STALLION ASSET
CREATING ALPHA

DHFL

CMP: Rs.326 Weight : 7%

Changing Rules Changing Lives

STOCK DATA

Market Cap(Rs. cr)	10,204
EPS (Diluted)	23.73
P/E	13.74
P/B	1.95
Promoters Holding	39.31%
52 week high/low	336.20/140.55
Shares outstanding (in Cr.)	31.3

KEY FINANCIALS **(Rs. in cr)**

Y/E March	2014	2015	2016	Q2 FY17
AUM (Rs in cr.)	44822	56884	69524	75220
NII (Rs in cr.)	993	1380	1669	492
Gross NPA (%)	0.78	0.95	0.93	0.96
CAR (%)	17.16	16.56	16.74	15.27
ROE (%)	17.59	17.88	17.78	19.34
ROA (%)	1.70	1.65	1.52	1.64
NIM (%)	2.71	2.89	2.96	3.05
Cost to Income	25.99	27.32	26.82	23.14

VALUATION – DHFL is a No brainer at 10.5x FY 2017 PE, trading at 1.65x FY 2017 price to book, expecting an FY17 ROE of 16.5%, with PAT expected to grow at 25%+ for next 2 years. It is the cheapest stock in housing finance space, and with improving corporate governance it can get get re-rated. We strongly believe that there is 60-80% upside is next 1 year.

Dewan Housing Finance Limited (DHFL)

Thesis

We at Stallion Asset have a consistent Strategy of buying companies which have serious tailwinds and can grow at more than 20% sustainably.

We are extremely bullish on the NBFC space and we certainly believe that 2015-2019 will be marked in history as period of upsurge of NBFC in India.

Housing Finance is a well discovered story in the capital market with expected sustainable growth of about 20% for the next decade.

Housing Finance is an easy business to understand, the company borrows at a Rate, lends at a higher rate, the difference is the gross profit. There are two main cost 1) Operating Cost and 2) Credit Cost (NPA).

We have selected DHFL for the Following Reasons:

1) Mispriced Valuations
2) Large Opportunity Size
3) Improving Governance
4) Longevity Trust by Debt Holders
5) Tailwinds in the Sector

What has changed that our conviction has increased so much in DHFL?

DHFL came out with its maiden Non-convertible debenture (NCD) issue In August 2016 for 4,000 Cr. and it was oversubscribed to 19,000 cr. on First Day Itself.

It came out with its 2nd NCD worth 10,000 Cr. in the same month and it got fully subscribed on the first day itself.

Debt Holders are extremely risk averse and the fact that DHFL got a mind-blowing response on Day 1 itself in both issues suggest that debt markets already believe in the longevity of DHFL.

Introduction:

DHFL is a Housing finance company and has grown its revenue at 41% CAGR in last 10 years. The company has never had an ROE of less than 15% in the last 15 years and has been consistently paying dividends.

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	15 Year	10 Year	5 Year
Gross Revenue	103	115	130	147	164	227	332	523	694	993	1451	2469	4078	4969	5981	7316	33%	42%	38%
Book Value	14	15	16	18	19	25	28	30	35	51	74	87	126	139	159	172	18%	21%	18%
EPS	2.2	2.2	2.7	3.1	3.5	4.2	4.6	7.2	7.6	9.9	13.2	14.5	19.2	20.6	23.9	25.0	18%	20%	14%
ROE	15.8%	15.2%	17.1%	18.3%	19.3%	18.9%	17.4%	25.1%	23.3%	22.8%	21.0%	18.0%	18.0%	15.5%	16.0%	15.1%	19%	19%	17%

*** CAGR Growth ** Adjusted for bonus**

DHFL Peer Comparison

The Below Table sums up the valuation difference between the listed housing finance companies.

