Housing Finance

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Tough choices before HFCs

Ever since the IL&FS crisis of September 2018, the prevailing risk-averse environment and liquidity constraints have forced HFCs to grapple with tough choices of a strategic nature: 1) consciously growing at a slow pace while facing the risk of spread compression 2) shoring up balance sheet liquidity, and thereby credibility and 3) figuring out the route to bank conversion for permanent insulation from liquidity shocks. The exact choice would be a function of each HFC's self-assessment of the severity of liquidity headwinds, continuity of the current scenario, and the ability to survive or evade competition from banks if funding scenario remains adverse for long.

Structural issues of bond markets (in freeze mode since March-April 2018) and heightened risk aversion by banks (driven by existing high exposure and deep corporate NPL cycle) make this liquidity crisis different from the prior ones. NHB refinancing has become tighter and merit-based; international funding may not be an avenue open to all. While the money market has normalized thanks to RBI's efforts, the ensuing overdependence on the same is at the core of the liquidity crisis. The absence of long-term funding is indeed a sticky issue for HFCs, and regulators or the government must address it at the earliest.

Needless to say, HFCs facing both bond and bank funding challenges would have to make a harder choice. We have the case of a large HFC trying to generate liquidity, de-risk book and augment equity at the same time. Another player has initiated a transaction to merge with a small bank for the sake of long-term stability. On the other hand, HFCs blessed with reasonable money flow from banks, NHB and international markets (but at higher cost) are still talking about growth and market differentiation; however, they hesitantly acknowledge that the eroding price competitiveness could make FY20 a year of moderate growth and margins.

The key monitorable in this context is how would banks capitalize on this advantageous scenario and for how long. For banks, home loans have traditionally been a portfolio risk balancing product. In recent years, amid the challenges of corporate, SME and agri portfolios, home loans proved one of the most profitable lending products. This trend notwithstanding, the home loan portfolio of large bank players is only growing at 12-18% yoy. So, are these banks geared to grow at a faster rate to grab substantial market share from HFCs? If not organically, maybe through portfolio buyouts. And would their home loan focus sustain in the longer term when more financing opportunities open-up in the corporate and SME lending space? May be not, going by the preceding cycles. Historically, HFCs have persistently gained market share in mortgage financing, irrespective of interest rate and liquidity cycles, and they have contained NPLs at a much lower level than banks.

Hence, in a more likely outcome, the better-off large HFCs (HDFC, LIC HF and PNB HF) would navigate through the current constraints with a transient financial impact, before gradually reverting to trend growth and margins. For other HFCs inflicted with deeper pain, the tough times may well last longer. It is very critical that bond market reverts to normalcy to help HFCs improve their competitiveness and growth prospects. In the worst case, if HFCs are forced to change their business models from 'originate-to-hold' to 'originate-to-sell', the impact on their profitability could be significant besides the ensuing undue volatility. The operating focus would then shift to origination at the cost of underwriting and collections, which may not be good for the industry.

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We met with the management of PNB Housing Finance (PNB HF) to study the funding situation and learn their business plans, as also the likely impact of shareholding changes. Below are the key takeaways of the interaction:

- ✓ Liquidity is available to stronger players like PNB HF which recently raised short-term CP at around 7.5%, compared to rates well above 8% during Sept-November 2018. Unlike a few larger peers, company's CPs are being smoothly rolled over, sustaining CP share at 10-12% in borrowings. Bank money is easily accessible too, but at a MCLR + 10-15bps spread. Company raised 5-year ECB totaling US$465mn (Rs33.2bn) at blended, fully hedged cost of 8.7-8.8% in Q3 FY19. PNB HF also received Rs35bn refinance sanction from NHB at a similar rate.

- ✓ Deposits mobilization has been activated and has significantly improved over the past 12 months. Currently, deposits are the cheapest source of medium-term money costing 8.4%. Securitization is being used tactically to manage liquidity and capital consumption and would be contained at 10-12% of AUM.

- ✓ Management is confident of growing AUM at 1.5-1.7x the industry rate (pegged to HFC growth forecast by ICRA). So, while the expected moderation in industry growth would mark a growth deceleration even for PNB HF, the pace of market share gains remains intact. The current product mix would be largely maintained in the longer run. The company has clarified that it will not change its customer segment or loosen its operational rigor to penetrate Tier-2/3 markets.

