	1141	18.1	20.0	19.4	1.3	1.4	1.4	27	34	38	150	177	208	18.2	14.8	13.1	3.3	2.8	2.4
HDFC	1067	1684	2375	20.7	21.0	21.1	2.6	2.6	2.6	12	13	14	190	214	245	89.3	79.1	74.4	5.6	5.0	4.4
DHFL*	232	68	563	15.1	15.4	16.4	1.3	1.3	1.3	24	26	32	159	179	203	9.7	8.8	7.2	1.5	1.3	1.1
Indiabulls Housing*	**735.8**	**309**	**513**	**29.0**	**25.9**	**24.8**	**3.7**	**3.6**	**3.5**	**55**	**59**	**71**	**186**	**254**	**285**	**13.4**	**12.4**	**10.4**	**4.0**	**2.9**	**2.6**

(*Bloomberg) source: PhillipCapital India Research Estimates

Key Risk

Geographical concentration may pose a risk in terms of asset quality

RHFL has a 63% exposure to Tamil Nadu and the four southern states contribute 90% of total business. Any adverse impact from politics, economic downturn, or natural calamities poses a risk to its business growth and asset quality. Kerala still remains a grey area due to suppressed rubber prices and moderation in expatriate income from Middle East. Nevertheless, low inventory in residential mortgage in this region, stable property prices, and low LTVs suggest low risk.

Our interaction with the management suggests that the recent floods in Chennai is unlikely to slowdown the demand for loans or add any stress to the asset quality. Out of the 146 branches 11 were located in the flood impacted areas and the loan exposure to areas impacted by the floods was 17%. However, only ~3% of the borrowers have been impacted by the flood. RHFL has provided a relief by rescheduling 2-3 instalments. Hence, these loans will continue to be classified as standard, as per NHB norms.

Annexure: 1

Impact of Housing on GDP

National Council of Applied Economic Research (NCAER) released a report in April 2014 on 'the study on impact of investments in the housing sector on GDP and employment in the Indian economy'.

Key findings in the report:

- The contribution to GDP by the construction sector was 8.2%, and real estate, ownership of dwelling units, and business services contributed to another 11.4% thereby contributing to nearly one -fifth of India's GDP.
- Housing is the fourth-largest employment-generating sector.
- 99.41% of jobs in housing sector are informal. This sector's labour-to-output ratio (number of persons employed to produce 100,000 units of output), is 2.34 – highest among all the sectors.
- For every 100,000 invested in the housing sector, 2.69 new jobs (2.65 informal and 0.4 formal) are created. With induced effect, the number of jobs created would be 4.06 (3.95 informal and 0.11 formal).
- For every investment in the housing sector, household income increases by 0.41. With induced effect, this is estimated to be 0.76.
- **Every additional rupee invested in housing can add 1.54 rupees to the GDP and considering household expenditure, it will add 2.84 rupees.**
- For every rupee invested in creation of housing, 0.12 gets collected as indirect taxes.

Annexure: 2

Housing scenario in India

The Indian mortgage industry is still in a nascent stage and Housing Finance Companies (HFCs) continue to remain in the sweet spot given multiple long-term growth drivers. The mortgage industry CAGR is 15%+ over the past five years. However, it is a highly under penetrated in India vs. most emerging economies. The opportunities for HFCs are expected to remain large due to multiple growth drivers, as the housing shortage is for real. Urbanisation of tier 2/3 cities will lead to demand in housing. Rehabilitation of slum areas and shortage of housing in urban areas will increase the thrust in low-cost housing finance. The government's strong focus on affordable housing via the launch of 'Housing for all by 2022' scheme will ensure strong growth and meaningful lending opportunities in the longer term.

Structural story to continue – Despite intensifying competition in mortgage, we expect all players to do well, given rising income levels and low penetration (8% of GDP) despite 15% CAGR over the last five years; this is the lowest among developing markets which are at 15-20% penetration. With improving income levels and lower penetration rate, we see mortgage penetration rising (the way it has in the last decade).

Intensifying competition but opportunity for all – Large HFCs (HDFC, LICHF) have been very competitive as they benefit from low opex cost, economies of scale, and competitive cost of funds. However, smaller players have created a niche for themselves and have become prominent players in affordable housing and LAP. This has enabled smaller player to get good chunk of re-financing from NHB – this has become a significant proportion of overall borrowings. Lower cost of funds has made smaller players competitive as well.

Annexure: 3

Policy initiatives

The government has played a vital role in providing fillip to the housing sector by announcing various policies and initiatives. Some of the policies announced are:

- Allowing 100% FDI in development projects for townships, setting up urban housing fund, and providing impetus to subsidy schemes such Rajiv Rinn Yojana, which have strengthened the sector.
- Allocating Rs 80bn for supporting rural housing and Rs 40bn for affordable housing to NHB. Initiative to increase the flow of cheap credit for housing. Setting up Mission on Low Cost Affordable Housing to provide housing for all by 2022. This scheme will also incentivise the development of low-cost affordable housing.

