PNB Housing Finance Ltd

In a sweet spot: Strong growth, reasonable valuations

INDIA | NBFC | IPO Note

24 October 2016

Background: Promoted by Punjab National Bank, PNB Housing Finance (PNBHF) is the fifth-largest HFC with a loan portfolio of Rs 309bn. It offers housing-loan products (71% of loan book) such as loans for residential properties or plots, and 'non-housing' loans in the form of loans against property, non-residential premises loans, lease-rental discounting, and corporate term loans. Its last four-year loan portfolio CAGR was 62% to touch Rs 272bn. Its customers include salaried (40%), self-employed (44%), and corporate (16%). Its incremental loans through in-house channels such as branches and direct sales is 55%; it sources the rest through third-party channels such as DSAs.

Objective: The IPO intends to augment PNBHF's capital base, which will increase its CRAR to 30.5% from current 12.7%. The company's leverage has reached its threshold level of 15x of NOF – the capital infusion would enable it to continue on a course of high growth.

Business outlook: With PNBHF's focus on all major urban centres of the country, favorable macro factors (low mortgage penetration, rising income levels, stabilising real-estate prices, government's ambitious plan of housing for all by 2022) augur well. Strong brand recall coupled with deep penetration, scalable and centralised business model, and diversified product portfolio would enable it to capitalise the untapped opportunity in the Indian mortgage market. Declining interest rate environment and the regulator's accommodative stand on liquidity bode well for wholesale-funded businesses. Conducive operating environment provides PNBHF with an opportunity to continue its rapid growth (we expect 35-40% over FY16-18) with an upward bias to NIM due to low funding cost and equity infusion. Its increasing size will gain PNBHF operational efficiency, translating into a reduced cost-to-income ratio of 25.7% by FY18 from current level of 30.2%. Prudent credit underwriting, monitoring, and efficient collection has enabled the company to grow rapidly, without compromising on asset quality. In fact, we see asset quality increasing slightly as the denominator effect (due to high growth) wanes.

Key risk: High growth in its non-housing segment could throw a negative surprise if there is a slowdown in economic growth. Significant reduction in interest rate in the system can adversely impact spreads as 87% of its loan book is floating vs. just 12% floating-rate borrowings. Since housing is a commoditised product, product differentiation is minimal. Hence, superior delivery platform and competitive pricing become imperative – inability to deliver these and an unfavorable movement in interest rate could impact performance.

Valuation: At the upper end of the price band (Rs 750-775), the issue is valued at 2.5x its post-issue book value per share of Rs 316. PNBHF saw an AUM CAGR of 61% in FY12-16, translating into earnings growth of 40% and RoE range of 15.4-18.5%. We expect PAT CAGR of 49% over FY16-18, driven by a loan book CAGR of 39% and NIM expansion of 40bps to 3.2%. At the upper end of the price band, the issue is valued at 2.3x/2.1x FY17/18 adjusted book value of Rs 336/371 and 25x/18x FY17/18 EPS of Rs 31/44. We recommend investors Subscribe to this issue based on strong growth and reasonable valuations.

Subscribe

COMPANY DATA

ISSUE OPENS	25th October 2016
ISSUE CLOSES	27th October 2016
PRICE BAND	Rs 750-775
PRE- ISSUE EQUITY SHARES	126.9 mn
POST- ISSUE EQUITY SHARE	165.6 mn
FRESH SHARES TO BE ISSUED	38.7-40.0 mn
OFFER FOR SALE	0
ISSUE SIZE	Rs 30bn
MKT CAP (at upper band)	Rs 128bn

Pre-IPO SHARE HOLDING PATTERN, %

Promoter (mn)	64.7	51%
Public (mn)	62.2	49%
Total (mn)	126.9	100.0%

Financials

Y/E Mar, Rs mn	FY16	FY17e	FY18e
NII	6,844	11,094	15,611
PAT	3,276	5,168	7,266
NETWORTH	21,445	56,128	62,713
ABVPS	166.9	335.6	370.9
EPS	25.8	31.2	43.9
P/ABVPS @Rs 775	4.6	2.3	2.1
P/E@775	30.0	24.8	17.7

