India Banking & Finance Sector
HFCs: Mortgage spreads set to expand

Equities

India
Diversified Financial

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Wholesale rates down 100+bps YTD vs 35-50bps for TD rates; +ve for HFCs
With easing liquidity and lower inflation, wholesale rates have fallen faster than retail term deposit rates with 3 year AAA rates declining by 130bps YTD (in-line with fall in 10-yr G-Sec rates of ~100bps) vs ~35-50bps fall in 1-3 year retail term deposits rates. UBS economy and strategy team expects wholesale rates to further decline, with 10-yr G-Sec rates touching 6.5% by Mar '16 (vs 7.9% now) which could translate into 100-150bps decline in banks' lending and deposit rates.

Mortgage spread of HFCs to expand as lending rates cut will be lower
We believe that housing finance companies (HFCs) will be the biggest beneficiaries among NBFCs as cost of funds will fall faster than lending rates. Mortgage rates for large players have remained stable (down only by 0-10bps YTD) as banks are yet to cut base rates. However, incremental cost of funds for HFCs has fallen by 40-70bps as bond borrowings constitute 40%-68% of total borrowings of leading HFCs. As a result, incremental spreads have improved by 20-60bps. While banks have raised long term bonds since July'14; we are yet to see any aggressive pricing from banks in this segment which we believe will mitigate concerns on HFCs.

Robust demand and margins improvement to boost earnings growth
Mortgage growth has remained resilient for leading HFCs and we expect growth to remain strong at 19-20% over FY16-17E. Loan growth in non-mortgage segment has been subdued; however, this should pick up in H2FY15/FY16. This coupled with improvement in margins would boost earnings growth of HFCs. We expect HDFC's earnings (standalone) to improve from 15% CAGR over FY12-14 to 20% CAGR in FY16-FY17E, whereas LICHF could report 29% earnings growth CAGR in FY16/17E.

LICHF preferred pick; upgrading HDFC, IHFL to Buy
LICHF remains our preferred pick (Buy, new PT of Rs 550) on falling interest rate cycle and likely improvement in mortgage spread. We also upgrade our ratings on HDFC and IHFL to Buy with new PTs of Rs 1300 and Rs 575 on favourable business cycle.

Figure 1: EPS, Rating and Price Target changes

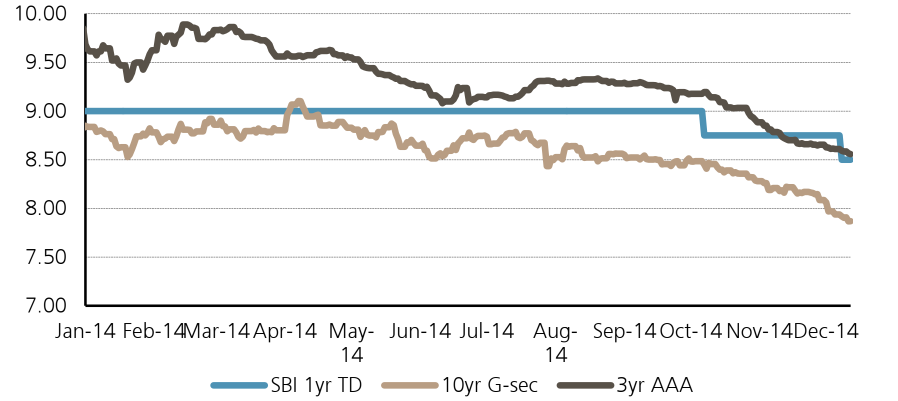
	Rating		Price target		2015E EPS			2016E EPS			2017E EPS		
	Old	New	Old	New	Old	New	Cons.	Old	New	Cons.	Old	New	Cons.
LICHF	Buy	Buy	500	**550**	28.9	28.9	27.5	38.1	**38.2**	36.1	47.8	**48.3**	44.8
HDFC	Neutral	**Buy**	1,180	**1,300**	40.9	40.9	39.5	48.0	**48.6**	46.4	56.0	**57.3**	54.4
IBUL	Neutral	**Buy**	520	**575**	55.8	55.8	54.9	58.2	**61.1**	63.5	69.2	**70.4**	75.4

Source: Bloomberg, UBS estimates

Wholesale rates fall higher than retail term deposit rates

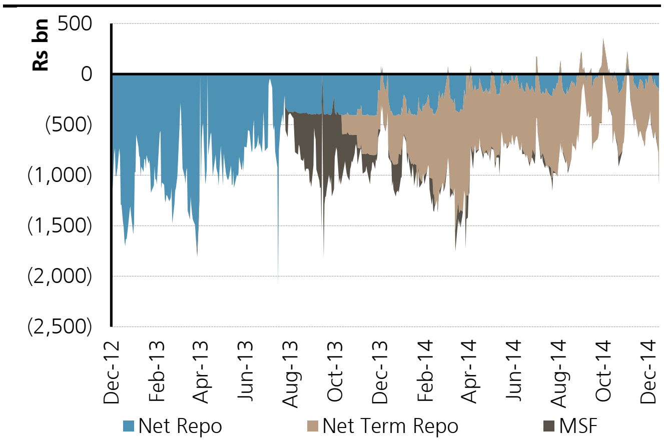
With easing liquidity and lower inflation, wholesale rates have fallen faster than retail term deposit rates with 3 year AAA rates declining by 130bps YTD (in-line with fall in 10-yr G-Sec rates of 100bps) vs ~35-50bps fall in 1-3 year retail term deposits rates. Post current fall, 3 year AAA bond rates are now closer to retail term deposit rates at ~8.6%.

Figure 2: Bond yields have corrected more than retail term deposit rates



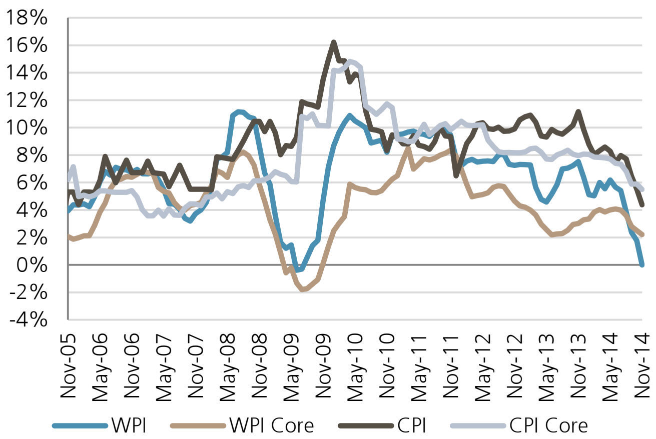
Source: Bloomberg, UBS Research

Figure 3: Liquidity pressure has eased



Source: Bloomberg, UBS Research

Figure 4: Inflation has also moderated



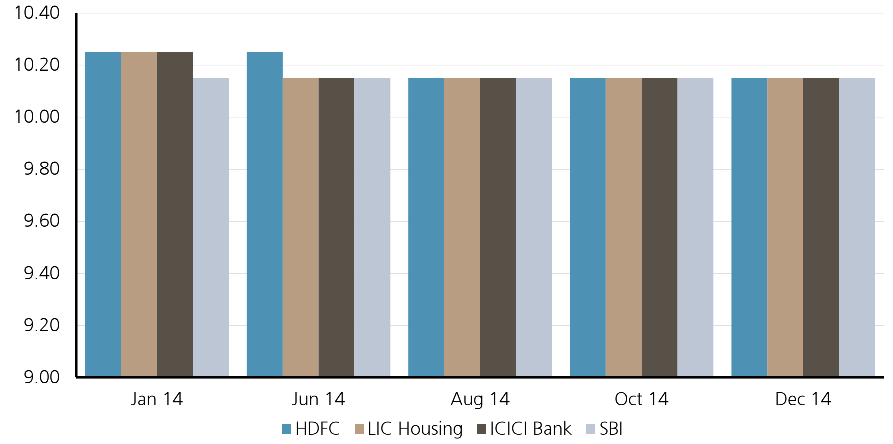
Source: Bloomberg, UBS Research

UBS economy and strategy team expects wholesale rates to further decline, with 10-yr G-Sec rates touching 6.5% by Mar '16 (vs 7.9% now) which could translate into 100-150bps decline in banks' lending and deposit rates.