Company Name	Loans 30-06-2016	Revenue FY 2016	Growth YOY	PAT FY 2016	Growth YOY	Gross NPA 30-06-2016	ROE FY 2016	Current market Cap	MarketCap to Loans	PE Ratio FY 2016	P/B FY 2016
LIC Housing	1,27,437	12396	16%	1661	20%	0.59%	19.5%	26669	21%	16	3.2
DHFL	72,012	7312	22%	729	17%	0.98%	17.8%	9933	14%	14	1.8
IndiaBulls	71,026	8290	28%	2345	23%	0.84%	26.0%	36076	51%	15	3.4
PNB	30,901	2700	51%	328	69%	0.27%	17.6%	12837	42%	39	2.4
Gruh	11,543	1275	20%	244	20%	0.56%	31.5%	11967	104%	49	14.3
Can Fin	11,183	1084	33%	157	82%	0.24%	17.9%	4831	43%	31	5.5
Repco	7,959	882	27%	150	24%	2.20%	17.7%	4786	60%	32	5.0

DHFL is clearly the Cheapest among them in all valuation Parameters. DHFL is available at P/B of 1.8x V/S peer median average of 3.4x. DHFL's trailing PE ratio is 14x V/S peer Average of 28x. DHFL has Market Cap to Loan Ratio of 14% V/S Average of 48%.

What Factors Affects Valuation of Housing Finance Companies?

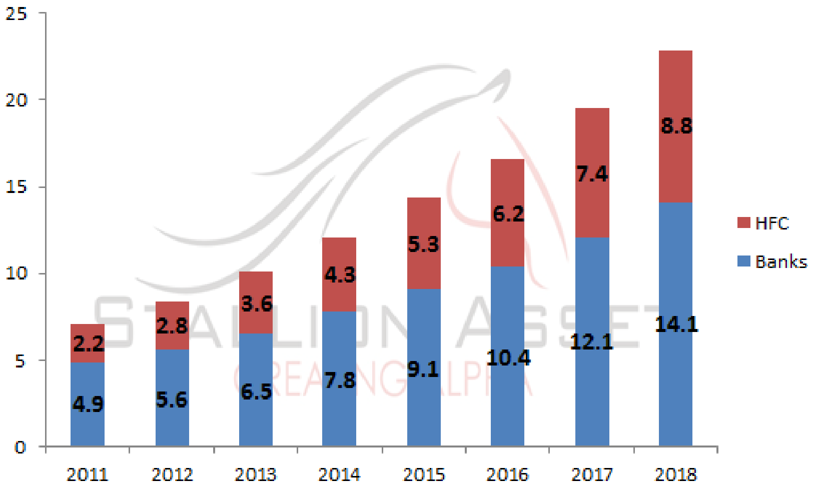
We have identified 7 Factors that affect the Valuations of Housing Finance companies.

	Growth	NPA	NIM	ROE	Average Ticket Size	Self Employed	Governance
LIC Housing	Medium	Medium	Medium	Medium	Medium	Low	Medium
DHFL	Medium	Medium	Medium	Medium	Low	Medium	Low
IndiaBulls	Medium	Medium	Medium	High	Medium	Medium	Low
PNB	High	Low	Medium	Medium	High	Medium	Medium
Gruh	Medium	Medium	High	High	Low	Medium	High
Can Fin	High	Low	Medium	Medium	Medium	Low	Medium
Repco	High	High	High	Medium	Low	High	Medium

#High Growth= High Valuation **#High NPA= Low Valuation** **#High Net Interest Margin = High Valuation**
#High ROE = High Valuation **#High Self-Employed = Low Valuation** **#Good Governance = High Valuation**

