Indiabulls Housing Finance Ltd.

Initial Opinion BUY

Equity | India | Financial Services-Consumer/Commercial
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Revamped business model to drive returns; initiate at Buy

Bank of America Merrill Lynch

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Initiate at Buy with PO of Rs305 (40%+ upside potential)

We initiate coverage on Indiabulls Housing Finance Ltd. (IHFL) at Buy with a PO of Rs305, post completion of ‘reverse merger’ with 100% owned housing finance co. IHFL is a mortgage lender operating as a housing finance firm, with 70% assets in home loans and loan against property. Our Buy call is driven by: 1) bullish on mortgage/loan against property market; IHFL set to gain market share; 2) consistent profit delivery to drive up return ratios; 3) asset quality to remain manageable even in a weak asset-quality situation; and 4) B/S liquidity to support growth.

Market share gains to drive sustainable 20% net profit growth

IHFL’s market share in home loans is <2% (o/s), and with rising distribution/tie-ups, it should sustain above-average volume growth. We estimate net profit growth at 20%+ for FY14-16, driven by loan (AUM) growth sustaining at 21-22%; spreads sustaining, but NIMs to rise owing to warrant capital infusion. Finally, IHFL should benefit on costs front, driven by in-house sourcing and strategic tie-ups with banks.

See rise in credit costs, but asset quality to be manageable

We estimate credit costs for IHFL to rise to about ~65/60bp in FY14/15 (vs 47bp in FY13), factoring in higher NPLs. The rise in credit costs factors in a weak macro, leading to an extended credit cycle in India. Hence, for IHFL too, we estimate NPLs to almost double in FY14 YoY and rise another 40-45% in FY15, factoring in commercial credit / commercial vehicle book (about 15% of AUM). However, overall asset quality will still be very manageable, with gross NPLs estimated at only 1.4% / 1.6% of book (0.9% now); cover at about 110%+ (including specific and general).

Rising return ratios to drive re-rating (target P/B about 1.7x)

IHFL trades at 1.2x FY14E adj. book. Our PO of Rs305 is based on target P/B of 1.7x 1-year forward adjusted book and based Gordon theoretical multiples, wherein we assume sustainable RoEs of 27% and CoE at 15.5%. We are positive on IHFL’s ability to grow its core ‘mortgage’ book, gain share, and hence, deliver above-average RoA/RoE. Improvements in financial / operating leverage should complement, boosting ROE (core RoEs estimated at an avg of ~27% through FY14-16). As a combine, these should drive a continued re-rating of the stock, in our view.

Stock Data

Price	Rs213.80
Price Objective	Rs305.00
Date Established	1-Nov-2013
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs165.25-Rs290.00
Mrkt Val / Shares Out (mn)	US$1,162 / 333.2
Market Value (mn)	Rs71,241
Average Daily Volume	964,398
BofAML Ticker / Exchange	XFQGF / NSI
Bloomberg / Reuters	IHFL IN / INBF.NS
ROE (2014E)	27.2%
Leverage (2013A)	NA
Est. 5-Yr EPS / DPS Growth	20.0% / 15.0%
Free Float	61.8%

Estimates (Mar)

(Rs)	2012A	2013A	2014E	2015E	2016E
Net Income (Adjusted - mn)	9,961	12,543	14,978	18,023	21,564
EPS	32.00	40.19	46.68	54.44	65.16
EPS Change (YoY)	34.1%	25.6%	16.2%	16.6%	19.7%
Dividend / Share	13.00	20.00	23.50	27.00	32.50
Free Cash Flow / Share	NA	NA	NA	NA	NA

Valuation (Mar)

	2012A	2013A	2014E	2015E	2016E
P/E	6.68x	5.32x	4.58x	3.93x	3.28x
Dividend Yield	6.08%	9.35%	10.99%	12.63%	15.20%

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iQprofile[SM] Indiabulls Housing Finance Ltd.

Key Income Statement Data (Mar)	2012A	2013A	2014E	2015E	2016E
(Rs Millions)					
Net Interest Income	12,528	15,597	20,098	24,585	29,573
Net Fee Income	0	0	0	0	0
Securities Gains / (Losses)	NA	NA	NA	NA	NA
Other Income	6,089	5,706	6,210	6,793	7,541
Total Non-Interest Income	6,089	5,706	6,210	6,793	7,541
Total Operating Income	18,617	21,303	26,308	31,378	37,114
Operating Expenses	(3,802)	(4,275)	(4,590)	(5,326)	(6,287)
Pre-Provision Profit	14,815	17,028	21,718	26,051	30,827
Provisions Expense	(2,240)	(1,332)	(2,211)	(2,376)	(2,451)
Operating Profit	12,575	16,066	19,507	23,676	28,376
Non-Operating Income	645.40	484.57	581.48	668.71	769.01
Pre-Tax Income	13,221	16,550	20,088	24,345	29,145
Net Income to Comm S/Hold.	9,982	12,584	15,072	18,141	21,711
Adjusted Net Income (Operating)	9,961	12,543	14,978	18,023	21,564
Key Balance Sheet Data					
Total Assets	322,274	391,288	455,766	528,742	625,518
Average Interest Earning Assets	281,769	347,194	410,505	474,191	550,274
Weighted Risk Assets	268,416	318,844	392,381	477,810	602,513
Total Gross Customer Loans	255,944	309,402	378,564	455,075	546,607
Total Customer Deposits	NA	NA	NA	NA	NA
Tier 1 Capital	49,055	50,558	59,231	65,118	74,245
Tangible Equity	49,055	50,558	59,231	65,118	74,245
Common Shareholders' Equity	49,055	51,686	59,231	65,118	74,245
Key Metrics					
Net Interest Margin	4.45%	4.49%	4.90%	5.18%	5.37%
Tier 1 Ratio	18.3%	15.9%	15.1%	13.6%	12.3%
Effective Tax Rate	23.9%	23.5%	24.5%	25.0%	25.0%
Loan / Assets Ratio	79.0%	78.7%	82.4%	85.2%	86.5%
Loan / Deposit Ratio	NA	NA	NA	NA	NA
Oper Leverage (Inc Growth - Cost Growth)	13.6%	2.0%	16.1%	3.2%	0.2%
Gearing (Assets / Equity)	6.6x	7.6x	7.7x	8.1x	8.4x
Tangible Common Equity / Assets	15.2%	12.9%	13.0%	12.3%	11.9%
Tangible Common Equity / WRAs	18.3%	15.9%	15.1%	13.6%	12.3%
Revenue Growth	18.3%	14.4%	23.5%	19.3%	18.3%
Operating Expense Growth	4.8%	12.4%	7.4%	16.0%	18.0%
Provisions Expense Growth	-12.5%	-40.5%	66.0%	7.4%	3.2%
Operating Revenue / Average Assets	6.5%	6.0%	6.2%	6.4%	6.4%
Operating Expenses / Average Assets	1.3%	1.2%	1.1%	1.1%	1.1%
Pre-Provision ROA	5.2%	4.8%	5.1%	5.3%	5.3%
ROA	3.5%	3.5%	3.5%	3.7%	3.7%
Pre-Provision ROE	31.4%	34.2%	39.6%	41.9%	44.2%
ROE	21.1%	25.0%	27.2%	29.2%	31.2%
RoTE	20.3%	24.8%	25.3%	27.7%	29.0%
RoWRAs	3.7%	3.9%	3.8%	3.8%	3.6%
Dividend Payout Ratio	40.5%	49.6%	50.3%	49.6%	49.9%
Efficiency Ratio	20.4%	20.1%	17.4%	17.0%	16.9%
Headline Cost/Income Ratio	20.4%	20.1%	17.4%	17.0%	16.9%
Total Non-Interest Inc / Operating Inc	33%	27%	24%	22%	20%
Market-Related Revenue / Total Revenues	0%	0%	0%	0%	0%
Provisioning Burden as % of PPP	15.1%	7.8%	10.2%	9.1%	7.9%
NPLs plus Foreclosed Real Estate / Loans	0.9%	0.9%	1.4%	1.6%	1.7%
Loan Loss Reserves / NPLs	58.0%	58.1%	58.6%	61.3%	64.6%
Loan Loss Reserves / Total Loans	0.5%	0.5%	0.8%	1.0%	1.1%
Provisions Expense / Average Loans	1.0%	0.5%	0.6%	0.6%	0.5%
Other Metrics					
Income / Employee	4.39	5.23	6.42	7.38	8.25
(Operating Expenses) / Employee	(0.896)	(1.05)	(1.12)	(1.25)	(1.40)
Pre-Provision Profit / Employee	2.96	3.85	4.76	5.57	6.31
Net Profit / Employee	2.35	3.09	3.68	4.27	4.82