Lending rates have remained largely stable; likely to fall in-line with base rates

While incremental cost of funds has fallen sharply, mortgage rates have remained largely stable YTD (down only by 0-10bps YTD) as banks are yet to cut base rates. For loans up to Rs 7.5mn, leading banks SBI and ICICI Bank, are currently charging interest rate of 10.15% (base rate + 0.15%) to the borrowers. Large banks have not cut their base rates significantly YTD and consequently, home loans rates have remained largely stable.

Figure 5: Home loan rates largely stable YTD (for loans up to Rs 7.5mn)



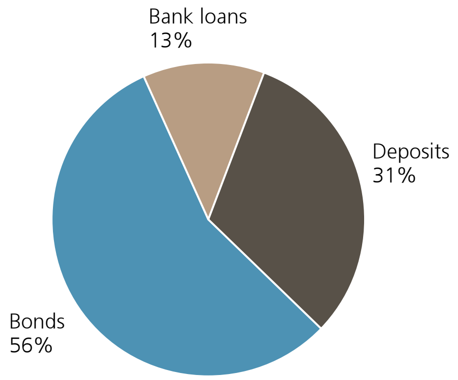
Source: Company data, UBS research

Incremental spreads set to expand by 20-60bps

With lending rates remaining largely stable and wholesale rates declining, incremental spread for housing finance companies is going up and extent of spread expansion would depend on % share of bond borrowings (where rates have fallen more). We expect spreads to expand by 20-60bps in our coverage universe.

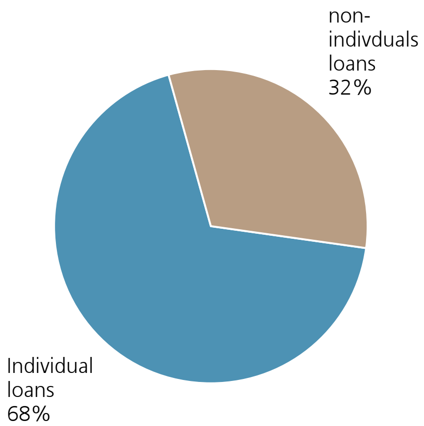
HDFC: Bond borrowings constitute ~56% of total borrowings for HDFC whereas deposits and bank borrowings constitute 31% and 13% respectively. Assuming similar liability composition, incremental cost of funds would decline by 50-55bps (assuming decline of 100bps in rates) and spreads would expand by 40-45bps (marginally lower due to slight fall in lending rates). On the asset side, ~68% loans are to individual segment. Assuming the company does not pass benefit of lower cost of funds in the individual segment (given wafer thin spreads); however, it pass on cost benefits in non-retail segment (where spreads are high), overall spread expansion will be limited to 25-30bps.

Figure 6: HDFC's borrowing breakup, Sep-14



Source: Company data

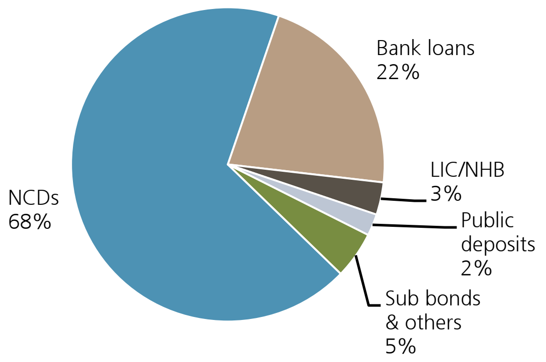
Figure 7: HDFC's loan book break-up, Sep'14



Source: Company data

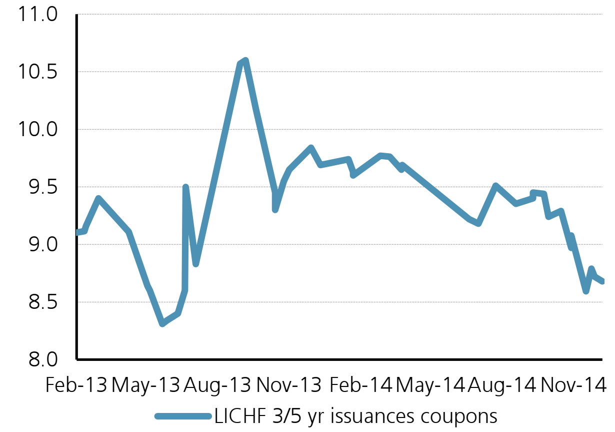
LIC Housing: LIC Housing could be a big beneficiary of faster decline in wholesale rates given higher bond borrowings and higher share of low margin mortgage book. As shown in Fig 9, LICHF's incremental borrowing costs in the bond segment (3/5yr bucket) have declined by 100bps since July 2014.

Figure 8: LICHF's borrowing breakup, Sep-14



Source: Company, UBS estimates

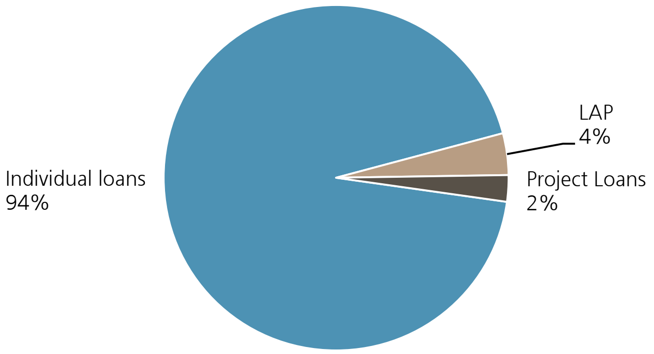
Figure 9: LICHF bond borrowing cost lower by 100bp since July 2014



Source: Reuters, UBS research

Assuming similar liability composition as shown in Fig 8, incremental spread could expand by 50-55bps. New book could contribute ~30-35% of the FY16-end book which could result in blended spread improvement of ~15bps in FY16.

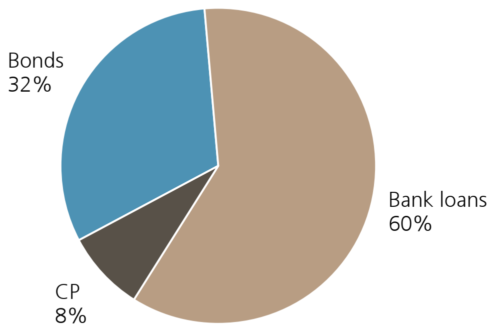
Figure 10: LICHF's loan book breakup, Sep-14



Source: Company, UBS Research

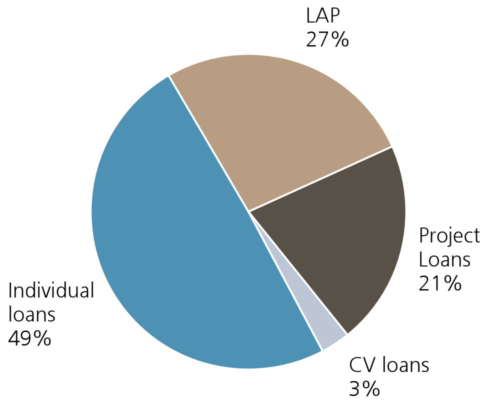
Indiabulls Housing (IHFL): Bond borrowings (including CPs) constitute only 40% of total borrowings for IHFL, whereas bank borrowings constitute remaining 60%. Assuming similar liability composition, incremental cost of funds would decline by 40-45bps and spreads would expand by 30-35bps. However on the asset side, only ~50% of loans are individual housing loans. Assuming the company does not pass benefit of lower cost of funds in the individual segment (given wafer thin spreads); however, it passes on cost benefits in non-retail segment (where spreads are high), overall spread expansion will be limited to ~20bps.