Some of the key initiatives announced in FY14-15 union budget are:

- For supporting rural housing, allocation for National Housing Bank increased to Rs 80bn from Rs 60bn.
- Rs 40bn allocated to NHB from the priority sector lending shortfall with a view to increase the flow of cheaper credit for affordable housing to the urban poor/EWS/LIG segment
- Extending additional tax incentive on home loans for encouraging young citizens to own houses.
- Mission on Low Cost Affordable Housing to be anchored by the National Housing Bank.
- Slum development to be included in the list of Corporate Social Responsibility (CSR) activities to encourage contribution from the private sector.
- To complete master planning of three new smart cities (Chennai-Bengaluru industrial corridor region, Ponneri in Tamil Nadu, Krishnapatnam in Andhra Pradesh and Tumkur in Karnataka). Development of industrial corridors with emphasis on Smart Cities, linkage to transport connectivity to spur growth in manufacturing, and increase urbanisation.
- Rs 70.6bn provided for developing 100 smart cities.

Annexure: 4

About Repco Home Finance

Repco Housing Finance (RHFL) is a Chennai-based housing finance company, established in April 2000 under Repco Bank (a government of India-owned enterprise). It is primarily into financing purchase of residential and commercial properties, and granting loan against property (LAP). It operates through a network of 146 branches and 40 satellite offices. RHF has strategically focused its lending operation to tier-2, tier-3, and the peripheries of tier-1 cities and has consciously developed its core strength in the highly under penetrated self-employed segment. Since inception, RHF has a balanced approach towards salaried and non-self-employed segment. Consequently, self-employed comprised 57% of its loans, while 43% comprised of salaried borrowers. Product wise, residential mortgage forms 81% of its loan portfolio and the remaining 19% comprises of LAP.

RHFL product offerings

Sr.No	Name of Loan Product	Product Details
1	Dream Home Loan	Loans for the purpose of construction or purchase of a property.
2	Home Makeover Loan	Loans for the purpose of repairs, renovation, and / or extension of a property.
3	Plot Loans	Loans for outright purchase of plots for construction of a house.
4	Super Loan	Loans for construction (including extensions and additions to existing property) on land owned by borrower's parents.
5	Fifty Plus Loan	Loans to persons above 50 years where loan repayments and disbursements are structured around the retirement / pension income stream of the borrowers.
6	NRI Housing Loan	Loans to non-resident Indians for the construction and purchase of houses in India.
7	Prosperity Loan	Loans against mortgage of immovable property for such purposes as may be desired by the borrower.
8	New Horizon Loan	Loans for purchase and / or construction of non-residential and commercial property.
9	Repco Rural	Loans to Individuals under "Weaker Section" Category in Rural areas for Purchase/Construction/Repairs/ renovation/upgradation of house with loan amount Up to Rs.1.5mn with construction cost/estimate not exceeding Rs.2.5mn
10	Repco Advantage	Housing Loan Up to Rs.3mn @ 10.50% p.a. onwards. Housing Loan Above Rs.3mn @ 10.75% p.a. onwards

Source: company

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16e	FY17e	FY18e
Interest income	6,695	8,415	10,600	13,483
Interest expenses	4,318	5,533	6,942	8,867
NII	**2,377**	**2,882**	**3,658**	**4,616**
Other income	235	305	387	480
Total income	2,613	3,187	4,045	5,097
Employee Expenses	335	427	551	629
Other Expenses	212	252	298	352
Operating expenses	547	679	849	981
PPP	**2,065**	**2,508**	**3,196**	**4,116**
Provisions	203	251	321	432
Pre tax profit	**1,862**	**2,257**	**2,875**	**3,684**
Tax expense	631	765	975	1,249
PAT	**1,231**	**1,492**	**1,901**	**2,435**

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16e	FY17e	FY18e
Cash & Bank Balances	175	218	264	316
Loans & Advances	60,229	76,623	97,801	124,961
Investments	124	151	182	214
Fixed Assets	89	112	143	179
Other Assets	139	145	205	340
Total assets	**60,757**	**77,249**	**98,594**	**126,010**
Share capital	624	626	628	630
Reserves & Surplus	7,497	8,853	10,579	12,786
Networth	8,121	9,479	11,207	13,416
Borrowings	51,044	66,186	85,359	110,015
Other liabilities	724	439	540	659
Provision	867	1,145	1,488	1,920
Total liabilities	**60,757**	**77,249**	**98,594**	**126,010**

Valuation Ratios

	FY15	FY16e	FY17e	FY18e
Per share data				
No. of shares	62.4	62.6	62.8	63.0
EPS	19.7	23.8	30.3	38.6
BV	130.2	151.4	178.5	212.8
Adj BVPS	125.5	146.5	173.1	207.3
DPS	1.5	1.8	2.3	3.0
Growth ratios				
Advances	29.0	27.2	27.6	27.8
Borrowings	30.8	29.7	29.0	28.9
NII	24.1	21.2	26.9	26.2
PPP	20.2	21.5	27.4	28.8
PAT	11.8	21.2	27.4	28.1
Margins				
Yield on funds	12.5	12.3	12.2	12.1
Cost of deposits	9.6	9.4	9.2	9.1
Spreads	3.0	2.9	3.0	3.0
NIMs	4.5	4.2	4.2	4.2
Cost ratios				
Cost to income	21.0	21.3	21.0	19.3
Cost to average assets	1.0	1.0	1.0	0.9
Return ratios				
RoA	2.3	2.2	2.2	2.2
RoE	15.9	17.0	18.4	19.8
Valuations				
P/E	33.4	27.7	21.8	17.1
P/Adj BV	5.3	4.5	3.8	3.2
Asset quality & CRAR				
GNPA	1.3	1.3	1.2	1.2
NNPA	0.5	0.4	0.3	0.3
Provision coverage Ratio	62.4	68.1	72.3	77.2
CRAR	20.3	19.8	18.3	17.2

Source: Company, PhillipCapital India Research Estimates

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

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