- ✓ Retail loan growth was sturdy in Q4 FY19 supported by increased traction in customer applications given that few competitors' disbursements were impacted. Portfolio run-off rate has come down to ~18% (annualized) from around 24% during FY18. This has supported AUM growth.

- ✓ Net lending spread in 9m FY19 stood at ~1.95%, but the company is confident of maintaining on-book spread at 2.05-2.15% in medium term. We believe this target can prove to be challenging given that bank's spread over the MCLR could be sticky, and the bond market may take a while to offer money at efficient rates.

- ✓ However, incremental spread is set to improve from the recent lows (due to spike in funding cost) aided by lending rate hikes (of about 15-20 bps) taken in February and April across products and likely softening in bank MCLRs. Around 73% of PNB HF's retail portfolio is on floating rates.

- ✓ NIM will be a function of equity and liquidity on the balance sheet. Company has raised liquidity on its balance sheet and would like to maintain a reasonable buffer in the future. With balance sheet leverage at ~10x, PNB HF plans to raise capital in H2 FY20. Headroom for raising Tier-2 capital and securitization can provide some leeway to time the equity raise; its quantum would be supportive of 2-2.5 years of growth.

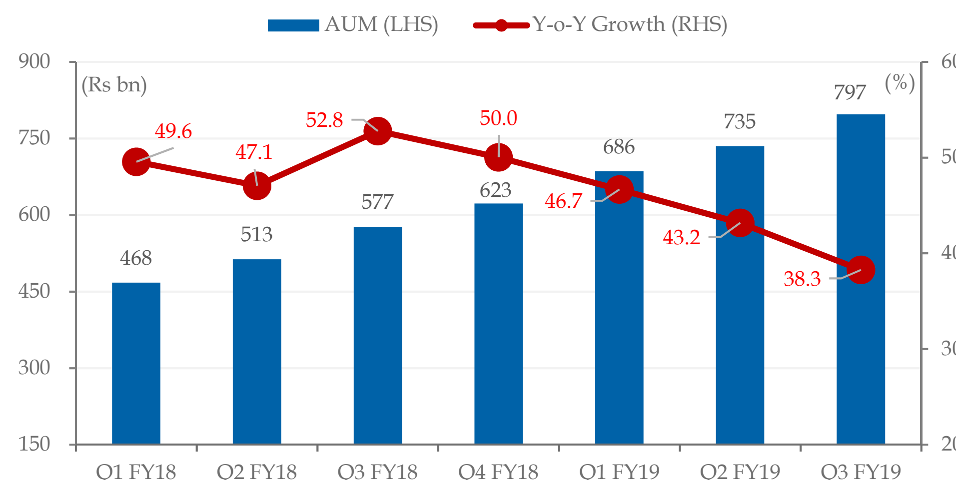
- ✓ In management's view, every HFC has its niche, which could be customer focus, sourcing/collection mechanism, operational rigor and the like. Also, banks endure higher cost of operations. As such, well-run HFCs cannot be displaced permanently by the banks. Further, considering the potential for housing finance, the market will stay supportive for the growth of all players.

- ✓ Post the divestment of ~13% stake to financial investors, the parent PNB would be left with 20% stake which the bank would retain for the next 12 months as per the share purchase agreement. Post that, the bank would be expected to come out of its asset quality woes

and attain better capital generation capability. PNB HF is not aware about the current intentions of the Carlyle group.