Figure 11: IHFL's borrowing breakup, Sep-14



Source: Company data

Figure 12: IHFL's loan book break-up, Sep'14



Source: Company data

Robust demand and margins improvement to boost earnings growth

Loan growth in the mortgage segment has remained resilient despite sharp slowdown in economy. Housing finance companies has reported a strong loan growth of 22-23% CAGR over FY12-14 in the retail segment. Leading banks have also reported strong loan book growth in this segment.

Figure 13: Retail housing loan growth has remained robust both for HFCs and Banks

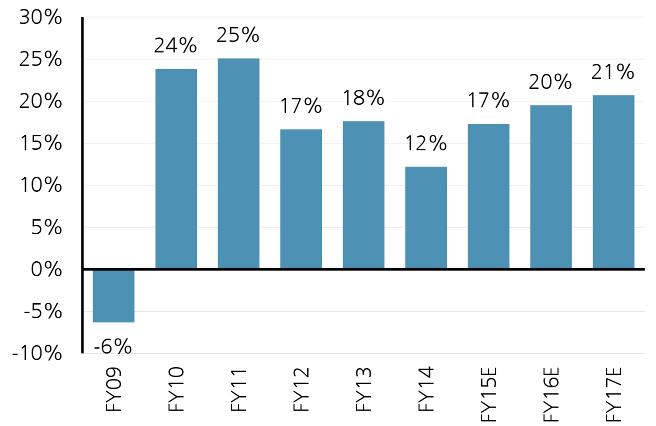
	FY09	FY10	FY11	FY12	FY13	FY14
HDFC						
Individual	13%	12%	20%	21%	25%	20%
Non-individual	23%	21%	19%	20%	13%	9%
LICHF						
Individual	22%	34%	38%	28%	25%	18%
Non-individual	84%	70%	5%	-27%	-16%	4%
ICICI– Home loans	-13%	-18%	14%	-10%	18%	23%
Axis – Home loans	35%	41%	28%	49%	38%	31%
SBI – Home loans	21%	32%	26%	14%	16%	18%

Source: Company Data; *Note: AUM growth for IHFL

Loan growth in non-mortgage segment has been subdued in FY14. Non-individual segment for HDFC grew by 9% in FY14 and 11.5% in H1FY15. However, with liquidity easing and demand likely to pick up with GDP growth improvement, we believe that loan growth should pick up in H2FY15/FY16. We expect HDFC's non-individual segment to grow by 19% CAGR over FY16-17.

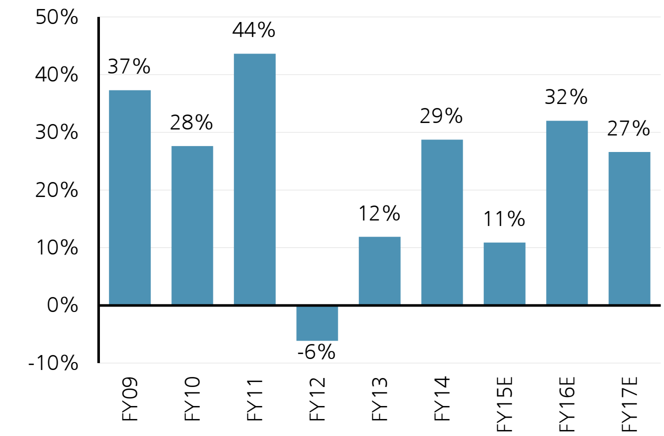
Healthy loan book growth coupled with improvement in margins would boost earnings growth of HFCs. We expect HDFC's earnings (standalone) to improve from 15% CAGR over FY12-14 to 20% CAGR in FY16-FY17E, whereas LICHF could report 29% earnings growth CAGR in FY16/17E.

Figure 14: HDFC earnings growth to improve to 20% CAGR



Source: Company, UBS estimates

Figure 15: LICHF earnings to grow at 29% CAGR over FY16/17E

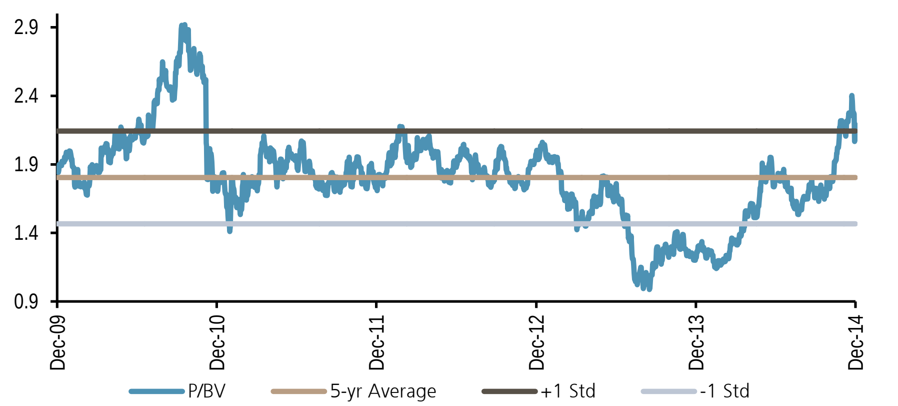


Source: Company, UBS estimates

LICHF preferred pick; upgrading HDFC, IHFL to BUY

Housing finance companies have rallied YTD; however, we believe that valuations are still reasonable given improving fundamentals and strong earnings visibility. LICHF remains our preferred pick (for more details, please see our earlier reports *Modi or No Modi, It's a Buy* dated 11 April 2014 and *Position for rate easing* dated 1 September 2014) on falling rate cycle as we expect strong earnings growth driven by margin expansion and robust loan book growth. The stock has performed well (91% up YTD vs 61% for Bankex) and is now trading at 20% premium to 5-year average which we believe is reasonable given improving profitability.

Figure 16: LICHF 1yr fwd. P/BV



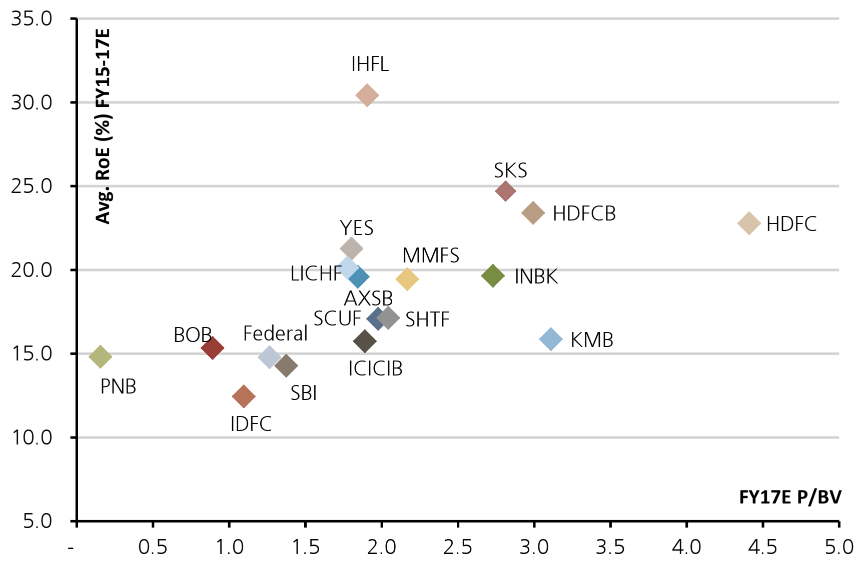
Source: Bloomberg, UBS research

HDFC has underperformed Bankex by 6% in last 6months (stock up 37% YTD vs 61% for Bankex) due to concerns on pricing pressures. However, with decline in wholesale rates, we expect competitive pressures to ease significantly and earnings growth to accelerate to 20% CAGR over FY16-17. We roll our estimates forward to Dec '15 which drives an increase in our PT to Rs 1300 (from Rs 1175) and therefore we upgrade our rating on the stock to Buy.