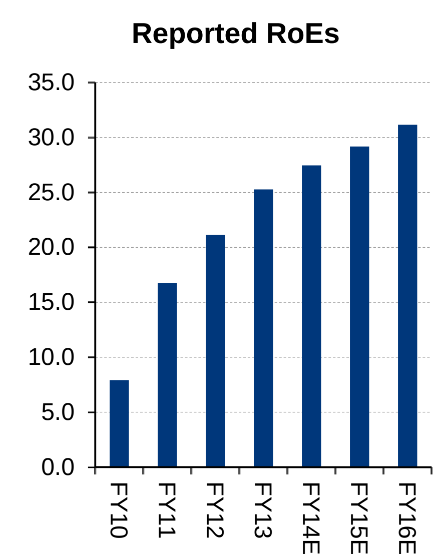
Company Description

Indiabulls Housing Finance Ltd. (IHFL) is a third largest housing financial companies, with total loan assets on a managed basis of $6.3bn as on H1FY14. IHFL offers a broad suite of lending and other financial products to target client base of middle and upper-middle income individuals and small- and medium-sized enterprises, or SMEs. It has presence across 200+ locations across India and in house sales team of sourcing agents .

Investment Thesis

We rate IHFL as a Buy on improving its B/S through maintaining adequate liquidity, high Tier I and high NPL coverage. Growth focus will be secondary. Given low market share in home loans (2%), we believe IHFL can continue to grow its volume above market average for next 3 years and also maintain its asset quality.

Chart 1: Reported RoEs



Source: BofA Merrill Lynch Global Research estimates

Stock Data

Price to Book Value	1.2x

Initiate at Buy, with PO of Rs305

IHFL has expanded its balance sheet with a focus on quality led by mortgage lending

We Initiate coverage of Indiabulls Housing Finance Ltd (IHFL) with a Buy and PO of Rs305. IHFL is a mortgage lender operating as a housing finance company with nearly 70% of assets in home loans and loan against property. Since FY2009, IHFL has completely focused on quality, de-risked its B/S by shedding high-risk loans and created B/S buffers (higher coverage, higher liquidity).

Simultaneously, IHFL has expanded its balance sheet with a focus on quality led by mortgage lending. Hence, while the leverage (net) has clearly increased from a low of 1.8x to about 5x+ now, this is backed by improving balance sheet quality, as articulated above, resulting in rising RoEs, but largely stable, although above-average RoAs. Average RoAs have been stable at around 3.5-3.7% for the past 3-4 years, but RoEs have risen from an average of about 15% (FY08-12) to 25-29%+ in FY13-15E.

Valuing IHFL at 1.7x one-year forward book

IHFL has been one of the better dividend-paying companies with an average payout ratio of 40-50% in the past three years

Our PO of Rs305 is based on the target P/B of 1.7x FY one-year forward estimated adjusted book. Long-term, we are positive on IHFL for its ability to grow its core ‘mortgage’ book and gain market share and hence deliver above-average RoAs of about 3.5%. This will also be complemented by improving financial / operating leverage, which should boost the ROEs and drive a continued re-rating of the stock. We value IHFL using growth-adjusted P/BV method (Gordon Model), with the following key assumptions:

- ROE: 27% (adjusted RoEs for zero-coupon bonds, in our view)
- Cost of equity at 15.5% (Risk free rate of 8%; Beta of 1.4; ERP of 5.5%)

IHFL has been one of the better dividend-paying companies with an average payout ratio of 40-50% in the past three years and an average dividend-yield ratio of 5-10% for the similar period. The return ratios of IHFL are also attractive with the RoE at 27-31% and the RoA at 3.6-3.8% in FY14-16. Given this scenario, we expect IHFL to maintain a healthy payout ratio of 45-50% in the future as well.

Investment case: Key reasons for Buy rating:

- **Bullish on mortgage / loan against property market; set to gain share:** While loan growth is estimated to be slower at about 12-13% in FY14 and 15-16% in FY15, we believe industry mortgage and loan against property (LAP) products will grow sustainably at 18-20%+ in the same period (Read). Home loans and LAP make up 70%+ of loan book for IHFL. Mortgage / LAP offers better growth prospects with least credit risk in the current challenging macro environment. IHFL should benefit on volume front, as its market share in home loans is <2% (o/s) and with rising distribution / tie-ups, it should sustain AUM growth at about 22% through FY14-16.

- **Consistent earnings delivery to drive up return ratios:** With stronger than industry loan growth for IHFL, we estimate net profit to grow at 20%+ in FY14-16 driven by loan (AUM) growth sustaining at 21-22%; spreads sustaining, but margins to rise owing to warrant capital infusion. We estimate credit costs to rise to ~65/60bp in FY14/15 (vs 47bp in FY13), factoring in higher NPLs. However, IHFL may still sustain above-average RoAs of about 3.6-3.7% and RoEs will rise further to 28-29% in FY14-15 vs 25%+ in FY13.