Manish Agarwalla (+ 9122 6667 9962)
Pradeep Agrawal (+ 9122 6667 9953)
Paresh Jain (+ 9122 6667 9948)

Comparative valuation

	Loan Book Rs bn			RoA %			RoE %			ABV Rs			P/ABV		
	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E
HDFC Ltd	2,587	2,928	3,305	2.7	2.5	2.4	21.8	20.4	20.1	208.0	232.2	259.7	6.4	5.8	5.2
LIC HF	1,252	1,457	1,687	1.4	1.4	1.4	19.6	19.7	20.0	175.8	207.0	244.9	3.4	2.9	2.5
PNB HF	272	385	523	1.3	1.4	1.4	17.6	13.2	11.3	166.9	335.3	367.5	4.6	2.3	2.1
Repco Home	77	99	127	2.2	2.1	2.1	17.0	18.3	19.5	146.8	172.3	203.9	5.4	4.6	3.9
Can fin home	106	140	186	1.7	1.6	1.7	19.0	21.1	23.7	329.8	391.9	477.2	5.5	4.7	3.8
Dewan HF	618	730	856	1.2	1.3	1.4	15.1	17.3	16.7	163.3	191.0	221.9	2.1	1.8	1.5

Source: PhillipCapital India Research Estimates

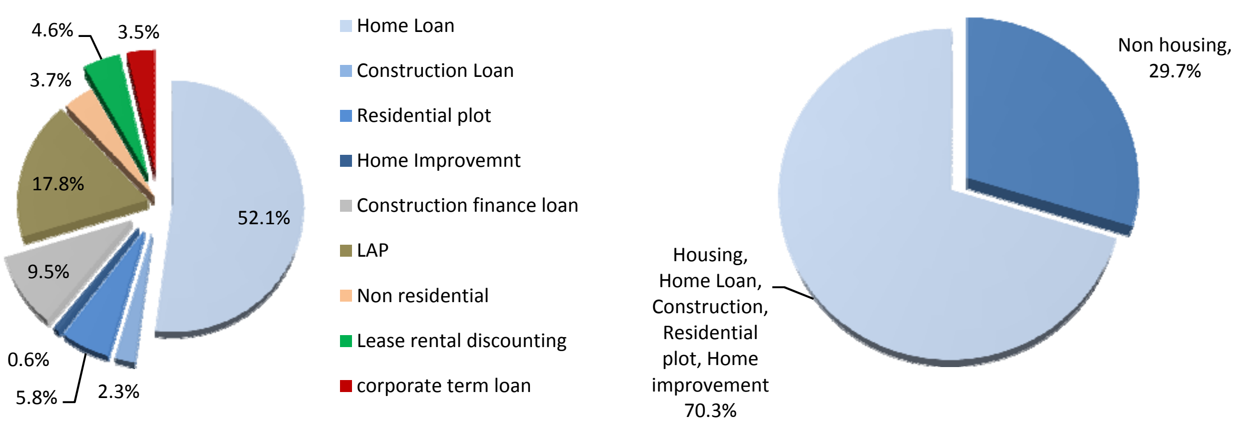
Favorable macro factors, diversified product portfolio to help tap opportunity

The Indian mortgage industry is in a very nascent stage and housing finance companies (HFCs) will remain in a sweet spot given their multiple long-term growth drivers. While the industry saw a CAGR of over 15% for the past five years, it remains highly under penetrated vs. most emerging economies. The opportunities for HFCs are expected to remain large due to multiple growth drivers, as the housing shortage is for real. Urbanisation of tier 2/3 cities will lead to demand in housing. Rehabilitation of slum areas and shortage of housing in urban areas will increase the thrust in housing finance.

Bouquet of products on offering

Through its network of 47 branches (north, south, and west India), PNBHF offers a range of products under housing loans and non-housing loans. In Q1FY16, its loan book was at Rs 309.4bn, of which ~70% was housing loans and ~30% non-housing. Its product portfolio is diversified – in housing loans, it has mortgage (60%) and construction finance (9%) and in non-housing it offers LAP (18%), non-residential premises loan (4%), lease-rental discounting (5%), and corporate term loans (3%).