IHFL should also benefit from favourable business cycle. While its margins are already better than peers, we believe that this could improve further in the near term due to sharp decline in wholesale rates, recent credit upgrades and change in

liability mix. Favourable cycle could support loan growth with low credit costs; consequently, return ratios could remain high in the near term. We upgrade IHFL to Buy from Neutral with a new price target of Rs 575/share (from Rs 520 earlier). At our PT, the stock would trade at 2.3x FY17 P/BV and 8.0x FY17 P/EPS.

Figure 17: Indian financials FY17E P/BV versus FY15-17E average ROE



Source: Bloomberg, UBS estimates

Figure 18: India Banking and Financial stocks under our coverage

	Rating	Price #	PT (Rs)	% upside	EPS (Rs) FY16E	FY17E	CAGR 15-17E	PER (X) FY16E	FY17E	5yr Avg.	PBR (X) FY16E	FY17E	5yr Avg.	RoE (%) FY16E	FY17E	RoA (%) FY16E	FY17E
PSU Banks																	
BOB	Buy	1,056	1,300	23	154	185	22.5	6.9	5.7	6.5	1.0	0.9	1.0	15.6	16.5	0.8	0.8
PNB	Buy	226	250	11	37	41	20.3	6.1	5.5	6.7	0.9	0.8	1.0	15.7	15.2	1.0	0.9
SBI	Buy	307	400	30	27	34	30.6	11.6	9.0	13.0	1.6	1.4	1.6	14.4	16.4	0.9	1.0
Private Banks																	
Axis	Buy	487	600	23	40	51	27.6	12.0	9.5	11.1	2.2	1.8	1.9	19.7	21.1	1.9	2.0
HDFCB	Buy	934	1,100	18	56	70	27.1	16.7	13.3	19.0	3.6	3.0	3.5	23.7	24.6	2.0	2.1
ICICI	Buy	345	415	20	24	29	21.0	14.5	12.0	14.9	2.2	1.9	1.7	15.8	16.8	1.9	1.9
IndusInd	Buy	774	950	23	43	54	25.9	17.8	14.3	14.8	3.3	2.7	2.3	19.8	20.8	1.9	1.9
FB	Buy	142	180	27	14	17	20.2	9.9	8.3	8.6	1.4	1.3	1.1	14.3	16.1	1.2	1.2
Yes	Buy	720	880	22	64	79	27.6	11.2	9.1	10.2	2.2	1.8	2.0	20.8	21.6	1.8	1.8
NBFCs																	
HDFC	Buy	1,098	1,300	18	49	57	18.4	22.6	19.2	22.8	4.9	4.4	4.6	23.1	24.3	2.7	2.7
IDFC	Neutral	155	180	17	15	16	10.8	10.0	9.4	12.7	1.2	1.1	1.6	12.7	12.2	2.6	2.1
LICHF	Buy	421	550	31	38	48	29.3	11.0	8.7	10.2	2.1	1.8	1.8	20.5	22.1	1.6	1.7
SHTF	Buy	1,121	1,400	25	79	97	28.4	14.1	11.5	11.3	2.3	2.0	2.1	17.7	18.5	3.3	3.6
SCUF	Neutral	1,766	1,900	8	114	140	21.3	15.5	12.6	10.2	2.4	2.0	1.8	16.5	17.4	3.7	3.8
IHFL	Buy	461	575	25	61	72	13.6	7.5	6.4	5.3	2.1	1.9	1.3	31.3	31.3	3.8	3.8
PFC	Buy	296	375	27	51	57	11.1	5.8	5.2	7.2	1.1	0.9	1.2	18.7	18.3	2.7	2.7
REC	Buy	330	400	21	63	71	12.3	5.2	4.7	6.5	1.1	0.9	1.3	23.1	21.9	3.3	3.2
MMFS	Neutral	299	350	17	22	27	27.5	13.5	11.1	12.1	2.5	2.2	2.2	20.1	21.0	3.2	3.2
SKS	Buy	380	500	32	20	29	30.3	18.6	12.9	NA	3.6	2.8	3.9	21.3	24.4	6.5	7.1

Source: Bloomberg, Company data & UBS estimates # Price as on 18-Dec-2014

LIC Housing Finance
Best beneficiary of lower wholesale rates

Margins to improve by 55bps over FY15-17E

We believe that LICHF will be the biggest beneficiary among leading HFCs of easing pricing pressures in the mortgage segment as mortgages constitute ~94% of total loan book. Expanding spread in this segment would provide further comfort to our estimate of ~55bps margin improvement over FY15-17E. Upward re-pricing of ~37% of loan book over FY16-18E, increasing proportion of higher yielding loans and change in liability mix from expensive bank borrowings to cheaper bonds should also boost margins (for more details, please see our earlier reports *Modi or No Modi, It's a Buy* dated 11 April 2014 and *Position for rate easing* dated 1 September 2014).

Advances to grow by 19% CAGR; Asset quality robust

LICHF's retail loan book could deliver a 19% CAGR supported by healthy demand in the mortgage segment and a robust 30%-plus CAGR in loans against the property segment. We expect project share to remain at ~3.0-3.5%. GNPLs in the retail segment remained low at 0.63% (Sep'14) and credit costs in the mortgage business remain among the lowest. GNPLs in Project loans (which constitute only 3% of total portfolio) have come down from 14% to 10.5% as one account was recovered in Q2FY15. While GNPLs are high, we believe that credit loss will not be significant given adequate collateral.

Expect 29% EPS CAGR over FY16/FY17; Estimate above consensus by 6-8%

While FY15 EPS growth would be lower at 11% despite strong growth and margin improvement as tax rate would increase to 34% from 28% in FY14, we believe that FY16-17E earnings could grow by 29% CAGR as margins improve. Our earnings estimates are 6-8% above consensus in FY16/FY17E. With strong earnings growth, we expect ROEs to improve from 18% in FY15E to ~22% in FY17E.

Valuation: Buy; PT Rs 550

LICHF remains our preferred pick among NBFCs given strong earnings potential and robust asset quality. We raise our PT to Rs 550 (from Rs 500 earlier) as we roll forward our estimates to Dec '15. Our PT is based on residual income model and implies 2.3x FY17 P/BV and 11.4x FY17 P/EPS.

Equities

India
Diversified Financial

12-month rating	**Buy**
12m price target	**Rs550.00**
	Prior: Rs500.00
Price	**Rs421.05**

RIC: LICH.BO **BBG:** LICHF IB

Trading data and key metrics

52-wk range	Rs460.40-191.60
Market cap.	Rs212bn/US$3.34bn
Shares o/s	505m (ORD)
Free float	60%
Avg. daily volume ('000)	3,289
Avg. daily value (m)	Rs1,255.6
Common s/h equity (03/15E)	Rs86.5bn
P/BV (03/15E)	2.5x
Tier 1 ratio	12%

EPS (UBS, diluted) (Rs)

	From	To	% ch	Cons.
03/15E	28.92	28.92	0.00	29.97
03/16E	38.13	38.18	0.13	37.07
03/17E	47.84	48.34	1.04	46.24

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Highlights (Rsm)	03/12	03/13	03/14	03/15E	03/16E	03/17E	03/18E	03/19E
Revenues	16,244	17,343	21,601	26,517	34,729	43,402	52,889	63,905
Profit before tax	12,312	13,735	18,254	21,799	28,777	36,437	44,407	51,719
Net earnings (local GAAP)	9,145	10,232	13,171	14,605	19,281	24,413	29,753	34,652
Net earnings (UBS)	9,145	10,232	13,171	14,605	19,281	24,413	29,753	34,652
Tier 1 ratio %	11.0	11.5	12.2	11.9	11.7	11.7	11.8	11.9
EPS (UBS, diluted) (Rs)	18.12	20.26	26.08	28.92	38.18	48.34	58.92	68.62
Profitability/valuation	**03/12**	**03/13**	**03/14**	**03/15E**	**03/16E**	**03/17E**	**03/18E**	**03/19E**
ROE (UBS) %	18.6	16.8	18.8	18.0	20.5	22.1	22.6	24.0
P/PPOP (diluted)	8.3	9.0	5.9	9.3	7.0	5.6	4.5	3.9
P/BV x	2.0	2.0	1.4	2.5	2.1	1.8	1.5	1.3
P/BV (UBS) x	2.0	2.0	1.4	2.5	2.1	1.8	1.5	1.3
P/E (UBS, diluted)	12.6	12.7	8.3	14.6	11.0	8.7	7.1	6.1
Net dividend yield %	1.6	1.5	2.1	1.4	1.8	2.3	2.8	3.3

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Rs421.05 on 18 Dec 2014 22:38 HKT

Investment Thesis

LIC Housing Finance

12-month rating **Buy**

12m price target **Rs550.00**

Investment case

LIC Housing Finance (LICHF) is the second-largest housing finance company (HFCs) in India and a pure play on retail mortgages, as more than 95% of its loans are individual mortgages. We believe that the mortgage segment provides strong growth potential for banks and HFCs in the medium term. Asset quality risks are also lower as slippages on home loans have historically been very low. Being a NBFC, LICHF is dependent on wholesale funds. As a result, likely decline in wholesale rates will be positive for NIMs and earnings growth.