- **Asset quality to remain manageable in a weak asset quality situation:** Since FY11, IHFL has not only de-risked its book by running down unsecured portion of the book, but also improved its risk management, and hence asset quality, since then, has been largely improving / stabilizing. IHFL's headline gross/net NPLs are among the lowest in the industry at about 0.9/0.4%, partly owing to mortgage lending. We believe that IHFL's NPLs should remain among the lowest across asset classes in the current challenging environment. We still estimate NPLs to almost double in FY14 and rise further by 40-45% in FY15, factoring in commercial credit / commercial vehicle book that makes up nearly 15% of AUM.
- **B/S liquidity to support growth:** IHFL has nearly US$1bn of cash and liquid investments, which we believe should support growth / margins in an volatile funding / rate environment. Moreover, as against minimum Tier 1 required of 6% for an HFC, IHFL currently has ~16% Tier 1, a high source of comfort in current challenging capital environment.

Risks (upside) and concerns

- Higher-than-expected asset quality risks driven by nearly 15% of the book in developer finance and commercial vehicles
- Reduction in competitive intensity can lead to higher margins and profitability
- Being a wholesale borrower, it could face liquidity / rate volatility during stree time periods
- Volume growth may be slower if macro growth continues to weaker
- Getting a banking license can be a huge positive

Nothing has changed, post the reverse merger

India Bulls Financial Services Ltd. (IBFSL), an NBFC got de-listed on 18th March 2013 for the 'reverse merger' with the 100%-owned housing finance subsidiary, IHFL, and has completed the 'transformation' to a full-fledged 'Housing Finance Company' (HFC) from a pure non-bank finance company. In its new avatar, the company got re-listed as a Housing finance company on 23rd July 2013. The key benefits for a HFC vs an NBFC, besides being regulated by National Housing Bank (NHB), the HFC regulator, vs the Reserve Bank of India for NBFCs, are lower capital requirements for a HFC vs. an NBFC.

Bull & Bear Case

Indiabulls Housing Finance	Bull case	Bear case	BofA-ML view
Competition	■ Grab market share (nearly 2% now).	■ Re-entry of banks and other NBFCs.	■ Low market share will ensure sustainable volume growth above market average, also driven by recent strategic tie-ups and rising own distribution.
Asset quality	■ Better asset quality could boost valuations.	■ Higher delinquencies could lead to higher credit costs and hurt return ratios. Downturn in economy could also lead to a rise in NPLs.	■ Faster growth in non-individual loans (developer) could hurt asset quality.
Funding	■ RBI eases funding constraints of NBFCs by allowing them to tap international money at ease, deposits, especially low-cost deposits, and the developed bond market.	■ Repeat of FY09 when funding channels to NBFCs come to a standstill, especially bank funding.	■ IHFL is thinly spread with a large wholesale borrowing model, which could hurt when liquidity is tight and interest rates rise.

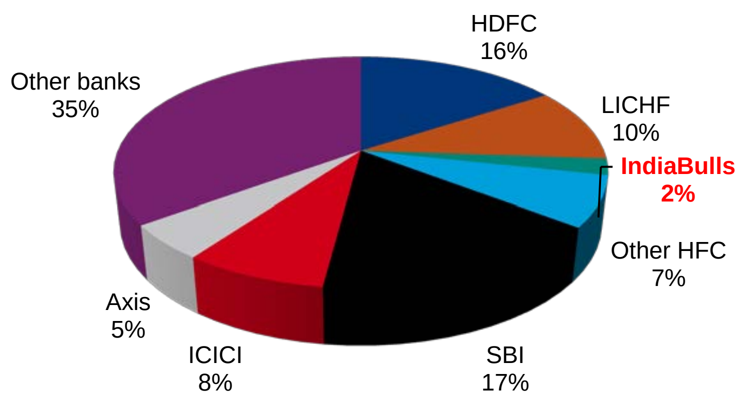
Source: BofA Merrill Lynch Global Research estimates

Market share gains to drive earnings

While loan growth is estimated to be slower at about 12-13% in FY14 and 15-16% in FY15, we believe industry mortgage and loan against property (LAP) products will grow sustainably at 18-20%+ in the same period (Read). Home loans and LAP make up 70%+ of loan book for IHFL. Mortgage / LAP offers better growth prospects with least credit risk in the current challenging macro environment. IHFL should benefit on volume front, as its market share in home loans is <2% (o/s) and with rising distribution / tie-ups, it should sustain AUM growth at about 22% through FY14-16.

IHFL, as on date, has nearly 2% market share in home loans

Chart 2: Low market share of IHFL, despite it being 3rd largest housing finance company



Source: BofA Merrill Lynch Global Research estimates

Net profit growth to sustain at 20% through FY14-16

We estimate net profit growth to sustain at 20% through FY14-16, driven by about 21-22% loan (AUM) growth, as IHFL gains market share. Moreover, average spreads should also sustain driven by well-diversified mix between low-yielding and high-yielding assets. We estimate net profit to grow 25% each in FY14/15.

- We estimate IHFL's AUM growth at 21-22%+ in FY14-15 vs industry mortgage market growth at about 16-18% in the same period. Faster growth will be owing to, besides favorable demographics, IHFL's ability to gain market share, as it expands distribution and strategic tie-ups. IHFL, as on date, has nearly 2% market share in home loans and the LAP market is likely to witness about 20-25% CAGR over the next few years.
- Spreads, in our view, will likely be stable, with upward bias coming from a sharp fall in rates, as IHFL has about 60-65% of liabilities from bank sources. Margin, however, may continue to rise owing to recent warrant conversion by the promoter and senior management group amounting to Rs4.5bn.
- Operating leverage may begin to play out, with cost-to-income ratio trending down to about 17-18% levels vs 20%+ earlier, as IHFL sources loans through bank partners (Yes Bank and Doha Bank), and given the bigger agency network, which already contributes almost 73% of loans and are sourced by in-house team and branches.
- We are factoring in a rise in credit costs to 65/60bp in FY14/15 vs 47bp in FY13, owing to India going through an extended credit cycle. IHFL has non-mortgage loans in the form of commercial credit/commercial vehicles, which may see some higher delinquencies due to a credit cycle. We see gross NPL at 1.4/1.6% in FY14/15 vs about 90bp now, but overall cover at 110%+.