Loan book breakup



Source: PhillipCapital India Research, Company

Rapid growth across product segments

Retail housing loans – its flagship product – has seen a CAGR of 57% since FY14. Construction finance and lease-rental discounting saw a CAGR of +100% over the same period due to the opportunity that emerged as large banks went slow in those segments. We expect PNBHF to continue its high-growth journey given the opportunity in the space; we see loan growth of ~40% over next few years, driven by most of its product segments.

Segment wise historical growth

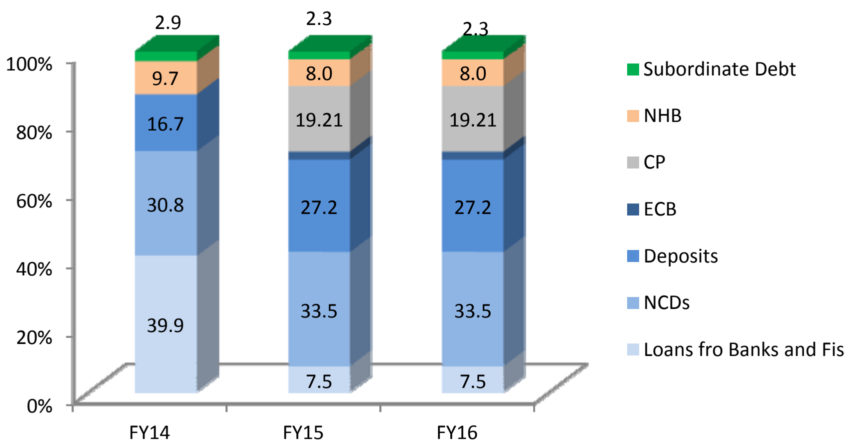
	CAGR (FY14-Q1FY17)	Proportion of loan book
Retail housing loan	57%	61%
Construction finance	100%	9%
Loan against property	51%	18%
Non- residential premises loan	66%	4%
lease rental discounting	109%	5%
corporate term loan	78%	4%
TOTAL	**61%**	**100%**

Source: PhillipCapital India Research, Company

Declining interest rate environment and accommodative stand on liquidity bodes well

Declining interest rates and the regulator's accommodative stand on liquidity has been a boon for wholesale-funded intermediaries. PNBHF has capitalised on the market opportunity and diversified its liability profile. Its main sources of funds are NCDs (30%), public deposits (25%), and commercial papers (20%). The share of commercial bank loans has reduced considerably to 7% in Q1FY17 from 40% in FY14. Consequently, its cost of funds fell to 8.65% in Q1FY17 vs. 9.30% in FY14. Its incremental market borrowing is at sub-8%, which could bring down its cost of funds further.

Borrowing Profile



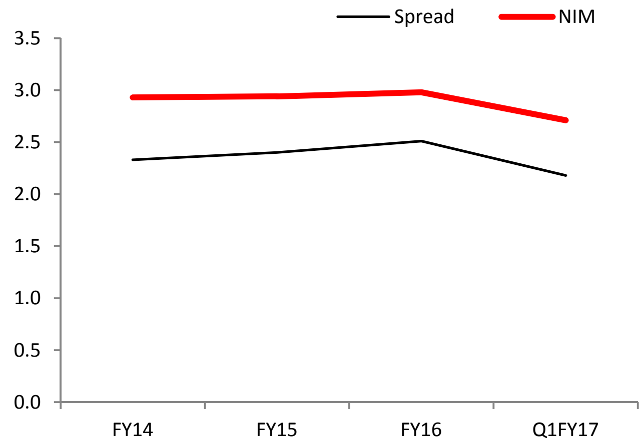
Source: PhillipCapital India Research, Company