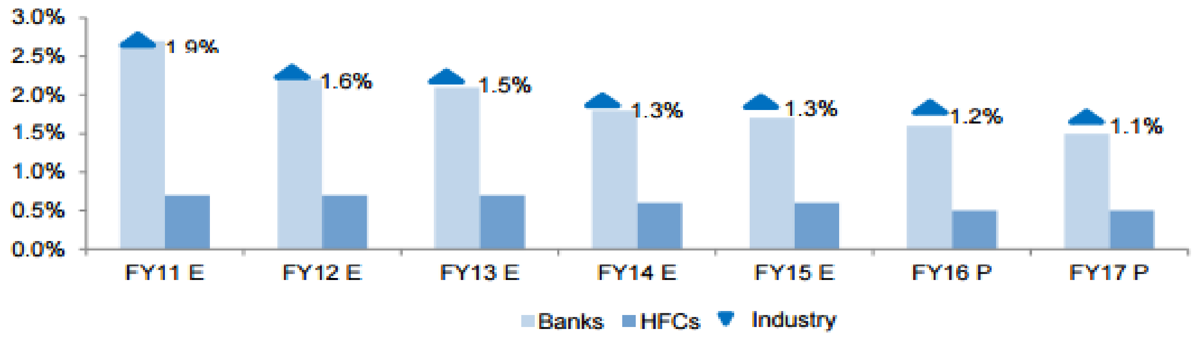
Industry Analysis

Housing Finance in India is forecasted to grow 20.00-22.00% from Fiscal Year 2015 to Fiscal Year 2020. In Particular, the government's push for affordable housing projects, reductions in interest rates and rising income levels are expected to contribute towards increased housing demand and improved house buyers' debt-servicing capabilities, thereby increasing outstanding housing loans in terms of both the number of disbursements and the quantum borrowed under each loan.



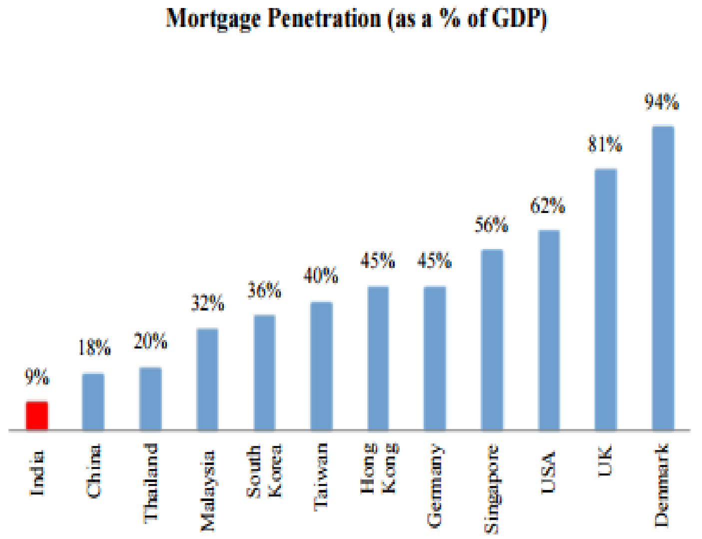
Out of the total housing mortgages of 16.6 Lakh Crores in 2016, Housing Finance companies were 6.2 Lakh cr.or 37.5% of market Size. The Share is expected to increase further to 39% by 2020 as per Crisil. The competition is high in High ticket size Loans where banks are big players, whereas NBFC dominate the low ticket size space in the mortgage business.

In Fiscal Year 2015, the gross NPA level for HFCs in the housing loan sector was estimated at 0.50% while it was slightly higher for banks, at 1.60% clearing showing that NBFC's have managed their portfolio a lot better than banks. NBFC's have created value in India as they have given out smaller ticket size loans category where banks are not interested as they need larger loans.



Opportunity Size

- India faces immense shortfall of housing units of 11 cr. houses by FY 2022 to keep up with the demand out of which 4.7 cr. is the demand in Urban India and 6.4 Cr. in Rural India.
- 50% of this demand comes from middle income group and lower income group families where DHFL has its strong presence.
- Investment of 120 lakh Cr. is required to address the current total housing shortage i.e. 15 lakh Cr. every year.



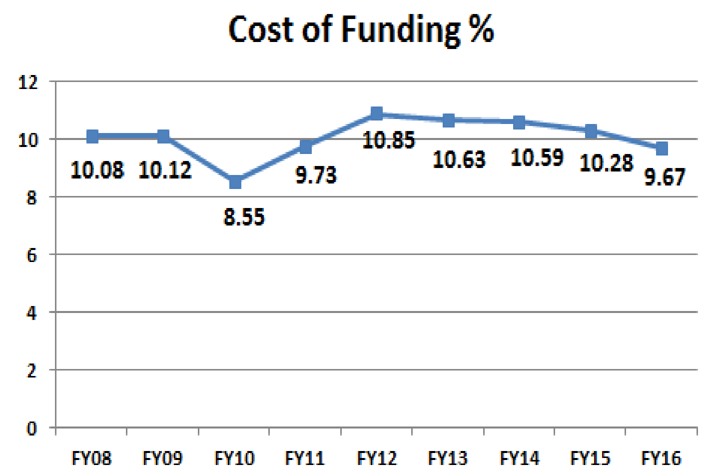
India's housing finance market still remains under penetrated in comparison to many advanced and emerging economies, evidenced by its low mortgage-to-GDP ratio. As of Fiscal Year 2015, India's mortgage-to-GDP ratio was 9.00%, whereas certain advanced economies (such as the Denmark and the United Kingdom) had a mortgage-to-GDP ratio of over 75.00%. In addition, emerging economies in Asia maintain higher mortgage-to-GDP ratios than that of India, such as 32.00% in Malaysia, 18.00% in China and 20.00% in Thailand. (Source: CRISIL Report)