Table 1: DuPont analysis

DuPont	FY11	FY12	FY13	FY14E	FY15E	FY16E
Revenue (Int. Income + Fees)	8.1	6.5	6.0	6.2	6.4	6.4
Operating Expenses	1.9	1.3	1.2	1.1	1.1	1.1
Interest Expense	4.6	6.7	7.3	7.5	7.5	7.5
Operating Profit	6.2	5.2	4.8	5.1	5.3	5.3
Other Income	0.2	0.2	0.1	0.1	0.1	0.1
Provision	1.3	0.8	0.4	0.5	0.5	0.4
PBT	5.1	4.6	4.6	4.7	4.9	5.1
Provision for Tax	1.2	1.1	1.1	1.2	1.2	1.3
ROA	3.8	3.5	3.5	3.6	3.7	3.8
Equity/Asset	22.8	16.4	14.0	13.0	12.6	12.1
ROAE	16.7%	21.1%	25.3%	27.5%	29.2%	31.2%

Source: BofA Merrill Lynch Global Research estimates

Loan mix change to contain NPLs

During the Global Financial Crisis (GFC) in 2008, there was a huge risk perception on NBFCs, and especially on firms like IHFL, as it was geared more towards unsecured and SME/corporate loans. Hence, around GFC, IHFL took shelter by stopping lending, de-risking and raising capital levels. Hence, since FY11, IHFL has not only de-risked its book by running down unsecured portion of the book, but also improved risk management and hence asset quality, since then, has been largely improving / stabilizing.

Table 2: Changing loan mix and NPLs mix

Loan Book Mix -%	FY08	FY09	FY10	FY11	FY12	FY13	FY14 YTD
Mortgage	55%	53%	31%	70%	71%	71%	71%
Corporate	18%	21%	54%	21%	21%	21%	21%
Commercial Vehicle	4%	6%	6%	7%	8%	8%	8%
Unsecured	23%	20%	9%	2%	0%	0%	0%
Total	100%	100%	100%	100%	100%	100%	100%
Gross NPA %	FY08	FY09	FY10	FY11	FY12	FY13	FY14 YTD
Mortgage-Home loans / LAP	0.2%	0.3%	0.7%	0.3%	0.3%	0.3%	0.3%
Corporate	0.0%	0.0%	0.6%	1.8%	1.6%	1.5%	2.0%
Commercial Vehicle	2.9%	2.7%	2.2%	1.8%	1.4%	2.3%	2.3%
Unsecured	0.3%	0.9%	1.0%	0.2%	0.1%	0.0%	0.0%
Total	0.7%	1.6%	1.9%	1.0%	0.8%	0.8%	0.9%

Source: BofA Merrill Lynch Global Research estimates

We estimate gross NPLs to rise to 1.4/1.6% of loans vs about 0.9% now, driven by our view that sector credit cycle will remain extended (Read) With IHFL's nearly 15% of the loan book to developers and commercial vehicle segment, we could see a spike in NPLs. But, overall asset quality will be 'very manageable', with cover at 60%+ and the overall cover at 110%+ (including specific + general).

Table 3: Asset quality

(Rs mn)	FY12	FY13	FY14E	FY15E	FY16E
Gross NPL (gross nos)	2188	2708	5145	7203	9004
Specific Provision	1269	1573	3013	4413	5813
Net NPL	919	1135	2132	2790	3191
General Provisions (incl Std Prov)	2010	3050	3321	3696	4147
NPL Coverage	58%	58%	59%	61%	65%
Total Provisions (SP+GP+FP)	3279	4623	6334	8109	9960
Gross NPA %	0.9%	0.9%	1.4%	1.6%	1.6%
Net NPA- %	0.4%	0.4%	0.6%	0.6%	0.6%
Total Cumulative Coverage	150%	171%	123%	113%	111%

Source: BofA Merrill Lynch Global Research estimates

Valuing at ~1.7x one-year forward

We value IHFL at about 1.7x one-year forward adjusted book, significantly above the historical average of 1.2x (since 2009). We value IHFL using growth-adjusted P/BV method (Gordon Model), with the following key assumptions:

- ROE: 27% (adjusted RoEs for zero-coupon bonds, in our view)
- Cost of equity at 15.5% (Risk free rate of 8%; Beta of 1.4; ERP of 5.5%)

Our PO of Rs305 is based on target P/B of 1.7x one-year forward adjusted book and on Gordon theory multiples model. We remain positive on IHFL's ability to grow its core 'mortgage' book, gain share, and hence, deliver above-average RoA/RoE. Improvements in financial / operating leverage should complement, boosting ROE (core RoEs estimated at an average of ~27% through FY14-16). As a combine, these should drive a continued re-rating of the stock, in our view.

Why should the stock re-rate?

Since FY2009, IHFL has completely focused on quality, de-risked its B/S by shedding high-risk loans and created B/S buffers (higher coverage, higher liquidity). Simultaneously, IHFL has expanded its balance sheet with a focus on quality led by mortgage lending.

IHFL has completely focused on quality, de-risked its B/S by shedding high-risk loans and created B/S buffers

Hence, while the leverage (net) has clearly increased from a low of 1.8x to about 5x, this is backed by improving B/S quality, as articulated above, resulting in rising RoEs, but largely stable, although above-average RoAs. Average RoAs have been stable at around 3.5-3.7% for the past 3-4 years, but RoEs have risen from an average of about 15% (FY08-12) to 25-29%+ in FY13-15E.

Table 4: B/S buffers to drive comfort

(Rs mn)	FY08	FY09	FY10	FY11	FY12	FY13	FY14E	FY15E	FY16E
ROAE	25.9	3.0	7.9	16.7	21.1	25.3	27.5	29.2	31.2
ROAA	6.5	0.8	2.7	3.8	3.5	3.5	3.6	3.7	3.8
Lever (x)	3.5	2.1	1.8	4.3	5.2	6.2	6.2	6.7	7.0
Tier I	26%	34%	32%	20%	13.0%	15.0%	15.1%	13.6%	12.3%
Cash % of assets	49%	23%	10%	9%	14%	13%	11%	8%	6%

Source: BofA Merrill Lynch Global Research estimates

IHFL's operating environment is driven by much more secured lending, with a clear visibility of net profit growth sustaining at about 20%, resulting in return ratio (RoEs) stepping up to 27-31%+ levels in FY14-16E vs <20-25% in FY12-13. Finally, IHFL is very well placed with high comfort on asset quality (gross at about 0.9%) and being very well capitalized (Tier 1 of 17%+).

Comparing IHFL with other HFC's across matrix

Below we compare IHFL with other housing finance companies and across parameters, IHFL stands out.