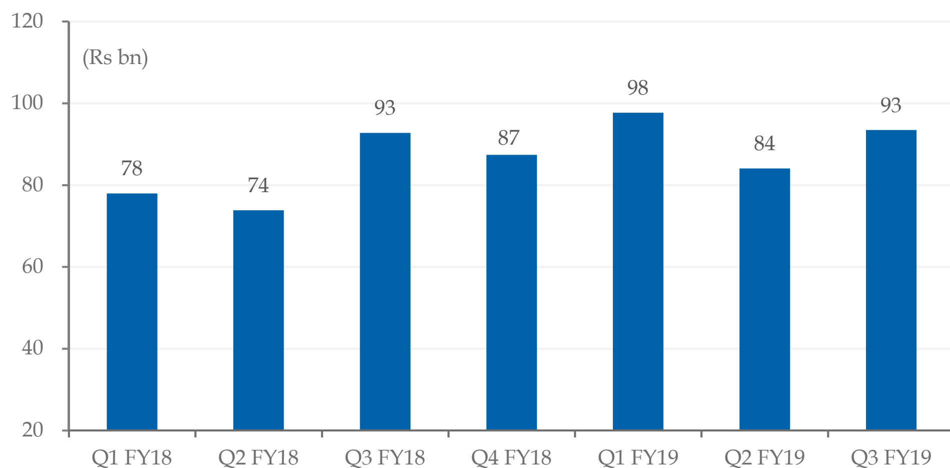
- ✓ The management expects no impact of the recent PNB stake divestment on the company's credit rating. India Ratings had already downgraded PNB HF's rating to AA+ in January in anticipation of share ownership changes.
- ✓ Being a professionally run entity, PNB HF's operations are immune to shareholding changes. The Board composition is likely to undergo a change: the hiked General Atlantic stake to 16.4% post the recent transaction will fetch it Board representation.
- ✓ PNB HF can continue to use the PNB trademark notwithstanding the recent stake reduction by the parent bank. Even if the bank were to completely exit in future, the company reckons business would remain unaffected, ably supported by the credibility and scale attained.
- ✓ In the wholesale portfolio, a handful of accounts have exhibited some stress. It includes two relatively large exposures to Supertech and Ireo aggregating ~Rs6.5bn. The concerned developers are engaged in taking corrective steps to ensure smooth repayment. Currently, while these exposures are Stage 1 and Stage 2 assets, the company is carrying ECL provisions based on conservative PD and LGD assumptions. Management is reasonably confident that these accounts will not slip to Stage 3.
- ✓ PNB HF's exposure to RE developers is largely restricted to Category A developers (Top builders with vintage, execution pedigree and a strong brand). Within construction finance, the company is a sole lender in most cases with an exclusive right on the security. The project cash flows are escrowed and first utilized towards loan repayment. It is worth noting that PNB HF's yield in this business segment is lower than peers at ~12.4%, representing the choice of moderate risk-reward. The company currently has 'zero NPL' in the wholesale segment.
- ✓ In addition to ECL provisions, the company holds Rs1.56bn of steady-state provisions which represent the wedge between expected and actual NPL trends (contingency provisions). Management expects FY20 credit cost at 30-40bps.