About DHFL

DHFL has an easy business to understand, the company borrows at Rate, lends at a higher rate, the difference is the gross profit. There are two main cost 1) Operating Cost and 2) Credit Cost (NPA).

1) Borrowing Cost

"When you're in a commodity business, the only way to thrive is to be a low-cost producer. And when you're selling money, you're in a commodity business." -- Duff McDonald author of Last Man Standing.



Borrowing cost is affected by 2 important factors

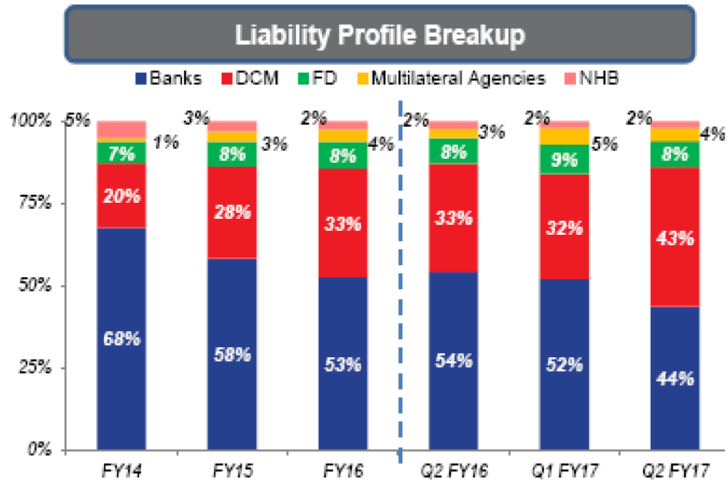
1) Credit Quality
2) Source of Funding.

Credit Quality – DHFL's credit quality has improved and latest NCD was rated AAA.

Source of Funding – After its Maiden NCD issue DHFL's percentage of high cost bank lending has decreased from 54% to 44%. We expect its full impact to come in Q3 and Q4 of this year.

COST OF FUNDS	FY14	FY15	FY16	Q2 FY16	Q1 FY17	Q2 FY17
Banks	11.00%	10.81%	10.10%	10.51%	10.05%	9.83%
DCM	9.84%	9.49%	9.28%	9.15%	9.06%	8.92%
FD	10.56%	10.34%	9.52%	9.85%	9.35%	9.35%
Multilateral agencies	10.73%	8.56%	8.71%	8.56%	8.92%	8.90%
NHB	8.04%	7.93%	7.59%	7.95%	7.59%	7.61%
Total	10.59%	10.28%	9.67%	9.90%	9.56%	9.33%

Source of Funding is very Important for every housing finance company. Direct capital Markets and multilateral agencies (private debt placement) are cheaper sources of funding compared to banks. NHB is the cheapest source of borrowing but it comes with a caveat that HFC are not allowed to charge 2-2.75% over the cost of capital. The management has guided that bank borrowings will come to 40% of book within 2 years.