Table 5: Comparing Housing Finance Companies

Particulars (FY14)	IndiaBulls	LIC Housing	HDFC Ltd
Earnings growth (FY14)	16.2%	25.2%	14.3%
Earnings growth (FY15)	16.6%	20.6%	17.2%
Tier 1 (FY14)	15.1%	10.4%	14.9%

Table 5: Comparing Housing Finance Companies

Particulars (FY14)	IndiaBulls	LIC Housing	HDFC Ltd
Tier 1 (FY15)	13.6%	9.5%	12.7%
RoA (FY14)	3.6%	1.5%	2.7%
RoA (FY15)	3.7%	1.5%	2.7%
RoE (FY14)	27.5%	18.4%	21.4%
RoE (FY15)	29.2%	19.1%	22.7%
Price to Book (FY14)	1.3	1.6	3.3
Price to Book (FY15)	1.1	1.4	2.7
Price to Earnings (FY14)	4.6	8.8	15.8
Price to Earnings (FY15)	3.9	7.3	12.3
RoE FY09-13	14.8%	22.2%	20.9%
RoE FY14-15	28.3%	18.7%	22.0%

Source: BofA Merrill Lynch Global Research estimates

Markets may pay high multiples for high consistent growth/ROEs

IHFL is very well placed with high comfort on asset quality

If a company like IHFL can generate a stronger ROE compared with its cost of capital, growth becomes higher and the multiple expands. High growth that is accompanied by a high ROE is valued by the market. In emerging markets, banks that can provide higher ROEs, with sound asset quality and strong growth potential, tend to trade at significantly higher multiples, as is the case with private banks in India. Hence, we believe the relationship between P/BV and ROE tends to be more exponential as ROEs expand beyond CoEs. The standard equation below is an example of how growth could be captured and how the P/BV multiple tends to expand exponentially as growth climbs:

Fair Value (P/Adj. BV) = (ROAE) / (Cost of Capital)

Hence, we value IHFL using growth-adjusted P/BV method (Gordon Model), with the following key assumptions:

- **ROE:** 27% (3 year est.; adjusted RoEs for zero-coupon bonds, in our view)
- **Cost of equity** at 15.5% (Risk free rate of 8%; Beta of 1.4; ERP of 5.5%)

We have traditionally valued NBFCs based on P/BV-ROE as we believe this best captures the risk-return trade-off. The ROE-P/BV relationship, however, is unlikely to be linear as the RoEs expand beyond the CoEs. Typically, a company is likely to get a premium over its P/BV multiple as it generates a higher RoE or is relatively better poised to capitalize on the growth opportunities in India. The BETA for IHFL has been higher at 1.4 (5 year average) owing to risk perception arising from non-mortgage book (~30%).

Bullish on home + LAP: 70% for IHFL

Focused approach driven by superior risk management practices offers 'low risk, high returns'

IHFL has nearly 70%+ loan book in mortgage and loan against property (LAP). We believe, in India's context, this product segment offers a very strong latent demand supported by India's demographic curve. Players like IHFL are best poised to capture this demand, as focused approach driven by superior risk management practices offers 'low risk, high returns'.

Mortgage: Latent demand still strong!

The overall demographics in India still point to a long-term favorable demand outlook for mortgages given the latent demand and the low level of mortgage penetration, even when compared with only "eligible households". For more details, refer to our in-depth loan growth report here (Read).

In the past few years, salary levels have risen at a fast pace, which is also depicted by the wage inflation witnessed across sectors. As per NCAER, number of households with annual income of over Rs200,000 (c.US$3,500?) has seen 18- 20% CAGR. But, the more relevant aspect is the much more rapid rise in households moving into middle and higher income groups, defined as "seekers" (US$3,500) and above, that typically constitute the key entry-level segment for housing (see Table 1). As per our estimates, there were only 4mn mortgage loans outstanding in India in 2005-06. With the addition of nearly 13mn households (seekers & above) between FY06 and FY10, there is a huge potential for mortgage market in India.

Table 6: India demographics

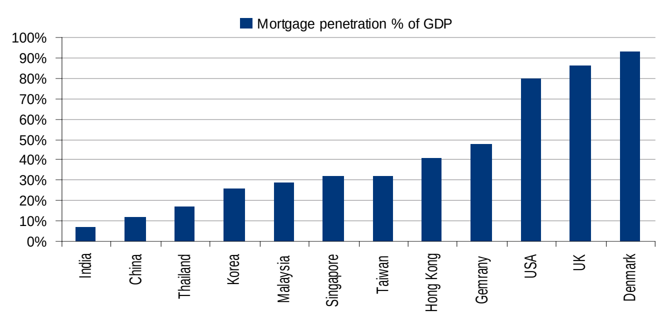
Classification (No of H/holds in '000)	Income Class (Rs in '000)	1995-96	2001-02	CAGR 1995-2002	2005-06	CAGR 2002-06	2009-10
Deprived	< 90	131,176	135,378	0.50%	132,250	-0.60%	114,394
Aspirers	90-200	28,901	41,262	6.10%	53,276	6.60%	75,304
Seekers	200-500	3,881	9,034	15.10%	13,813	11.20%	22,268
Strivers	500-1000	651	1,712	17.50%	3,212	17.00%	6,173
Near Rich	1000-2000	189	546	19.30%	1,122	19.70%	2,373
Clear Rich	2000-5000	63	201	21.30%	454	22.60%	1,037
Sheer Rich	5000-10000	11	40	24.00%	103	26.70%	255
Super Rich	> 10000	5	20	26.00%	53	27.60%	141

Source: NCAER

Penetration, urbanization, nuclearization, affordability

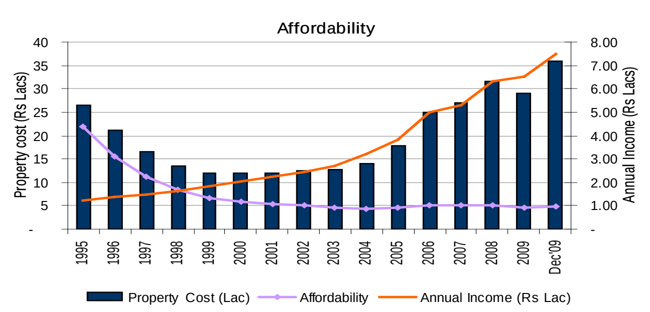
Mortgage penetration continues to be the lowest in India (at 7% of GDP). Further, the ratio is skewed towards the urban population. Top-7 cities in India account for above 54% of disbursements. With increasing urbanization and nuclearization of families in India, we believe the potential for mortgage lending is huge.