Exhibit 1: AUM growth decelerating, but remains well ahead of the industry



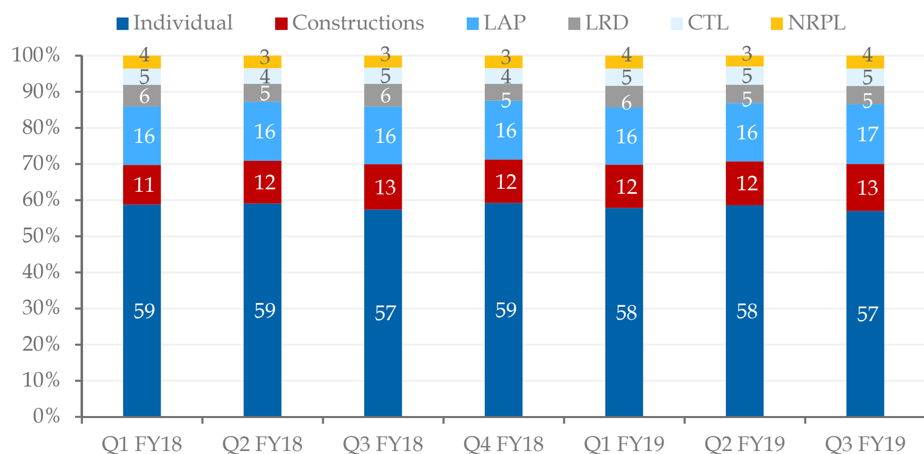
Source: Company, YES Sec - Research

Exhibit 2: Disbursements immune to liquidity conditions



Source: Company, YES Sec - Research

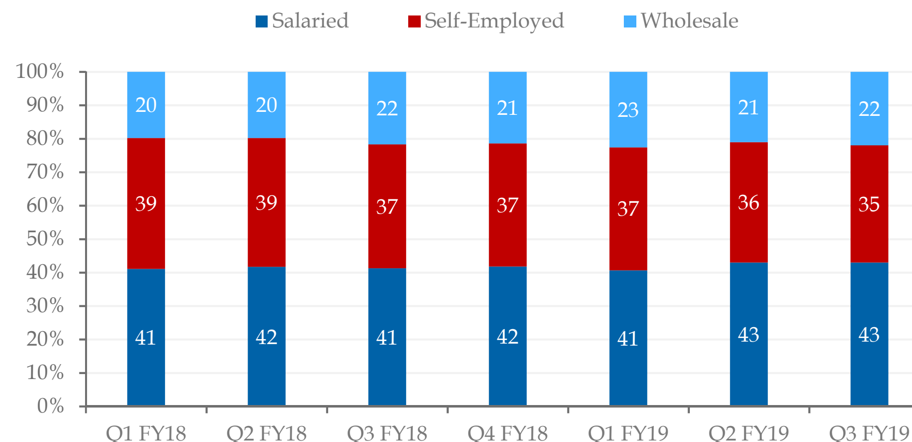
Exhibit 3: Product mix has been stable



	Q1 FY18	Q2 FY18	Q3 FY18	Q4 FY18	Q1 FY19	Q2 FY19	Q3 FY19
Individual	59	59	57	59	58	58	57
Constructions	11	12	13	12	12	12	13
LAP	16	16	16	16	16	16	17
LRD	6	5	6	5	6	5	5
CTL	5	4	5	4	5	5	5
NRPL	4	3	3	3	4	3	4

Source: Company, YES Sec – Research

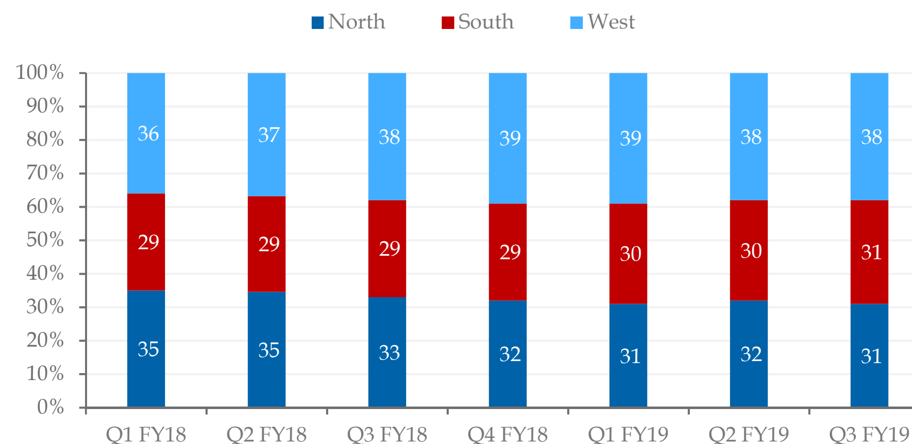
Exhibit 4: A gradual shift towards salaried customers and wholesale lending



	Q1 FY18	Q2 FY18	Q3 FY18	Q4 FY18	Q1 FY19	Q2 FY19	Q3 FY19
Salaried	41	42	41	42	41	43	43
Self-Employed	39	39	37	37	37	36	35
Wholesale	20	20	22	21	23	21	22

Source: Company, YES Sec – Research

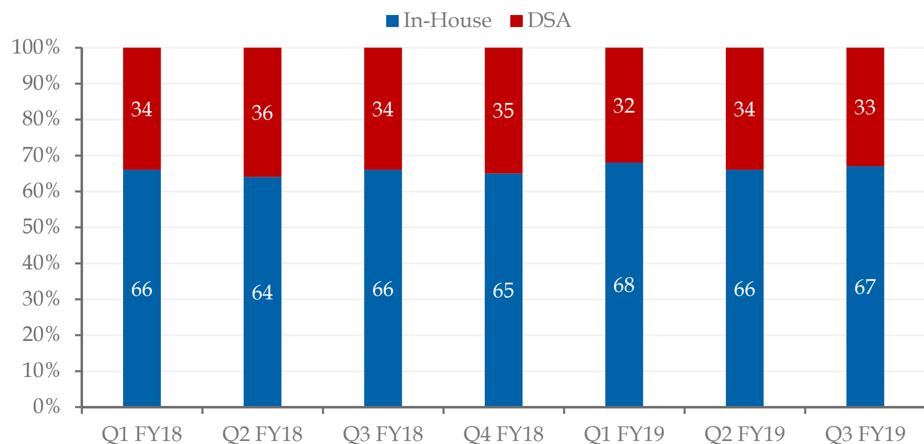
Exhibit 5: West and South regions have gained share in AUM