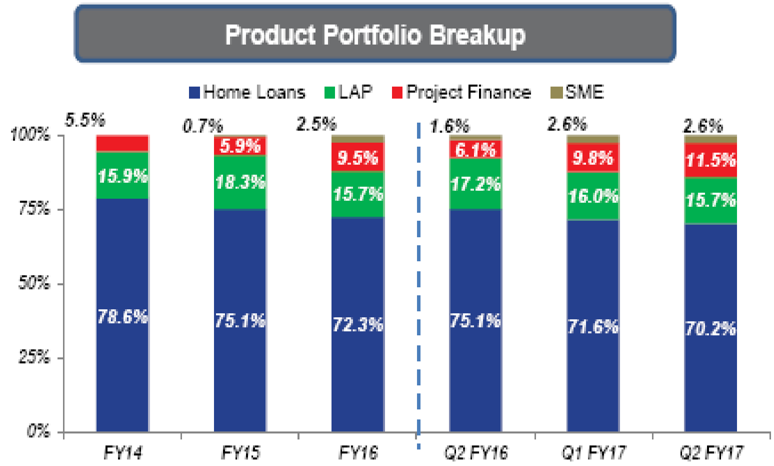


DHFL's has been decreasing its bank borrowing proportion for the last many years from 77% in 2012 to 44% today. The Cost of Funds between Q1 2017 and Q2 2017 decreased 27bps primarily due to increased capital market borrowings. The management has guided to get the bank borrowing share to 40% in the next 2 years further decreasing the cost of capital and increasing its NIMs.

2) Lending Rate-

We use Net Interest Margin as a proxy to understand the lending rate.

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Net Interest Margin%	3.02	2.93	2.98	2.96	2.86	2.72	2.71	2.89	2.96



Non Retail book i.e. LAP, SME and Project finance has been increasing in last few years as management see better margins. We believe project finance is risky business and management capability is really important. The management has guided that they will not cross 12-15% of book in Project finance. Management has guided increase of SME business to 3-5% in next few years.

Q2FY17	GNPA
Home Loans	0.85%
LAP	1.2%
Project Finance	1.3%
Weighted Average	0.9%

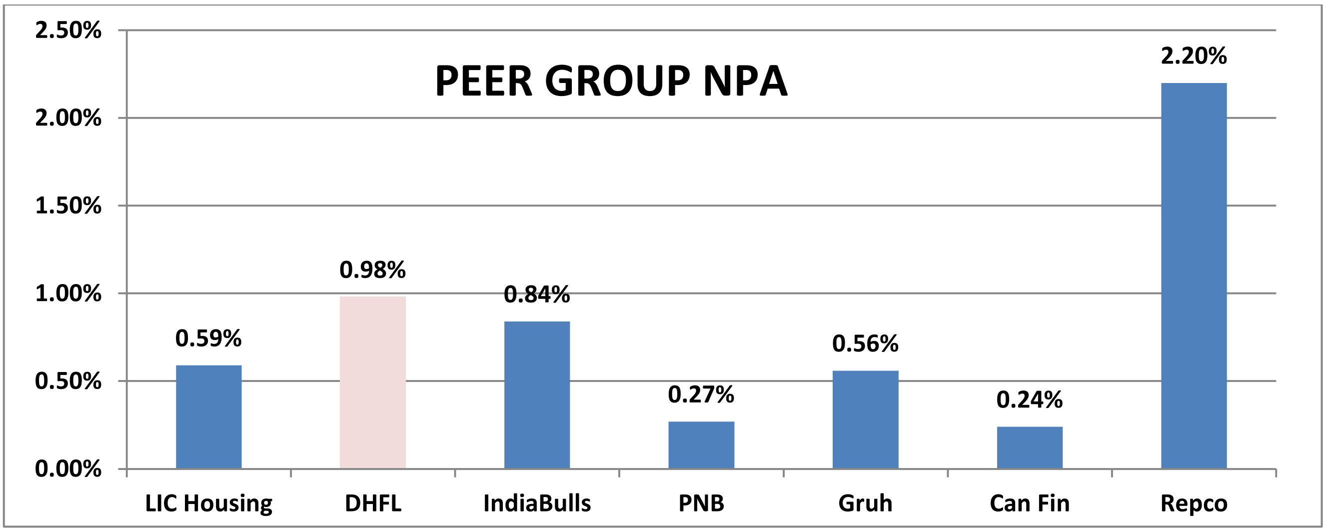
DHFL has maintained a Stable Net Interest Margin of between 2.7-3% for the last many years. In Q2 2017 (latest Quarter) the Net Interest Margin has increased to 3.05%, this happen due to change in product mix and increased borrowing to project finance.