Upside scenario

In our upside scenario, we expect a further 10bp improvement in margins supported by strong growth in higher yielding segments, faster than expected decline in rates and benign liquidity. The loan book could deliver a 21% CAGR. Earnings could generate 34% CAGR over FY16-17E, after growing at subdued pace of 11% y/y in FY15 and ROEs could improve to 23%+ by FY17E. We assign a valuation of 2.5x FY17E P/BV to arrive at a fair value of Rs600.00 per share.

Downside scenario

Our downside scenario assumes subdued GDP growth, slower than expected decline in interest rates and continued pressure in the project loan segment. Overall loan book CAGR could be lower at 17% in FY15-17E (versus 19% CAGR in our base case). NIMs could improve by ~40bp over FY15-17E (versus 50bps+ in our base-case scenario). Credit costs in retail segments are unlikely to increase significantly; however, credit costs in LAP and project loans could remain high. Earnings CAGR could moderate to 23% in FY16-17 vs 29% in base case. We assign a valuation of 1.5x FY17E BV to arrive at a fair value of Rs350 per share.

Upcoming catalysts

We believe that the key catalysts are: (1) an improvement in NIMs on account of upward re-pricing of assets and change in liability mix; (2) a decline in wholesale rates; and (3) recoveries in NPLs in the project loan segment.

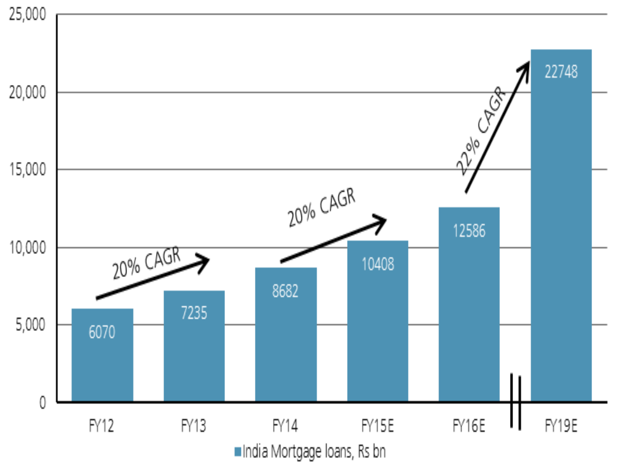
Business description

LIC Housing Finance (LICHF) was established by Life Insurance Corporation of India (LIC) in 1989 and listed in 1994. LICHF provides long-term housing loans to individuals, which made up 93.6% of the loan book, loans against property accounted for 3.9% and project loans 2.5% as of September 2014. The total loan portfolio was Rs975bn. LIC held 40.3% of the shares outstanding, while foreign institutional investors held 38.4% as at September 2014.

Industry outlook

We believe the mortgage market provides a strong growth opportunity for banks/housing finance companies (HFCs) due to the supply/demand mismatch and low penetration. As per CRISIL, the home loans market is expected to generate a 21% CAGR over FY14-19E. Despite rising competition from banks, HFCs has gained market share due to their strong origination capabilities and we believe that this will continue in the medium term.

Mortgage loans in India set for high growth



Source: CRISIL research

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Housing Development Finance Corporation
Easing rates to boost competitiveness

Equities

India
Diversified Financial

12-month rating	**Buy**
	Prior: Neutral
12m price target	**Rs1,300.00**
	Prior: Rs1,180.00
Price	**Rs1,098.00**

RIC: HDFC.BO **BBG:** HDFC IB

Trading data and key metrics

52-wk range	Rs1,160.10-766.15
Market cap.	Rs1,698bn/US$26.7bn
Shares o/s	1,546m (ORD)
Free float	100%
Avg. daily volume ('000)	2,286
Avg. daily value (m)	Rs2,472.4
Common s/h equity (03/15E)	Rs310bn
P/BV (03/15E)	5.5x
Tier 1 ratio	15%

EPS (UBS, diluted) (Rs)

	From	To	% ch	Cons.
03/15E	40.88	40.88	0.00	39.40
03/16E	48.08	48.64	1.18	44.90
03/17E	55.99	57.31	2.37	-

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Higher fall in wholesale rates very positive for mortgage business
We believe that higher decline in wholesale rates would strengthen HDFC's competitive position in the home loan segment. Assuming ~55-60% of borrowings are raised in the cheaper bond market, ~75bps higher decline in AAA bond rates would translate into higher spread of 40-45bps which will mitigate any risks on its profitability due to pricing pressure from banks. While RBI allowed regulatory exemptions on affordable housing segment in July '14, we are yet to see any aggressive pricing from banks in the affordable housing segment.

Loan growth to pick up in FY16/FY17
Loan book growth in FY14 was lower than historical averages at 16% Y/Y as non-individual segment grew by 8.7% Y/Y only. Loan book in non-individual segment improved to 11% in H1FY15 and we expect this to pick up to ~15-20% by FY16/FY17. This coupled with strong growth in individual segment should drive a 19% CAGR growth in loan book over FY16-17

Expect earnings growth to accelerate to 20% CAGR
HDFC has reported earnings growth of 15% CAGR over FY12-FY14 as lower growth in profitable non-individual segment has impacted profitability. However, with pick-up in growth in non-individual segment and marginal spread expansion, we expect earnings growth to improve to 20% CAGR over FY16-17.

Valuation: Upgrade to Buy, Raise PT to Rs1,300
HDFC has underperformed Bankex by 24% YTD (stock up 37% YTD vs 61% for Bankex) due to concerns on pricing pressures. We believe that risk reward is favourable now given sharp decline in wholesale rates. We increase our PT to Rs 1,300 and upgrade our rating on the stock from Neutral to Buy. Our price target is sum of the parts derived. We assign Rs 874 for mortgage business (4.4x FY17E P/BV and 16.1x FY17E P/EPS) and Rs 426 to its investments in subsidiaries and associate companies.