Chart 3: Mortgage as a % of GDP - various countries



Source: BofA Merrill Lynch Global Research estimates

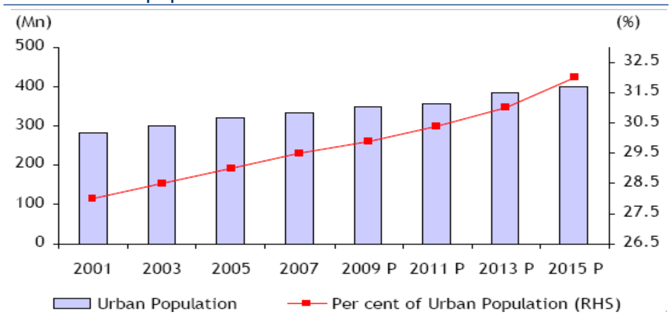
Chart 4: Affordability Index



Source: BofA Merrill Lynch Global Research estimates

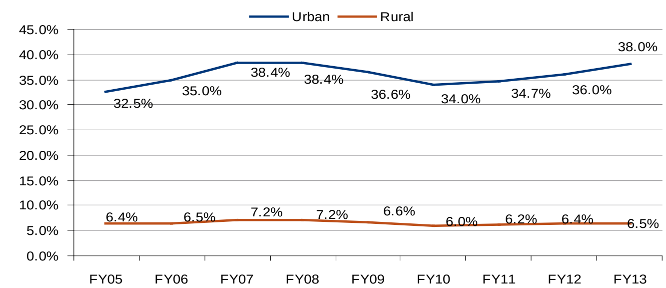
Thus, with urbanization, housing demand will step up, as on the one hand it reduces the area per household, and, on the other hand, it leads to an increasing need for more nuclear families, leading to formation of more households. Factors like increasing penetration (finance) in urban areas (36% in FY09E) as the rising distribution of players, increasing acceptability of loans among customers due to higher property prices, and comfortable earnings profile of a customer will lead to rising penetration.

Chart 5: Urban population trend



Source: CRISIL

Chart 6: Mortgage finance penetration -rural vs. urban



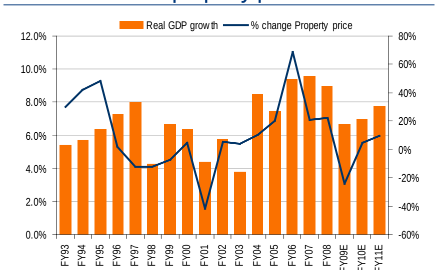
Source: CRISIL

Mortgage: Correlation with GDP and rates

Key observations from the past cycle are:

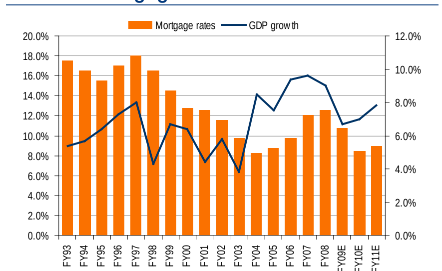
- **GDP growth vs property prices:** In the past cycle, GDP growth was on the upswing but property prices crashed in FY1995-97, as there was a large element of speculators/investors in that market.
- **Mortgage rates vs GDP growth:** There is a perfect correlation between mortgage rates and GDP growth. They both appear to move in tandem.

Chart 7: GDP and property price correlation



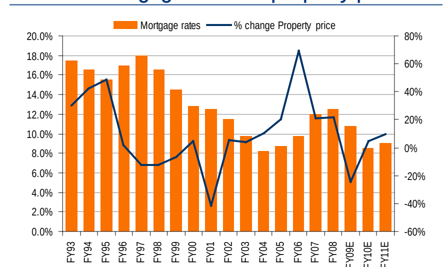
Source: BofA Merrill Lynch Global Research estimates

Chart 8: Mortgage rates and GDP correlation



Source: BofA Merrill Lynch Global Research estimates

Chart 9: Mortgage rate and property price



Source: BofA Merrill Lynch Global Research estimates

Hence, economic upswing (forecast to grow at above 6-7% from FY14-15) bodes well for mortgage market growth.

Low NPL risk in mortgages will also support volume growth

Mortgages still have lowest risk of default and an even lower risk of credit losses

Mortgages, in our view, still have lowest risk of default and an even lower risk of credit losses as: 1) this is cash flow-based lending — the repayment capability of the borrower is appraised (and EMIs are at <40-45% monthly income levels) before approval and loans are secured by real assets; 2) loan-to-value (LTV) ratios of 75-80% cushion against a decline in property prices. Moreover, accounting for undocumented value (10-20%), the LTV ratio tends to be lower at <60%; 3) there have been no securitization or assignment transactions in the past four years due to regulatory curbs; and 4) purchases for consumption rather than for investment reduces the propensity to default.

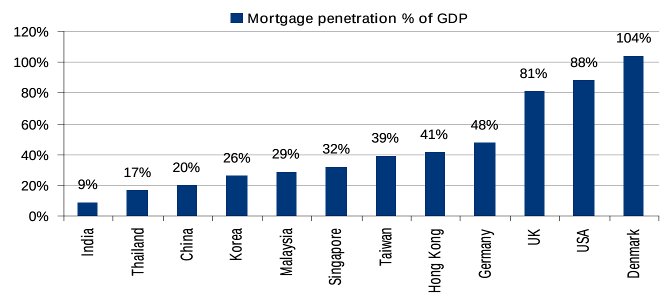
Mortgage loan growth to sustain at 16-18% through FY14/15

Players are beginning to see some margin compression arising

Mortgage lending for banks has picked up to about 16-17% in the past 3-6 months, driven by lack of alternatives and also price cuts by SBI. While at the sector level, underlying growth is still strong, players are beginning to see some margin compression arising, in part owing to balance transfers being effected by SBI, the largest player in the industry, that has priced its loans most competitively – almost 50bp lower than most private players. Further, if we include HFCs, we see growth is closer to 19% as HFCs are growing at 20%+.

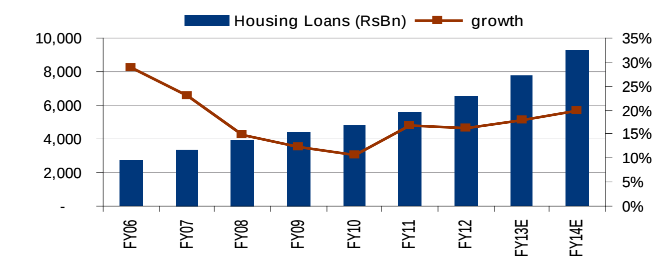
We expect mortgage lending growth to remain at about 16-18% for FY14, driven by latent demand and low delinquencies. However, we firmly believe that mortgage lending – that is only about 12% of overall sector loans – cannot significantly move the needle (pull up FY14 overall loan growth).

Chart 10: Mortgage / GDP ratio



Source: HDFC Ltd.

Chart 11: Growth in mortgages (YoY)



Source: BofA Merrill Lynch Global Research estimates

Real estate prices have remained broadly stable in Tier-II cities over the past three years, driving healthy growth in these areas, despite high interest rates. Measures in the form of interest rate subvention, affordable housing and higher income via implementation of sixth pay commission by the government and teaser rate loan schemes by mortgage financing firms, have encouraged mortgage demand in smaller cities. With stable property prices in Tier-II & Tier-III cities and improving affordability, mortgage growth in these areas is likely to rise.