3) Credit Cost

"Banking is very good business if you don't do anything dumb." -- Warren Buffett, chairman and CEO of **Berkshire Hathaway**

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Gross NPA	1.6	1.47	1.16	0.67	0.76	0.71	0.78	0.95	0.93

The NPA's have gone up from 0.71% in 2013 to 0.93% in 2016 as Share of non-retail financing (Loan against property and Project Finance) increased from 17% to 28% over the same period, resulting in an uptick in NPA's. We believe the NPA will be stable in the coming years.



4) Operating Cost -

Operating expenses

	2014	2015	2016	Q1 2017	Q2 2017
NII	9.93	13.8	16.69	4.56	4.92
Opex	3.69	4.49	5.25	1.3	1.33
Opex/NII	37.2%	32.5%	31.5%	28.5%	27.0%

OPEX% of NII FALLING

Opex as a Percentage of Net Interest income has been falling, which is positively impacting the margins of DHFL. There was a 150 bps point reducing this quarter over previous quarter. We are confident that the Opex as Percentage of NII will go lower in coming quarters.

*FY 2016	LIC Housing	IndiaBulls	Gruh	Can Fin	Repco	PNB	DHFL
Cost to Income	15%	15%	17%	19%	19%	26%	30%

The Reason of DHFL having higher Operating cost to income is because of higher advertisement (5.4% DHFL v/s 1.2% for the Industry) and very high Legal Expenses. However the management has guided for a reduction on both expenses going forward.

DHFL has investments in the following Subsidiaries:

1) **DHFL vyasa (9.47%)** – South Based Low Income Group housing Finance company
2) **Aadhar Housing Finance (14.9%)** – Central India based Low Income Group housing finance Company
3) **Avanse Education Loans (36.78%) –** Education Loans for Indians studying Abroad with Average ticket size of 14.4 Lakh. World Banks owns 20% stake.
4) **DHFL Pramerica Life Insurance (50%)-** It is a Life Insurance Company and made 51 Cr. of profit in FY 2016.
5) **DHFL Pramerica Asset Manager (50%) -** A Mutual Fund Company which has acquired deutsche mutual fund in March 2016.

Valuation

Let's go in a bit of detail of what affects valuation of Housing Finance companies.

Factor #1 – Growth – Higher the expected growth in AUM, higher the valuation. We believe the DHFL will double its AUM in next 3.5-4 years growing at 20% CAGR. DHFL is expected to grow in line with the housing finance Industry. Canfin home, Repco and PNB are expected to grow faster than the market and hence trade at premium valuations.

Factor #2- NPA – NPA is affected with asset quality of companies and percentage of retail book within the portfolio. Salaried class has historically been a low NPA product compared to Self-employed**.** Project Finance and LAP have historically had higher NPA compared to Retail home loan book.

Company	Self Employed
Repco	60%
PNB	45%
DHFL	40%
Gruh	40%
IndiaBulls	35%
LIC Housing	18%
Can Fin	16%

There is a direct proportion between self-employed loans and NPA. PNB is an outlier in NPA even after having a relativity high proportion given out to self-employed because the loan book has grown fast in last 2 years (the lagging 2 year NPA of PNB is more than 0.5%). Government backed companies like LIC housing and Can-fin homes are targeting the relatively safer salaried class.

Company	Gross NPA
Repco	2.20%
DHFL	0.98%
IndiaBulls	0.84%
LIC Housing	0.59%
Gruh	0.56%
PNB	0.27%
Can Fin	0.24%

Factor #3 =Net Interest Margin - In a commodity business, the one with the highest margin wins, in the housing finance business, money is a commodity. Higher the Net Interest margin, Higher the Valuation.

*FY 2016	NIM
Repco	4.4%
Gruh	4.1%
Can Fin	3.2%
IndiaBulls	3.2%
PNB	3.0%
DHFL	3.0%
LIC Housing	2.7%

Net Interest Margin is a factor of cost of borrowing and price of lending. Repco and Gruh have the highest NIM because of their presence in lowest income group where competition is lowest from banks. LIC housing finance is the lowest cost borrower, but gives out loans only to salaried class where competition is high. India bulls maintain its NIM due to high exposure to corporate loan market and Loan against property.