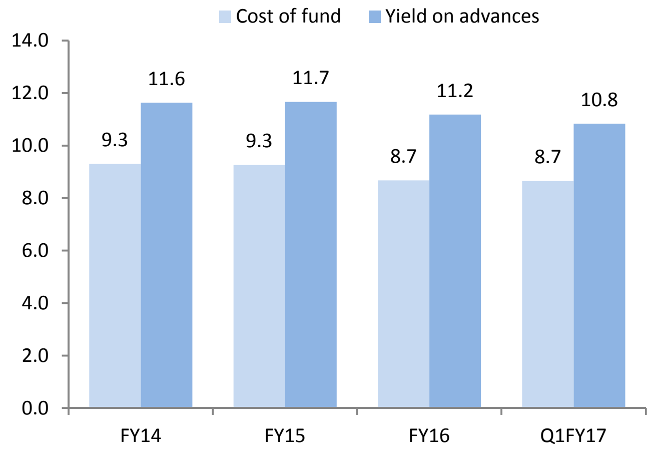
Despite stiff completion from banks and HFCs, PNBHF has maintained healthy spreads and NIMs through a judicious mix of borrowing and diversified loan portfolio. Its loan portfolio enjoys healthy yields, given that a significant chunk is non-housing. Its LAP portfolio, 18% of its loan book, earns 300bps higher yields than its housing loan portfolio (10.0-10.5%). This yield gap has enabled stronger spreads, despite rising competition in the mortgage business. Its current borrowing profile will help PNBHF in reducing its cost of funds further, in a declining interest-rate cycle.

Spread to remain stable, but NIMs to improve due to equity infusion

Competitive pressure on housing and non-housing product would see further pressure on yields; the benefits of declining funding costs would eventually have to be passed on to the customer. Given limited headroom in increasing its non-housing portfolio, PNBHF's spread seemed to have reached a cap. However, NIMs are likely to expand in the near term, driven by the large capital infusion through this IPO.

Yield Spread Movement (%)





Source: PhillipCapital India Research, Company

Segment wise spread

segmental yield %	FY14	FY15	FY16	Q1FY17
Housing	11.06	10.84	10.46	10.34
Non-housing	13.06	13.65	12.93	12.00
segmental spread %				
Housing	1.76	1.58	1.79	1.69
Non-housing	3.76	4.39	4.26	3.35

Source: PhillipCapital India Research, Company

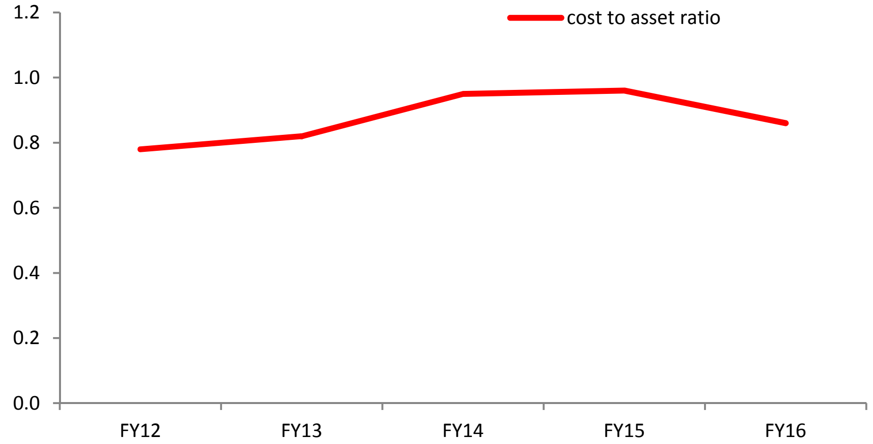
Increase in asset base to improve operational efficiency

PNB HF has the highest cost-to-asset ratio vs. its peers (attributable to its rapid growth from FY14) because of: (1) high commission payouts to direct selling agents, (2) high advertisement and publicity, and (3) implementation of business process reengineering programme called "*Project Kshitij*".

PNBGF underwent a business re-engineering under the initiative "Project Kshitij" which began in FY11 and concluded in FY16, it aimed at providing the stability of a public sector unit and dynamism of a private sector entity. The program aimed at improvement, centralization and standardization of the business processes, payment and credit policies. In terms of improvement in business it has initiated changes in loan origination and sourcing strategy with improvement in the credit underwriting and monitoring functions. It has broadened its team by hiring in-house sales representatives, fraud prevention specialists, collection experts, legal experts and technical and property valuation experts.