Loan against property: Pioneering by IHFL to continue

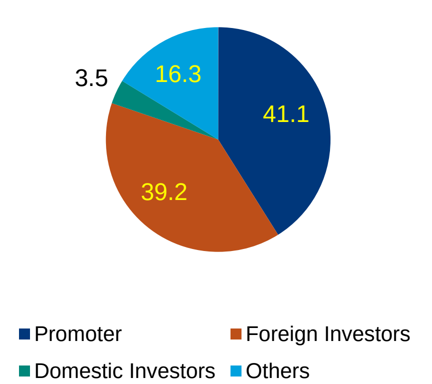
We believe inherent credit risk is much lower for LAP products vs home loans for lenders

Per our estimate, of the total LAP market of Rs380bn+ in 2013, IHFL controls almost 20%+ of the market. The product has been in the offering since 2005 by IHFL. Per industry estimates, this market has the potential to still continue to see 20%+ CAGR over the next 3-5 years. The risk factors in LAP products are much lower, contrary to perception, given shorter average duration (seven years for LAP vs about 15-20 years for home loans); higher yields capturing risk profile (14% LAP yields vs about 10-11% for home loans) and lower LTVs at origination (<50% vs nearly 70-75% for home loans). Hence, we believe inherent credit risk is much lower for LAP products vs home loans for lenders.

HFCs have advantage vs banks in mortgage

While HFCs like IHFL have lower spreads due to higher cost of funds compared to banks, operating costs for HFCs have been lower, led by their niche focus and mono−line business models. Cost to assets for HFCs in the range of <1.0% are significantly lower than that of banks (2-2.5%) and other NBFCs. Lower operating costs and lower loan−loss provisions are likely to sustain the higher profitability of HFCs compared to banks. In aggregate, we do not foresee a huge shift in market shares as we think only 4-5 banks are likely to sustain their stronghold in the industry; while for HFCs, this remains their core business.

Chart 12: Shareholding pattern



Source: BSE

Company description

Indiabulls Housing Finance Ltd (IHFL) is the third largest housing finance company in India regulated by the National Housing Bank (NHB) and listed on the Bombay Stock Exchange and the National Stock Exchange. It was established as a wholly-owned subsidiary of Indiabulls Financial Services Ltd (IBFSL), a leading non-banking financial firm providing home loans, commercial vehicle loans and business loans, that was established in 2000. In early 2013, keeping with IBFSL's long-term commitment to the housing finance business, the company was reversed-merged into its housing finance subsidiary IHFL. IHFL has expanded its business rapidly with the present asset book at over Rs380bn and net worth of more than Rs57bn. IHFL has AA+ long-term credit rating. With a wide network of about 200 walk-in branches across the country and a strong sales team of 2,000 executives, IHFL has given cumulative loans to 5.62 lakhs retail customers

Management team

Mr. Gagan Banga: Mr. Banga has been the Chief Executive Officer of Indiabulls Financial Services Ltd since December 2004, and assumed charge as the Managing Director and CEO of Indiabulls Housing Finance Ltd (IHFL) after the reverse merger of the former into IHFL was completed in early 2013.

Other management team members:

- Mr. Ashwini Kumar Hooda – DMD
- Mr. Sachin Chaudhary – Business Head – Mortgages
- Mr. Mudit Gupta – Business Head – Commercial Vehicle
- Mr. Mukesh Garg – CFO
- Mr. Kaushik Chatterjee – Policy & Credit Underwriting Head – Mortgages
- Mr. V. Ramaprasad – National Sales Head – Commercial Vehicle
- Mr. Vipin Verma – Credit Head – Commercial Vehicle
- Mr. Monu Ratra – National Sales Head – Mortgages
- Mr. M.S.Walia – National Sales Head – Loan Against Property
- Mr. Shailesh Yadav – Collections Head – Mortgages
- Mr. Pinank Shah – Treasury Head
- Mr. Ramkumar – Compliance Head
- Mr. Ramnath Shenoy – Analytics Head

Financials

Table 7: Profit and loss account

Year to Mar (Rs mn)	FY12	FY13	FY14E	FY15E	FY16E
Financing Revenues	31729	41588	51835	61486	72666
Interest Expense	19201	25991	31737	36901	43093
Net Interest Income	12528	15597	20098	24585	29573
Other Income	6089	5706	6210	6793	7541
Net Revenue	18617	21303	26308	31378	37114
Operating Expenses	3802	4275	4590	5326	6287
Operating Profit	14815	17028	21718	26051	30827
Other Income	645	485	581	669	769
Provision for NPL	33	324	1440	1400	1400
General Prov	1323	340	271	376	451
Bad Debts written off	884	669	500	600	600
PBT	13221	16180	20088	24345	29145
Provision for Tax	3156	3891	4922	6086	7286
PAT	10065	12290	15167	18258	21859
Minority Interest	82	75	94	118	147
PAT	9982	12214	15072	18141	21711

Source: BofA Merrill Lynch Global Research estimates

Table 8: Balance sheet

Balance Sheet					
As at March	FY12	FY13E	FY14E	FY15E	FY15E
Total Net Fixed Assets	445	456	456	456	456
Investments	17968	23079	19617	18636	17704
Total Current Assets	302763	366112	435693	509650	607357
Advances	254675	307829	375551	450662	540794
Total Assets	303,237	365,992	430,541	502,262	597,657
Equity Capital	624	625	666	666	666
Reserves & Surplus	48,431	49,933	58,565	64,451	73,579
Net Worth	49,055	50,558	59,231	65,118	74,245
Total Loans	252,867	312,858	369,861	435,695	521,963
Total Liabilities	303,237	365,992	430,541	502,262	597,657