Highlights (Rsm)	03/12	03/13	03/14	03/15E	03/16E	03/17E	03/18E	03/19E
Revenues	61,975	72,567	81,683	95,536	113,349	133,290	156,913	187,607
Profit before tax	56,656	65,728	74,402	87,244	103,812	122,316	144,280	173,058
Net earnings (local GAAP)	41,226	48,483	54,402	63,792	75,907	89,436	105,496	126,538
Net earnings (UBS)	41,226	48,483	54,402	63,792	75,907	89,436	105,496	126,538
Tier 1 ratio %	11.7	13.9	15.4	14.7	14.0	13.4	12.7	12.2
EPS (UBS, diluted) (Rs)	27.66	31.35	34.86	40.88	48.64	57.31	68.22	81.83
Profitability/valuation	**03/12**	**03/13**	**03/14**	**03/15E**	**03/16E**	**03/17E**	**03/18E**	**03/19E**
ROE (UBS) %	22.7	22.1	20.6	21.7	23.1	24.3	25.3	28.3
P/PPOP (diluted)	17.4	17.1	16.9	19.4	16.3	13.8	11.6	9.7
P/BV x	5.2	4.6	4.6	5.5	4.9	4.4	3.9	3.4
P/BV (UBS) x	5.2	4.6	4.6	5.5	4.9	4.4	3.9	3.4
P/E (UBS, diluted)	24.2	23.7	23.4	26.9	22.6	19.2	16.1	13.4
Net dividend yield %	1.6	1.7	1.7	1.5	1.8	2.1	2.5	3.0

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Rs1,098.00 on 18 Dec 2014 22:38 HKT

Investment Thesis

HDFC

12-month rating **Buy**

12m price target **Rs1,300.00**

Investment case

HDFC is the largest housing financing company in India with individual home loans forming 70% of its credit book. We expect it to be a key beneficiary of the structural growth in mortgages in India, given low penetration and rising demand from an expanding middle-income segment. It has a solid track record in managing risk in the non-individual segment (30% of the book), and therefore its overall asset quality risk is low compared with that of corporate banks It is also better placed in a tight liquidity environment due to less dependence on short-term market borrowing and well matched asset-liability profile. We like its stable asset quality and more predictable-than-peers growth profile.

Upside scenario

Our upside scenario builds in faster pick-up in non-individual loan growth, which would drive overall loan book growth of 21% CAGR (vs. 19% CAGR in base case). Margins would improve 5bps higher than our base case assumptions. Asset quality would remain best in class, with credit cost remaining at low levels similar to our base case assumptions. Earnings could grow at 21% CAGR over FY15-17E vs base case estimate of 19% CAGR. In this upside scenario, we expect the HDFC's lending business to trade at 5.0x FY17E book which would value the standalone business at Rs1000 and subsidiaries at Rs425 per share using a sum-of-the-parts methodology. This would result in a valuation of Rs1425.00 per share.

Downside scenario

Our downside scenario builds in subdued GDP growth and slower than expected decline in interest rates and hence overall loan book CAGR could be lower at 17% in FY15-17E (versus 19% CAGR in our base case). We expect margins to remain flat as against our base case assumption of slight margin improvement over FY15-17E. Earnings growth would be limited to 17% CAGR over FY15-17E vs our base case assumption of 19% CAGR. In such a downside scenario, we expect the stock to be valued at Rs1050.00 per share, implying valuation of Rs700.00 per share for its core lending business (3.6x FY17E book) and Rs300.00 per share for its subsidiaries using a sum-of-the-parts methodology.

Upcoming catalysts

We believe that the key catalysts for the stock are: (1) decline in wholesale interest rates and (2) pick-up in non-individual loan growth.

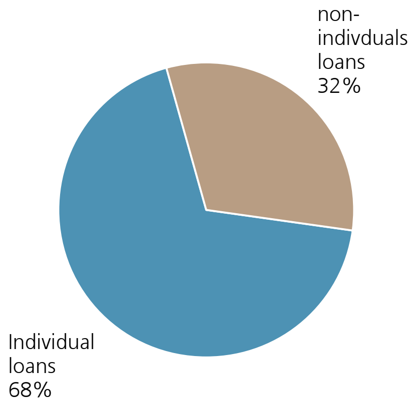
Business description

HDFC is one of the largest mortgage lenders in India with a strong brand franchise, which it has leveraged across other financial services products. Its sourcing strategy, in addition to its risk management system, is likely responsible for the low gross NPLs. As at September 2014, HDFC had a loan portfolio of Rs2.1trn and a Tier-1 ratio of 15.7%. HDFC has established and now holds stakes in several large entities including HDFC Bank, HDFC Standard Life, and HDFC Standard AMC. It has also invested in other finance companies including IDFC and Gruh Finance.

Industry outlook

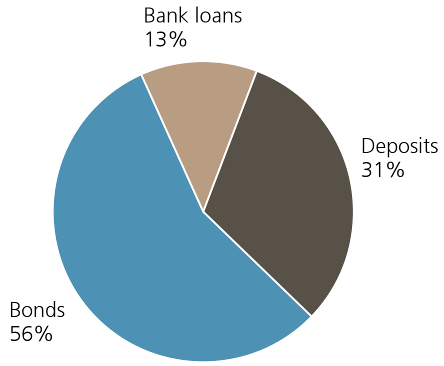
We believe the mortgage market provides a strong growth opportunity for banks/housing finance companies (HFCs) due to the supply/demand mismatch and low penetration. As per CRISIL, the home loans market is expected to generate a 21% CAGR over FY14-19E. Despite rising competition from banks, HFCs has gained market share due to their strong origination capabilities and we believe that this will continue in the medium term.

Loan book break-up (%) as at Sep'14



Source: Company data

Borrowings break-up (%) as at Sep'14



Source: Company data

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Figure 19: HDFC - fair value estimate using sum-of-the-parts methodology

FY17	HDFC's holding (%)	Value of companies (Rs bn)	Value per share (Rs)	Methodology adopted
HDFC - mortgage business		1,361	**874**	Based on residual growth model or 4.4x core book
Value of subsidiaries and associates			**426**	
HDFC Bank	22.6	2,662	308	Based on HDFC Bank's target price & 20% holding company discount
HDFC Standard Life MF	60.0	70	22	5% of AUMs & 20% holding company discount
Life insurance	74.0	120	46	14X FY14NBV + EV & 20% holding company discount
Gruh Finance	59.7	98	30	Based on current market price & 20% holding company discount
Others (General insurance, Venture Fund and other equity investments)			20	General insurance based on deal with ERGO, other equity investments at 2x book value
Total value per share			**1,300**	

Source: Company, UBS estimates

Indiabulls Housing Finance
Beneficiary of favourable business cycle

Lower wholesale rates and credit upgrades to support margins
IHFL's reported margins are much better than peers as ~50% of loan book are constituted by higher yielding loan against property (LAP), developer and commercial vehicle segment. However, with sharp decline in rates, we believe that margins could further expand in the near term. We note that leading credit rating agencies CRISIL and ICRA have upgraded IHFL's credit rating from AA to AA+ whereas CARE has upgraded from AA+ to AAA. Borrowing composition could also change in favour of cheaper bonds. At Sep'14-end, bank loans constituted 60% of borrowings whereas bonds/ commercial paper constituted 32%/ 8%. However, bonds constituted ~52% of incremental borrowings. We expect margins to improve by 20-30bps over FY16/FY17.

Favourable cycle could support loan growth with low credit costs
Sharp decline in rates, likely pick-up in economic growth and easing liquidity could boost credit demand while keeping credit costs low. We expect AUM to grow by 19% CAGR over FY16-17 as demand in mortgage and LAP segment remains strong and developer demand could pick up. Loan loss provisioning has remained low so far at average 50bps over FY12-15E despite high yields as GNPLs have remained at 0.8%. We expect credit costs to remain at 0.6%-0.7%. We are revising our earnings estimates by 2-3% in FY16/FY17 and expect PAT to grow by 18% CAGR over FY16-17.

High return ratios; however, competition key risk in the medium term
ROEs/ROAs of 3.5%/25%+ (after adjusting for zero coupon bonds) are best among peers supported by higher average yields and low credit costs. Given much higher risk adjusted returns, spread compression due to higher competition or higher credit costs is the key risks to its medium term profitability.

Valuation: Upgrade to Buy; new PT Rs 575
We increase our PT to Rs 575 (from Rs 520 earlier) and upgrade our rating on the stock to Buy as the business cycle is turning favourable with sharp decline in rates, in our view. Our PT is based on residual income model and implies 2.3x FY17E P/BV and 8x FY17E P/EPS.