	Q1 FY18	Q2 FY18	Q3 FY18	Q4 FY18	Q1 FY19	Q2 FY19	Q3 FY19
North	35	35	33	32	31	32	31
South	29	29	29	29	30	30	31
West	36	37	38	39	39	38	38

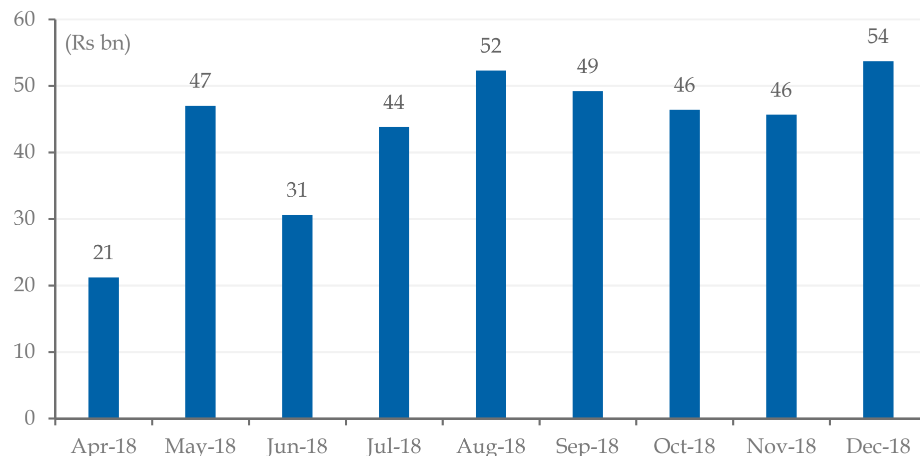
Source: Company, YES Sec - Research

Exhibit 6: Increased focus on in-house sourcing



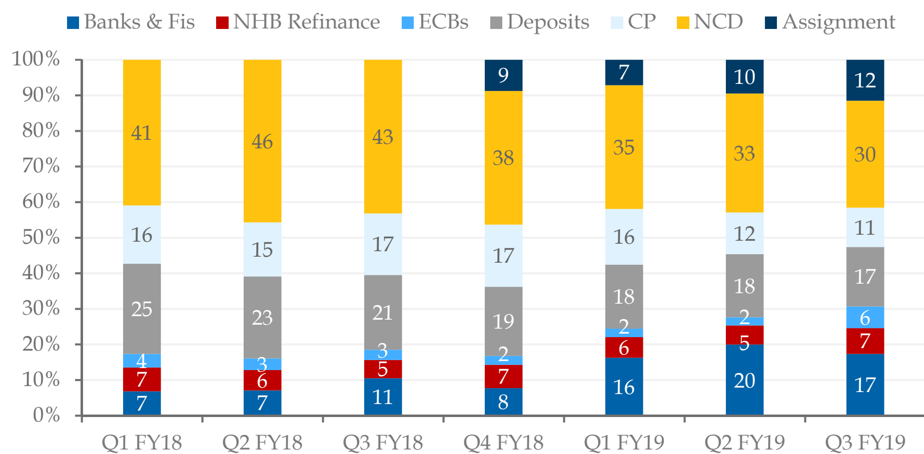
Source: Company, YES Sec – Research

Exhibit 8: Deposit mobilization has picked-up substantially



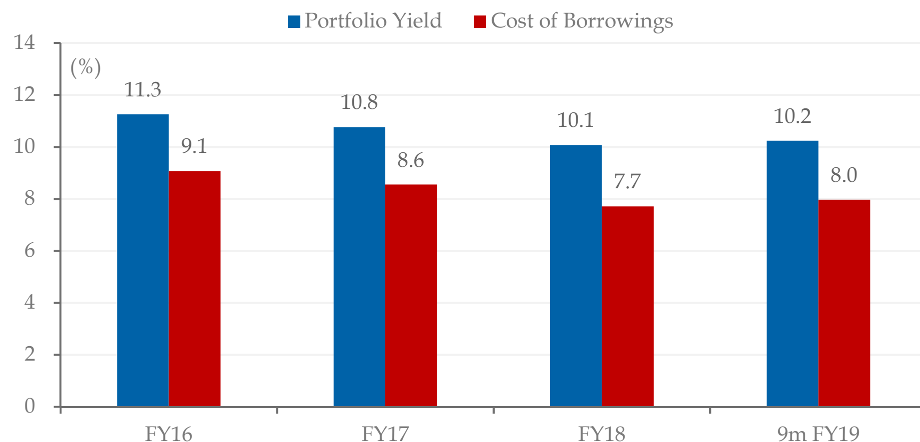
Source: Company, YES Sec - Research

Exhibit 7: Borrowing mix shifting towards banks, NHB and ECB



Source: Company, YES Sec – Research