Under the new operating model the branches are positioned as the primary point of sales with origination of loans and collecting process, while the processing hubs provides support functions such as loan processing, credit appraisal and monitoring. It has also made advances in IT infrastructure where it as has integrated the information platform for all activities and functions under single technology and data platform hence automating several processes and bringing efficiency to service delivery model.

Cost to asset ratio, %



Source: PhillipCapital India Research, Company

Despite an increase in balance sheet size, its cost-to-asset ratio increased between FY12 and FY15 due to growth-related costs – visible in its non-employee cost-to-asset ratio. PNBHF has the highest non-employee cost to asset ratio of 0.60% vs. HDFC's 0.14% and LICHF's 0.24%. There is ample room for improvement here, once its growth starts moderating. With an increase in asset base, we expect overall productivity to improve, resulting in some improvement in the cost-to-asset matrix.

Comparative Operating cost matrix

%	HDFC Ltd	LIC HF	PNB HF	Dewan HF	Repco HF	Canfin Home
Employee cost to asset	0.12	0.12	0.25	0.34	0.53	0.31
Other opex to asset	0.14	0.24	0.60	0.47	0.30	0.31
Cost to asset	0.26	0.36	0.86	0.81	0.83	0.62

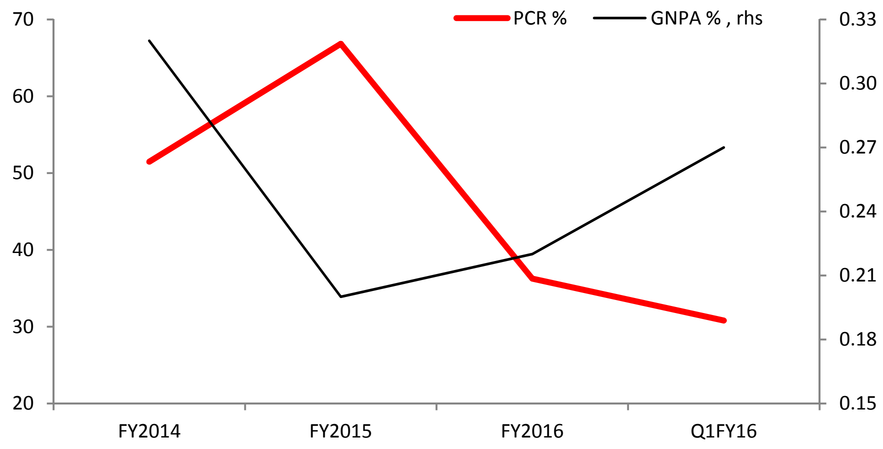
Source: PhillipCapital India Research, Company

Its stringent credit appraisal process is the key to healthy asset quality

PNBHF has a well-established credit underwriting check and monitoring and collection process – this complements its strategy of maintaining high growth, without compromising on asset quality. Retail loans (salaried and self-employed) are 84% of its loan book while corporate exposure is 15%. It follows stringent underwriting standards, with a weighted average loan to value (LTV) ratio of 66.1% at origination, for its retail housing loans, and weighted average LTV ratio of 46.5% at origination for retail non-housing loans.

Its processing hubs comprise of experienced credit appraisal team, which conducts a proper credit check and verification of each customer and a fraud control unit (FCU) to identify and prevent potential fraud at the earliest stage of loan processing. It has streamlined its collection process by replacing its third-party collection team with an in house team, to have better control over processes and to maintain high collection efficiencies through regular follow-ups. Consequently, as on Q1FY17, PNBHF's asset quality continues to remain healthy with a GNPA of 0.27%, while GNPA in its LAP portfolio is 0.30%. Segment-wise asset-quality data suggests that its corporate book is unseasoned since the GNPA in that segment is zero. Similarly, the GNPA in the self-employed segment is just 18bps higher than the salaried segment, which is at 0.23%.