Equities

India
Diversified Financial

12-month rating	**Buy ***
	Prior: Neutral
12m price target	**Rs575.00**
	Prior: Rs520.00
Price	**Rs458.20**

RIC: INBF.BO **BBG:** IHFL IB

Trading data and key metrics

52-wk range	Rs469.20-189.25
Market cap.	Rs152bn/US$2.40bn
Shares o/s	333m (ORD)
Free float	55%
Avg. daily volume ('000)	2,685
Avg. daily value (m)	Rs1,162.6
Common s/h equity (03/15E)	Rs63.2bn
P/BV (03/15E)	2.4x
Tier 1 ratio	14%

EPS (UBS, diluted) (Rs)

	From	To	% ch	Cons.
03/15E	55.84	55.84	0.00	55.50
03/16E	58.18	61.11	5.05	63.39
03/17E	69.20	72.06	4.13	76.25

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Highlights (Rsm)	03/12	03/13	03/14	03/15E	03/16E	03/17E	03/18E	03/19E
Revenues	19,264	21,788	26,789	31,768	39,003	46,211	53,041	61,227
Profit before tax	13,220	16,551	19,818	23,906	28,776	34,377	38,674	45,567
Net earnings (local GAAP)	9,981	12,584	15,642	18,654	22,096	26,053	29,310	35,073
Net earnings (UBS)	9,981	12,584	15,642	18,654	22,096	26,053	29,310	35,073
Tier 1 ratio %	18.2	15.0	15.0	14.0	14.5	13.9	13.2	11.1
EPS (UBS, diluted) (Rs)	32.07	40.27	46.82	55.84	61.11	72.06	81.07	97.01

Profitability/valuation	03/12	03/13	03/14	03/15E	03/16E	03/17E	03/18E	03/19E
ROE (UBS) %	21.1	25.2	29.0	31.0	31.3	31.3	31.1	34.9
P/PPOP (diluted)	3.3	4.3	3.4	5.8	5.0	4.2	3.7	3.2
P/BV x	1.1	1.6	1.3	2.4	2.1	1.9	1.7	1.5
P/BV (UBS) x	1.1	1.6	1.3	2.4	2.1	1.9	1.7	1.5
P/E (UBS, diluted)	5.2	6.0	4.9	8.2	7.5	6.4	5.7	4.7
Net dividend yield %	7.8	8.2	12.5	6.1	6.0	7.1	8.0	8.0

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Rs458.20 on 18 Dec 2014 22:38 HKT

* Exception to core rating bands; See page 17.

Investment Thesis

Indiabulls Housing Finance

12-month rating **Buy ***

12m price target **Rs575.00**

Investment case

Over the past five years, Indiabulls Housing Finance has cleaned up its credit book by writing down bad personal loans and by focusing on the secured loans segment. It was relisted as a housing financing company with mortgages constituting more than 70% of the loan book. With impending sharp decline in rates and likely shift in borrowing composition to cheaper bond borrowings, we expect IHFL's margins (which is already higher than peers on account of higher yielding book) to expand further. Apart from expected sharp fall in interest rates, improving business cycle (pick-up in economic growth and easing liquidity) would boost credit demand while keeping credit costs low. We expect earnings to grow at 17% CAGR over FY16-17E and ROEs to remain best in class at 25% (after adjusting for zero coupon bonds).

Upside scenario

In our upside scenario, we expect AUM to grow by 21% CAGR over FY15-17E (vs. 19% CAGR in base case) and margins to average 5.0% over FY15-17E (vs. 4.8% in base case). Credit cost would average at 50bps over the period. Earnings could grow at 22% CAGR and ROEs would remain best in class at average of 32% over FY15-17E. We assign a valuation of 2.6x FY17E P/BV to arrive at a fair value of Rs650.00 per share.

Downside scenario

Our downside scenario builds in continued subdued GDP growth, slower than expected decline in interest rates and continued asset quality concerns in the project loan segment. Overall loan book CAGR could be lower at 18% in FY15-17E (versus 19% CAGR in our base case). NIMs could average at 4.7% over FY15-17E (versus 4.8% in our base-case scenario). Credit cost at avg. 60bps over FY15-17, would be higher than what is assumed in the base case (average 50bps). In such a scenario, Earnings CAGR could moderate to 16% in FY15-17E vs 18% in base case. We assign a valuation of 1.9x FY17E BV to arrive at a fair value of Rs465.00 per share.

Upcoming catalysts

We believe that the key catalysts are: (1) reduced reliance on relatively high cost bank borrowing, (2) decline in systemic interest rates and (3) pick-up in loan growth.

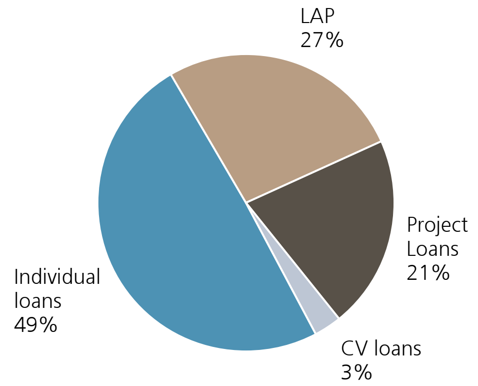
Business description

Indiabulls Financial Services was started in 2000 as a non-banking financial company offering products such as home loans, loans against property, commercial vehicle loans, and developer funding. It entered the consumer finance segment in 2005-06 with a focus on small ticket unsecured loans. Since 2008, after losses in unsecured loans, it increasingly focused on secured mortgage lending and got itself reverse merged into its housing finance arm in 2013. Indiabulls Housing Finance is India's third-largest HFC, with Rs450bn of AUM as at September 2014. As at September 2014, promoters/FIIs had a 27.8%/40.5% stake.

Industry outlook

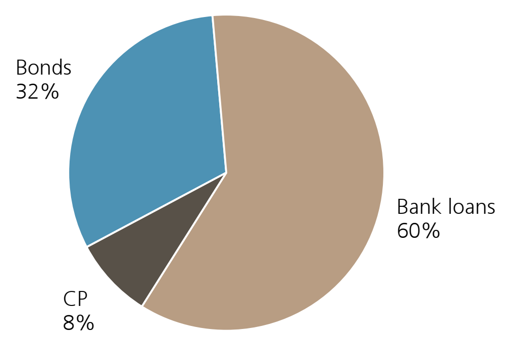
We believe the mortgage market provides a strong growth opportunity for banks/housing finance companies (HFCs) due to the supply/demand mismatch and low penetration. As per CRISIL, the home loans market is expected to generate a 21% CAGR over FY14-19E. Despite rising competition from banks, HFCs has gained market share due to their strong origination capabilities and we believe that this will continue in the medium term.

Loan book breakup (%) as at Sep'14



Source: Company data

Borrowings breakup (%)as at Sep'14



Source: Company data

* Exception to core rating bands; See page 17.

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Housing Development Finance Corporation Investment Case

HDFC is the largest housing financing company in India with individual home loans forming 70% of its credit book. We expect it to be a key beneficiary of the structural growth in mortgages in India, given low penetration and rising demand from an expanding middle-income segment. It has a solid track record in managing risk in the non-individual segment (30% of the book), and therefore its overall asset quality risk is low compared with that of corporate banks It is also better placed in a tight liquidity environment due to less dependence on short-term market borrowing and well matched asset-liability profile. We like its stable asset quality and more predictable-than-peers growth profile.

Indiabulls Housing Finance Investment Case

Over the past five years, Indiabulls Housing Finance has cleaned up its credit book by writing down bad personal loans and by focusing on the secured loans segment. It was relisted as a housing financing company with mortgages constituting more than 70% of the loan book. With impending sharp decline in rates and likely shift in borrowing composition to cheaper bond borrowings, we expect IHFL's margins (which is already higher than peers on account of higher yielding book) to expand further. Apart from expected sharp fall in interest rates, improving business cycle (pick-up in economic growth and easing liquidity) would boost credit demand while keeping credit costs low. We expect earnings to grow at 17% CAGR over FY16-17E and ROEs to remain best in class at 25% (after adjusting for zero coupon bonds).