Source: BofA Merrill Lynch Global Research estimates

Table 9: Key ratios

Key Ratios	FY10	FY11	FY12	FY13	FY14E	FY15E	FY16E
EPS	9.9	23.9	32.0	40.2	46.7	54.4	65.2
EPS growth	217%	140%	34%	26%	16%	17%	20%
CEPS	9.7	24.2	32.3	40.6	45.5	54.8	65.5
ROAE -%	7.9	16.7	21.1	25.3	27.5	29.2	31.2
ROAA-%	2.7	3.8	3.5	3.5	3.6	3.7	3.8
BV/ Share (Rs)	139	146	157	162	178	195	223
Gross NPLs	1.9%	1.0%	0.9%	0.9%	1.4%	1.6%	1.6%
Net NPLs	0.9%	0.4%	0.4%	0.4%	0.6%	0.6%	0.6%
Specific Provision Coverage	53%	64%	58%	58%	59%	61%	65%
Cumulative (Spec.+ General) Coverage	63%	107%	150%	171%	123%	113%	111%
Tier I CAR	32.4%	19.9%	13.0%	15.0%	15.1%	13.6%	12.3%
Interest Coverage (x)	1.8	2.1	1.7	1.6	1.6	1.7	1.7
Net Interest Margins	6.8%	6.2%	4.3%	4.2%	4.5%	4.7%	4.8%
Specifc Provisions / AUM	3.1%	1.4%	0.4%	0.3%	0.5%	0.4%	0.4%
C-I Ratio	26.3	23.1	20.4	20.1	17.4	17.0	16.9
P/E	21.7	9.1	6.8	5.4	4.6	4.0	3.3
P/ Adj Book Value	1.6	1.5	1.4	1.4	1.2	1.1	1.0
Dividend Per Share	5.0	10.0	13.0	20.0	23.5	27.0	32.5
Dividend Pay Out Ratio	50%	42%	41%	50%	50%	50%	50%
Dividend Yield	2%	4.6%	6.0%	9.3%	10.9%	12.5%	15.0%
Equity / assets	35%	19%	16%	14%	14%	13%	12%
Adj. BV / Shr	136	144	154	158	171	187	213
PPP per share	24.44	38.92	47.51	54.49	65.18	78.18	92.51
Cost / Assets	2%	1.5%	1.3%	1.2%	1.1%	1.1%	1.1%
AUM growth	23%	80%	39%	25%	22%	22%	21%
Equity / Loans	40%	23%	19%	16%	16%	14%	14%
tax rate	33%	24%	24%	24%	25%	25%	25%
Loan Yield	11%	13.2%	13.4%	13.4%	13.6%	13.2%	12.9%
Funding cost	8%	6.6%	8.6%	9.2%	9.3%	9.2%	9.0%
Gross NPLs (RsMn)	2115	2064	2188	2708	5145	7203	9004
Net NPLs (RsMn)	992	740	919	1135	2132	2790	3191
Total CAR	32%	20%	19%	18%	18%	16%	14%
Specific Provision	4.2%	1.5%	0.4%	0.4%	0.6%	0.5%	0.4%

Source: BofA Merrill Lynch Global Research estimates

Price objective basis & risk

Indiabulls Housing Finance Ltd. (XFQGF)

IHFL trades at 1.2x FY14 adj. book. Our PO of Rs305 is based on target P/B of 1.7x one-year forward adjusted book. We remain positive on IHFLs ability to grow its core 'mortgage' book, gain share, and hence, deliver above-average RoA/RoE. Improvements in financial / operating leverage should complement, boosting ROE. As a combine, these should drive a continued re-rating of the stock, in our view. We value IHFL using growth-adjusted P/BV method (Gordon Model), with the following key assumptions: ROE: 27% (adjusted RoEs for zero-coupon bonds, in our view) and Cost of equity at 15.5% (Risk free rate of 8%, Beta of 1.4, ERP of 5.5%). Risks are a very strong business growth leading to a spike in NPLs, which could hurt earnings momentum, and a sharp rise in wholesale borrowing costs can lead to spread compression.

Link to Definitions

Financials

Click here for definitions of commonly used terms.

Analyst Certification

I, Veekesh Gandhi, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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India - Financials Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	Credit Analysis & Research Ltd (CARE)	XSEIF	CARE IN	Veekesh Gandhi
	HDFC	HGDFF	HDFC IN	Rajeev Varma
	HDFC Bank	XHDFF	HDFCB IN	Rajeev Varma
	HDFC Bank	HDB	HDB US	Rajeev Varma
	ICICI Bank	ICIJF	ICICIBC IN	Rajeev Varma
	ICICI Bank - A	IBN	IBN US	Rajeev Varma
	Indiabulls Housing Finance Ltd.	XFQGF	IHFL IN	Veekesh Gandhi
	Indian Bank	INDIF	INBK IN	Veekesh Gandhi
	Kotak Mahindra Bank	XXRVF	KMB IN	Rajeev Varma
	LIC Housing Finance, Ltd.	LHFLF	LICHF IN	Veekesh Gandhi
	Mahindra and Mahindra Financial Services	XGDAF	MMFS IN	Veekesh Gandhi
	Max India	XMXIF	MAX IN	Rajeev Varma
	ORBC	ORBCF	OBC IN	Veekesh Gandhi
	Power finance corporation Ltd	PWFEF	POWF IN	Veekesh Gandhi
	Reliance Capital	RLCCF	RCAPT IN	Veekesh Gandhi
	Rural Electrification Corporation Ltd	XULEF	RECL IB	Veekesh Gandhi
	Shriram Transport Finance	SHTFF	SHTF IN	Veekesh Gandhi
	Yes Bank Ltd	YESBF	YES IN	Veekesh Gandhi
NEUTRAL				
	Axis Bank	XAXSF	AXSB IN	Rajeev Varma
	Axis Bank - GDR	XBKSF	AXB LI	Rajeev Varma
	Bank of Baroda	BKBAF	BOB IN	Rajeev Varma
UNDERPERFORM				
	Bank of India	XDIIF	BOI IN	Rajeev Varma
	Canara Bank	CNRKF	CBK IN	Rajeev Varma
	Corporation Bank	XCRRF	CRPBK IN	Veekesh Gandhi
	Federal Bank	XFDRF	FB IN	Veekesh Gandhi
	IDBI	XDBIF	IDBI IN	Veekesh Gandhi
	Indusind Bank	IDUBF	IIB IN	Veekesh Gandhi
	Infrastruct Dev	IFDFF	IDFC IN	Rajeev Varma
	Manappuram	XMGPF	MGFL IN	Veekesh Gandhi
	Punjab	PUJBF	PNB IN	Rajeev Varma
	SBI	SBINF	SBIN IN	Rajeev Varma
	SBI -G	SBKFF	SBID LI	Rajeev Varma
	Union Bank India	UBOIF	UNBK IN	Rajeev Varma
RVW				
	Bajaj Finserv Limited	XBVJF	BJFIN IN	Rajeev Varma

iQmethod SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

iQmethod SM is the set of BofA Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase ® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by BofA Merrill Lynch.

Important Disclosures

Investment Rating Distribution: Financial Services Group (as of 30 Sep 2013)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	110	48.89%	Buy	96	87.27%
Neutral	62	27.56%	Neutral	50	80.65%
Sell	53	23.56%	Sell	36	67.92%

Investment Rating Distribution: Global Group (as of 30 Sep 2013)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1672	49.06%	Buy	1234	73.80%
Neutral	856	25.12%	Neutral	622	72.66%
Sell	880	25.82%	Sell	551	62.61%

* Companies that were investment banking clients of BofA Merrill Lynch or one of its affiliates within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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