GNPA Movement



Source: PhillipCapital India Research, Company

Segment wise asset quality

Segmental GNPA%	FY14	FY15	FY16	Q1FY17
Overall GNPA	0.32	0.20	0.22	0.27
Salaried	0.13	0.13	0.21	0.23
Self employed	0.33	0.28	0.31	0.41
Corporate	1.01	0.11	0.00	0.00

Source: PhillipCapital India Research, Company

Key Risks

Strong non-housing loan book may exert pressure on asset quality: PNBHF has demonstrated strong growth across product segments. Retail housing loans has seen 57% CAGR since FY14 while construction finance and lease rental discounting saw +100% CAGR. Most of its loan book is unseasoned – its outstanding loan book is just 2.8 years old. The GNPA/NNPA ratio of 0.27%/0.19% is understated due to very high growth in the denominator. Meaningful slowdown in economic growth, correction in real-estate prices, and adverse liquidity could impact earnings capacity of the borrower, translating into high credit cost.

Higher reliance on fixed rate funding instruments to impact NIMs during rising interest: PNBHF has a high reliance on fixed-rate debt instrument such as NCDs, deposits, and CPs for borrowings; fixed-rate comprises 88% of its total borrowing, but 87% of its lending book is floating in nature. Even considering that commercial papers are a very short-term instrument, the fixed proportion of its borrowing is still high at 68% vs. its 13% fixed loan book. In case of a fall in interest rate, its spread may come under pressure. The regulator has been cutting policy rates for the last few years and there may be a few more cuts; however, the transmission of these cuts has not been very efficient due to the asset-quality problems that some large banks are facing, which have been hurting earnings. If lending rates start declining, either due to further policy rate cut or transmission by banks, PNBHF's spreads could come under pressure.

Re-pricing nature of asset and liability

%	Floating	Fixed
Loan book	87	13
Borrowings	12	88

Source: PhillipCapital India Research, Company

Financials

Income Statement

(Rs mn)	FY14	FY15	FY16	FY17E	FY18E
Interest income	10,559	16,708	25,447	36,859	49,878
Interest expenses	8,016	12,648	18,603	25,765	34,267
NII	**2,543**	**4,060**	**6,844**	**11,094**	**15,611**
Other income	644	1,095	1,549	1,883	2,304
Total income	3,187	5,155	8,393	12,977	17,915
Employee Expenses	404	671	753	1,069	1,336
Other Expenses	689	1,159	1,786	2,552	3,271
Operating expenses	**1,093**	**1,830**	**2,539**	**3,621**	**4,607**
PPP	2,094	3,326	5,854	9,357	13,308
Provisions	304	381	811	1406	2130
Pre tax profit	**1,790**	**2,945**	**5,043**	**7,950**	**11,178**
Tax expense	493	1004	1767	2783	3912
PAT	**1,297**	**1,941**	**3,276**	**5,168**	**7,266**

Balance Sheet

(Rs mn)	FY14	FY15	FY16	FY17E	FY18E
Cash & Bank Balances	1,384	2,931	2,485	3,109	3,885
Loans & Advances	105648	167913	271773	385397	523481
Investments	6,455	15,860	16,223	21,090	26,362
Fixed Assets	288	577	622	684	752
Other Assets	1620	3072	5623	7563	10201
Total assets	**1,15,396**	**1,90,352**	**2,96,725**	**4,17,842**	**5,64,681**
Share capital	657	1,038	1,269	1,656	1,656
Reserves & Surplus	8,684	14,749	20,175	54,472	61,056
Networth	9,341	15,787	21,445	56,128	62,713
Borrowings	101077	164808	260137	339054	470701
Other liabilities	2353	4996	10170	15407	20460
Provision for contingencies	2625	4762	4973	7253	10808
Total liabilities	**1,15,396**	**1,90,352**	**2,96,725**	**4,17,842**	**5,64,681**