LIC Housing Finance Investment Case

LIC Housing Finance (LICHF) is the second-largest housing finance company (HFCs) in India and a pure play on retail mortgages, as more than 95% of its loans are individual mortgages. We believe that the mortgage segment provides strong growth potential for banks and HFCs in the medium term. Asset quality risks are also lower as slippages on home loans have historically been very low. Being a NBFC, LICHF is dependent on wholesale funds. As a result, likely decline in wholesale rates will be positive for NIMs and earnings growth.

Statement of Risk

We believe a sustained economic slowdown could impact the banking and finance sector on several fronts: lead to a slowdown in credit, increase NPL risk, impact fee income, and exert pressure on NIMs.

Required Disclosures

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UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	47%	34%
Neutral	FSR is between -6% and 6% of the MRA.	42%	28%
Sell	FSR is > 6% below the MRA.	11%	21%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2014.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

KEY DEFINITIONS: Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. **Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). **Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. **Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. **Equity Price Targets** have an investment horizon of 12 months.

EXCEPTIONS AND SPECIAL CASES: UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; **Neutral:** Neutral on factors such as structure, management, performance record, discount; **Sell:** Negative on factors such as structure, management, performance record, discount. **Core Banding Exceptions (CBE):** Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

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UBS Securities India Private Ltd: Ishank Kumar, CFA; Vishal Goyal, CFA. **UBS AG Hong Kong Branch:** Stephen Andrews, CFA.

Company Disclosures

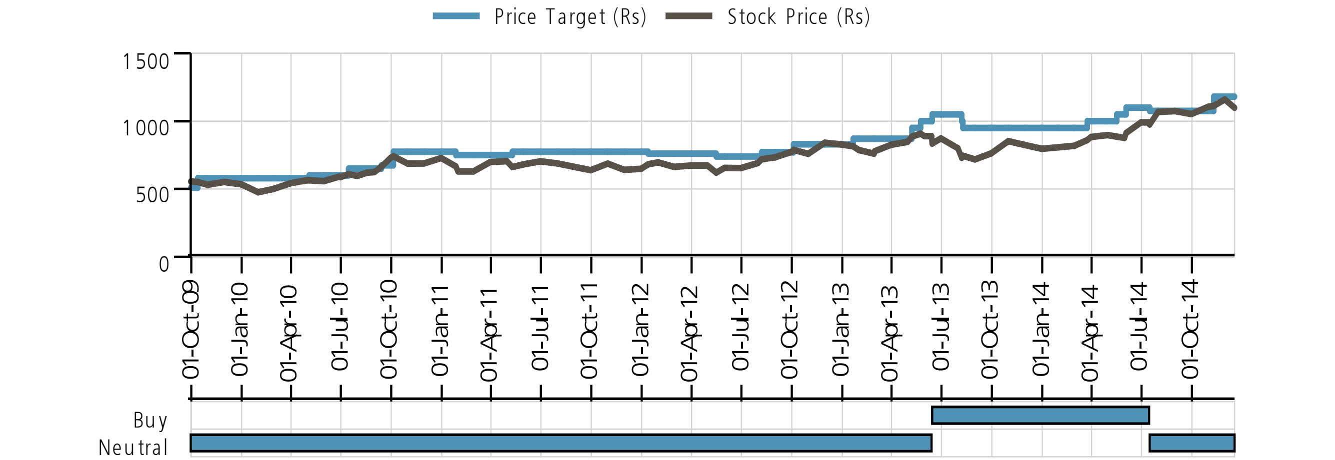
Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Housing Development Finance Corporation	HDFC.BO	Buy	N/A	Rs1,098.00	18 Dec 2014
Indiabulls Housing Finance[20]	INBF.BO	Buy (CBE)	N/A	Rs458.20	18 Dec 2014
LIC Housing Finance	LICH.BO	Buy	N/A	Rs421.05	18 Dec 2014

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

20. Because this security exhibits higher-than-average volatility, the FSR has been set at 15% above the MRA for a Buy rating, and at -15% below the MRA for a Sell rating (compared with 6/-6% under the normal rating system).

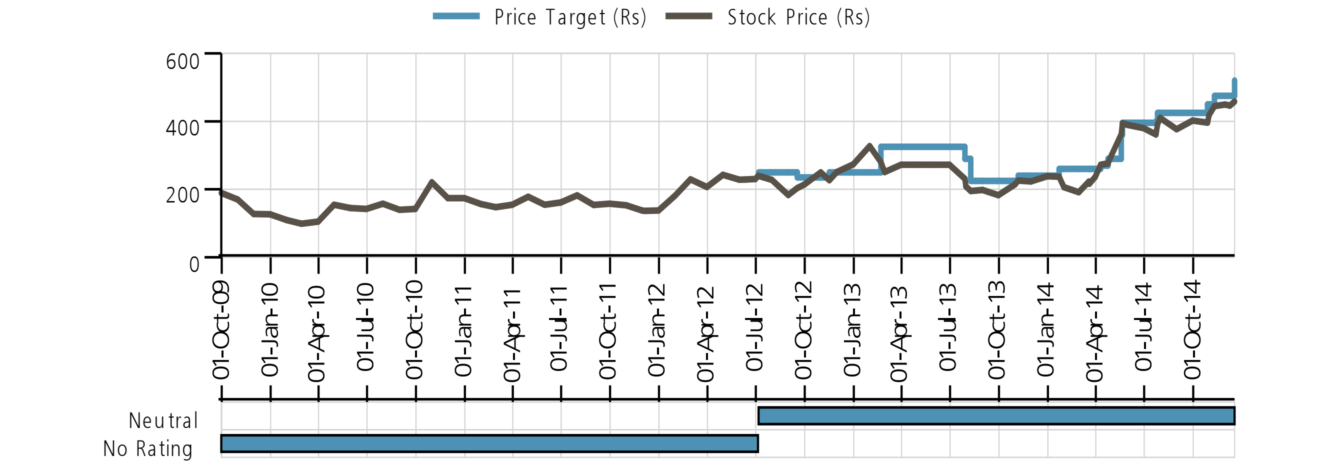
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Housing Development Finance Corporation (Rs)



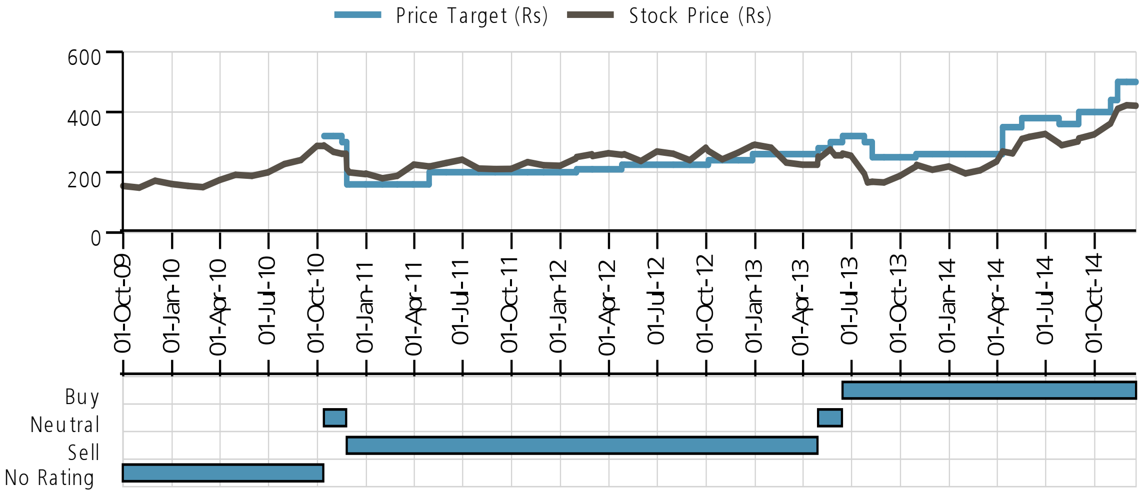
Source: UBS; as of 18 Dec 2014

Indiabulls Housing Finance (Rs)



Source: UBS; as of 18 Dec 2014

LIC Housing Finance (Rs)



Source: UBS; as of 18 Dec 2014

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