Exhibit 9: Lending spread has been maintained



Source: Company, YES Sec - Research

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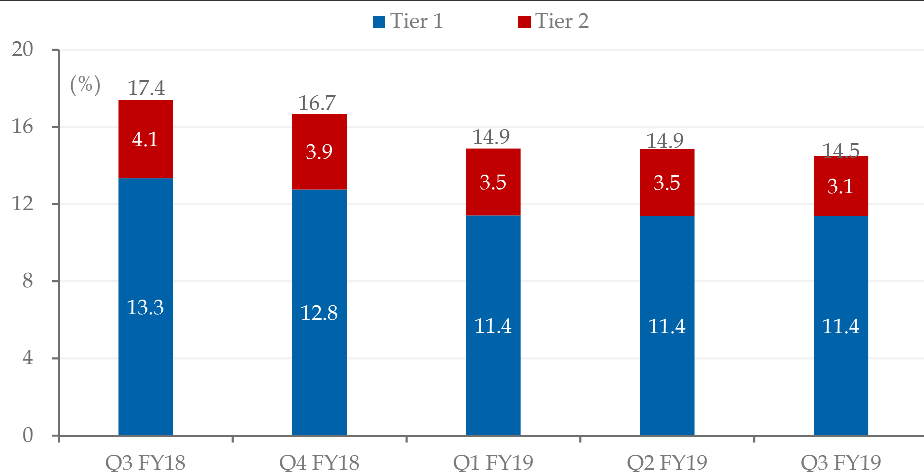
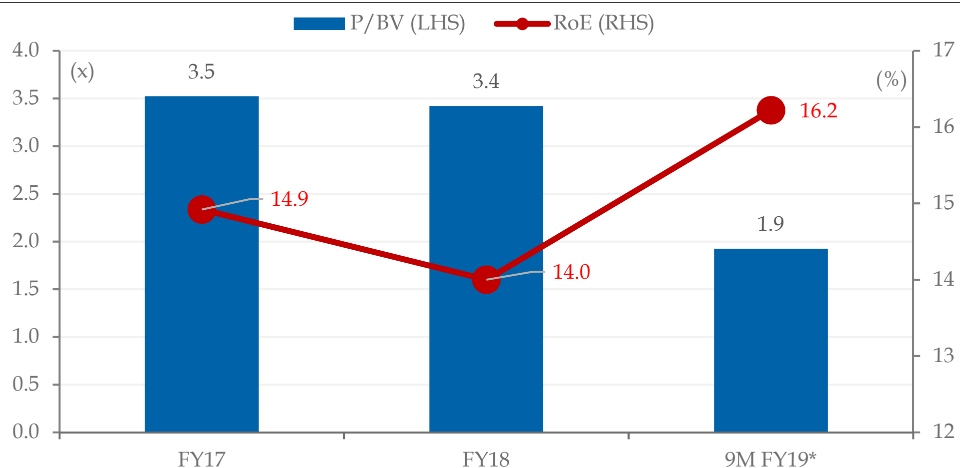
Exhibit 10: Capital adequacy managed through securitization



Source: Company, YES Sec – Research

Exhibit 11: Valuation has de-rated significantly in recent past



Source: Company, YES Sec – Research
* 9m FY19 P/BV based on current M-cap

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ADD 5% to 15%

HOLD -15% to +5%

SELL > - 15%

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