Key Ratios

	FY14	FY15	FY16	FY17E	FY18E
Per share data					
No. of shares (mn)	65.7	103.8	126.9	165.6	165.6
EPS	19.7	18.7	25.8	31.2	43.9
BV	142.2	152.0	169.0	338.9	378.6
Adj BVPS	140.5	151.3	166.9	335.6	370.9
Growth ratios					
Advances	60.1	58.9	61.9	41.8	35.8
Borrowings	53.4	62.9	59.0	30.9	39.3
NII	45.7	59.6	68.6	62.1	40.7
PPP	46.4	58.8	76.0	59.8	42.2
PAT	37.0	49.6	68.8	57.8	40.6
Margins					
Yield on funds	11.2	11.1	10.7	10.5	10.4
Cost of deposits	9.5	9.5	8.8	8.6	8.5
Spreads	1.7	1.6	1.9	1.9	1.9
NIMs	2.6	2.7	2.8	3.1	3.2
Cost ratios					
Cost to income	34.3	35.5	30.2	27.9	25.7
Cost to average assets	1.1	1.2	1.0	1.0	0.9
Return ratios					
RoA	1.4	1.3	1.3	1.4	1.5
RoE	16.7	15.4	17.6	13.3	12.2
Valuations					
P/E	39.3	41.5	30.0	24.8	17.7
P/Adj BV	5.5	5.1	4.6	2.3	2.1
Asset quality & adequacy					
GNPA	0.3	0.2	0.2	0.4	0.7
NNPA	0.2	0.1	0.1	0.2	0.4
Provision coverage Ratio	51.4	66.7	36.2	42.9	50.0
CRAR	12.6	13.3	12.7	19.5	16.2

Source: Company, PhillipCapital India Research Estimates

Rating Methodology

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

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

Management

Vineet Bhatnagar (Managing Director)	(91 22) 2483 1919
Kinshuk Bharti Tiwari (Head – Institutional Equity)	(91 22) 6667 9946
Jignesh Shah (Head – Equity Derivatives)	(91 22) 6667 9735

Research

Automobiles
Dhawal Doshi (9122) 6667 9769
Nitesh Sharma, CFA (9122) 6667 9965

Banking, NBFCs
Manish Agarwalla (9122) 6667 9962
Pradeep Agrawal (9122) 6667 9953
Paresh Jain (9122) 6667 9948

Consumer & Retail
Naveen Kulkarni, CFA, FRM (9122) 6667 9947
Jubil Jain (9122) 6667 9766
Preeyam Tolia (9122) 6667 9950

Cement
Vaibhav Agarwal (9122) 6667 9967

Economics
Anjali Verma (9122) 6667 9969

Engineering, Capital Goods
Jonas Bhutta (9122) 6667 9759
Vikram Rawat (9122) 6667 9986

IT Services
Vibhor Singhal (9122) 6667 9949
Shyamal Dhruve (9122) 6667 9992

Infrastructure
Vibhor Singhal (9122) 6667 9949
Deepak Agarwal (9122) 6667 9944

Logistics, Transportation & Midcap
Vikram Suryavanshi (9122) 6667 9951

Media
Manoj Behera (9122) 6667 9973

Metals
Dhawal Doshi (9122) 6667 9769
Yash Doshi (9122) 6667 9987

Mid-Caps & Database Manager
Deepak Agarwal (9122) 6667 9944

Oil & Gas
Sabri Hazarika (9122) 6667 9756

Pharma & Speciality Chem
Surya Patra (9122) 6667 9768
Mehul Sheth (9122) 6667 9996

Strategy
Naveen Kulkarni, CFA, FRM (9122) 6667 9947

Telecom
Naveen Kulkarni, CFA, FRM (9122) 6667 9947
Manoj Behera (9122) 6667 9973

Technicals
Subodh Gupta, CMT (9122) 6667 9762

Production Manager
Ganesh Deorukhkar (9122) 6667 9966

Editor
Roshan Sony 98199 72726

Sr. Manager – Equities Support
Rosie Ferns (9122) 6667 9971

Sales & Distribution

Ashvin Patil (9122) 6667 9991
Shubhangi Agrawal (9122) 6667 9964
Kishor Binwal (9122) 6667 9989
Bhavin Shah (9122) 6667 9974
Ashka Mehta Gulati (9122) 6667 9934
Archan Vyas (9122) 6667 9785