Factor #4 Average Ticket Size

Company	Ticket Size
PNB	32 lakhs
IndiaBulls	24 lakhs
LIC Housing	20 lakhs
Can Fin	17 lakhs
Repco	13 lakhs
DHFL	12 lakhs
Gruh	7 lakhs

Gruh is the lowest as its rural focused whereas PNB has the highest average ticket size due to its Urban Focus. Higher the Average ticket size, higher the competition from banks. NBFC cannot compete with banks on the pricing front as banks have low cost of capital. DHFL has an edge in the low income housing finance as it has immense amount of experience of dealing with the needy. The Average ticket size of loans for DHFL has doubled in last 5 years from 5.9 Lakh in 2011 to 12.4 Lakh in 2016. As average ticket size increases further, it will improve the cost to income ratio.

Factor #5 – ROE

Company Name	ROE FY 2016	P/B FY 2016
LIC Housing	19.5%	3.2
DHFL	17.8%	1.8
IndiaBulls	26.0%	3.4
PNB	17.6%	2.4
Gruh	31.5%	14.3
Can Fin	17.9%	5.5
Repco	17.7%	5.0

Higher the ROE, Higher than valuation of a housing finance company. Over the last 15 years DHFL has consistently maintained an ROE of 15+% and we expect in the next 2 years ROE to inch toward 19%. GRUH has higher ROE because of its higher net interest margin and low cost structure. Gruh trades at 14x book whereas DHFL trades at 1.8 times book. The key difference between the two is corporate governance and ROE. Gruh is backed by HDFC whereas DHFL is backed by Wadhawan (never had a good reputation in real estate market in Mumbai).

There Difference in valuation between LIC housing and DHFL is unjustified and we believe DHFL has strong margin of safety at current level and will trade at 3x book in coming 1-2years. We expect DHFL to do profits between 900-950 crores for FY2017, and should have shareholders' Equity of approximately 6000Cr (book Value per share of 210). We expect DHFL to be re-rated going forward and trade at 3x FY 2017 book atleast. We expect 70-80% returns by next Diwali in DHFL unless something unforeseen happens.

Risks

1) DHFL has expanded its book in risky project finance business which has higher NIM's but also higher NPA's. We will be scared if DHFL expands its project finance book more than 15%.

2) DHFL has done a large NCD issue of 14,000 crore in August 2016 which has a fixed yield of 9-9.3% whereas its home loans (assets) have floating rates i.e. further drop of Interest rate will not help DHFL to the full extend. If interest rate decrease more than 150 bps in next 2 years DHFL can have a large asset liability mismatch.

3) Markets hate's the corporate governance of DHFL as it was sister concern company to HDIL (which has a bad name in Mumbai real estate market) but we at stallion believe it's definitely improving and this will get reflected in valuations in few quarters. Kapil Wadhawan (owner of DHFL) and Dheeraj Wadhawan (Owner of HDIL) have completely separated since 2014 at that time DHFL had a market cap of 1045 Cr. and HDIL had a market cap of 9595 Cr, today DHFL has a market cap of 10,000 Cr. whereas HDIL has a market cap of 3,400 Cr.

Conclusion

There is no doubt that Housing Finance is in a multiyear bull market and DHFL is the cheapest of them all. NBFC as a class has been a leader in this bull market and we continue to believe that the story is far from over. How will we come to know that NBFC bull market is over? When Reliance capital goes up 100-200% in 2-3 month period, that would be the end of the NBFC bull. In every bull market the horse lead from the start, but in the last phase of the bull market the pigs run the fastest. When the pigs start running, we will be cautious on the sector. DHFL is more volatile than other housing finance companies but I am quite certain especially after PNB IPO that it has massive potential on the upside. I expect DHFL to report a 25-30% profit growth this year to 910-950 Cr. and expected to grow atleast 20+% after that. The Market gives valuation to expected longevity of growth, as DHFL shows good numbers we expect price to book to increase. The Debt market has already given a thumps up on the longevity on growth, slowly but surely we expect the equity market to give it the deserved valuations. Overall we have bought a company which is in the sector in-play, improving corporate governance, good financial track record, at cheap valuation and attractive margin of safety.

Disclosure: Amit Jeswani & Family have no positions

Analyst Disclosures: Has Positions – Juhi Shah

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