Sales Trader
Dilesh Doshi (9122) 6667 9747
Suniil Pandit (9122) 6667 9745

Execution
Mayur Shah (9122) 6667 9945

Corporate Communications

Zarine Damania (9122) 6667 9976
Bharati Ponda (9122) 6667 9943

Contact Information (Regional Member Companies)

SINGAPORE: **Phillip Securities Pte Ltd**
250 North Bridge Road, #06-00 RafflesCityTower, Singapore 179101
Tel : (65) 6533 6001 Fax: (65) 6535 3834
www.phillip.com.sg

MALAYSIA: **Phillip Capital Management Sdn Bhd**
B-3-6 Block B Level 3, Megan Avenue II, No. 12, Jalan Yap Kwan Seng, 50450 Kuala Lumpur
Tel (60) 3 2162 8841 Fax (60) 3 2166 5099
www.poems.com.my

HONG KONG: **Phillip Securities (HK) Ltd**
11/F United Centre 95 Queensway Hong Kong
Tel (852) 2277 6600 Fax: (852) 2868 5307
www.phillip.com.hk

JAPAN: **Phillip Securities Japan, Ltd**
4-2 Nihonbashi Kabutocho, Chuo-ku
Tokyo 103-0026
Tel: (81) 3 3666 2101 Fax: (81) 3 3664 0141
www.phillip.co.jp

INDONESIA: **PT Phillip Securities Indonesia**
ANZTower Level 23B, Jl Jend Sudirman Kav 33A, Jakarta 10220, Indonesia
Tel (62) 21 5790 0800 Fax: (62) 21 5790 0809
www.phillip.co.id

CHINA: **Phillip Financial Advisory (Shanghai) Co. Ltd.**
No 550 Yan An East Road, OceanTower Unit 2318
Shanghai 200 001
Tel (86) 21 5169 9200 Fax: (86) 21 6351 2940
www.phillip.com.cn

THAILAND: **Phillip Securities (Thailand) Public Co. Ltd.**
15th Floor, VorawatBuilding, 849 Silom Road, Silom, Bangrak, Bangkok 10500 Thailand
Tel (66) 2 2268 0999 Fax: (66) 2 2268 0921
www.phillip.co.th

FRANCE: **King & Shaxson Capital Ltd.**
3rd Floor, 35 Rue de la Bienfaisance
75008 Paris France
Tel (33) 1 4563 3100 Fax : (33) 1 4563 6017
www.kingandshaxson.com

UNITED KINGDOM: **King & Shaxson Ltd.**
6th Floor, Candlewick House, 120 Cannon Street
London, EC4N 6AS
Tel (44) 20 7929 5300 Fax: (44) 20 7283 6835
www.kingandshaxson.com

UNITED STATES: **Phillip Futures Inc.**
141 W Jackson Blvd Ste 3050
The Chicago Board of TradeBuilding
Chicago, IL 60604 USA
Tel (1) 312 356 9000 Fax: (1) 312 356 9005

AUSTRALIA: **PhillipCapital Australia**
Level 10, 330 Collins Street
Melbourne, VIC 3000, Australia
Tel: (61) 3 8633 9800 Fax: (61) 3 8633 9899
www.phillipcapital.com.au

SRI LANKA: **Asha Phillip Securities Limited**
Level 4, Millennium House, 46/58 Navam Mawatha, Colombo 2, Sri Lanka
Tel: (94) 11 2429 100 Fax: (94) 11 2429 199
www.ashaphillip.net/home.htm

INDIA
PhillipCapital (India) Private Limited
No. 1, 18th Floor, Urmi Estate, 95 Ganpatrao Kadam Marg, Lower Parel West, Mumbai 400013
Tel: (9122) 2300 2999 Fax: (9122) 6667 9955 www.phillipcapital.in

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PhillipCapital (India) Pvt. Ltd.
Registered office: No. 1, 18th Floor, Urmi Estate, 95 Ganpatrao Kadam Marg, Lower Parel West, Mumbai 400013

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