Can Fin Homes Ltd (NSE Code: CANFINHOME) – Alpha/Alpha + stock recommendation for May'13

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Dear Members,

Housing Finance companies have played a very vital role in the last 10 odd years in helping individuals buy their dream homes. We believe, besides getting your houses financed, one can also consider starting investing at a young age in fundamentally strong, fast growing and reasonably valued companies from the Housing finance space so as to reduce the quantum and the tenure of your home loan at the time of buying your house.

HDFC, Gruh Finance, LIC Housing Finance are some of the very well known listed Housing Finance companies, however we would like to share details with you on another Housing Finance stock i.e. **Can Fin Homes Ltd (NSE Code – CANFINHOME)** which until recently was growing at 7-8%, however the renewed focus from the management and the aggressive branch expansion promises better growth prospects for the next few years.

Can Fin Homes Ltd (NSE Code – CANFINHOME) – Promoted by Canara Bank (42.38% stake), Can Fin pre-dominantly offers loans for home purchase, home construction, home improvement/extension and site purchase as well as non-housing finance loans such as Personal loans, Child education loans, etc. Housing loans constitute ~98% of the advances of the company.

Particulars (in cr.)	FY 13	FY 12	FY 11	FY 10	FY 09
Interest Income	384.69	279.9	226.32	210.58	217.64
Net Interest Income (NII)	101.68	84.37	72.19	65.58	50.98
Profit Before Tax (PBT)	75.09	60.99	58.52	54.84	43.83
Profit After Tax (PAT)	54.12	43.76	42.01	39.19	31.53
No. of Branches	69	52	41	40	39
Loan Disbursements	1,814	859	473	547	300
Loan Book	4,016	2,674	2,207	2,106	1,887
Capital Adequacy Ratio (CAR)	15.40%*	17.40%	19.10%	17.10%	16.10%
Gross NPA (%)	0.46%	0.80%	1.10%	1.10%	
Net NPA (%)	0.00%	0.00%	0.00%	0.00%	
* - At the end of H1 FY 13					

Investment Snapshot (As on 8th May'13)

Recommendation – Buy

Portfolio Allocation Strategy –

1. Start with ~4% portfolio allocation in the range of 150-160.

Profit Booking – Refer weekly updates or get your portfolio reviewed regularly

Current Market Price – Rs 156.10

BSE Code – 511196; **NSE Code** – CANFINHOME

Bloomberg Code – CANF: IN

Market capitalization – Rs 318 cr.

Total Equity shares – 2.048 cr.

Face Value – Rs 10.00

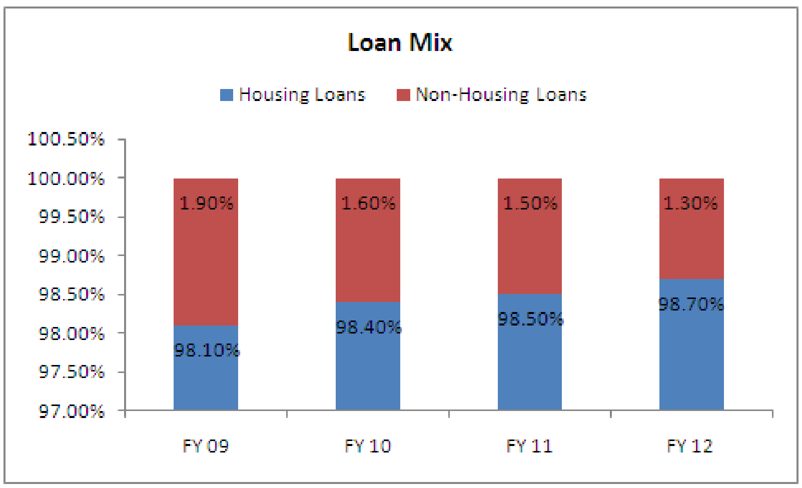
52 Weeks High/Low – Rs 187.85/ Rs 99.00

Promoter's holding – 42.38%

Can Fin Homes – Basic Details

Though you may not have seen or heard of Can Fin Homes, Canara Bank is a relatively well known bank and is the promoter of Can Fin Homes Ltd (CFHL) with 42.38% stake at the end of Mar'13.

CFHL pre-dominantly offers loans for home purchase, home construction, home improvement/extension and site purchase as well as non-housing finance loans such as Personal loans, Child education loans, etc. Housing loans constitute ~98% of the advances of the company.



Most of the branches of the company are located in South India (~65%) and that too outside cities as the company caters to individual customers requiring relatively smaller loans of up to Rs 10-15 lakhs, which are also eligible for interest subvention.

As per the various reports, about 98% of the company's loans is to individuals (salaried and self-employed) and about 2% is in the corporate segment. The company also uses a referral-based sourcing approach whereby the existing customer is incentivized for referring new customers.

We believe higher share of loans to individuals lends robustness to the asset quality of the company as owning a house is one of the basic necessities with very strong emotional value attached to it for an individual and his/her family.

Our view is also corroborated by the fact that at the end of FY 13 CFHL's Gross NPA is just 0.46% while the Net NPA is NIL.

CFHL enjoys a 5-Star rating from the National Housing Bank (NHB) for the purpose of refinance and an AA+ rating from CARE for long term financing from banks. CFHL is one among the four HFCs selected by NHB in its first phase of securitization programme.

CFHL relies on banks (67% of its total borrowings) and the NHB (26% of its total borrowings) for funding. Due to a higher proportion of lending in the semi-urban and rural areas (about 40% of the disbursements), the company gets refinancing from the NHB at competitive rates. In addition, it largely focuses on long-term borrowings with an average tenure of seven to ten years due to the relatively higher tenure of its assets.

Overview of Housing Finance Industry in India

India's housing finance industry mainly comprises banks and HFCs, and to a certain limited extent, smaller institutions such as community-based organizations, self-help groups, etc. The NHB operates as the principal agency for promoting, regulating and providing financial and other support to HFCs at local and regional levels, while banks and NBFCs are managed and regulated by the RBI. As of February 5, 2013, 56 companies have been granted certificates of registration by NHB to act as HFCs.

Historically, the housing finance industry was dominated by HFCs. However, towards the end of the 1990s, the scheduled commercial banks became very active in lending to the housing sector in the backdrop of lower interest rates, rising disposable incomes, stable property prices and fiscal incentives by the government.

While banks depend on their own equity and reserves and large deposit base for funding their housing loan portfolios, HFCs primarily depend on funding sources such as loans from banks and financial institutions, financing from NHB, borrowing through bonds and debentures, commercial paper, subordinate debt and fixed deposits from public, besides their own equity and reserves.

Increased competition in the housing finance industry has led to the introduction of new mortgage products in the market, such as variable interest rate loans, loan for repairs and renovation, and customized products with features like ballooning EMI, depending on the need and eligibility of the borrowers concerned.

Key trends in Housing Finance Industry in India

Disbursements – As per CRISIL estimates, housing finance disbursements are estimated to have grown by around 16.1% in FY 2012 to Rs 2,044 billion (as compared with Rs 1,760 billion in Fiscal 2011). Over the next 5 years, housing finance disbursements are projected to grow at a CAGR of 16% to reach Rs 4,269 billion by Fiscal 2017.

Increase in transaction volumes, rise in property prices and higher loan to value ("LTV") ratios are some of the key drivers behind the growth in disbursements in the housing finance industry.

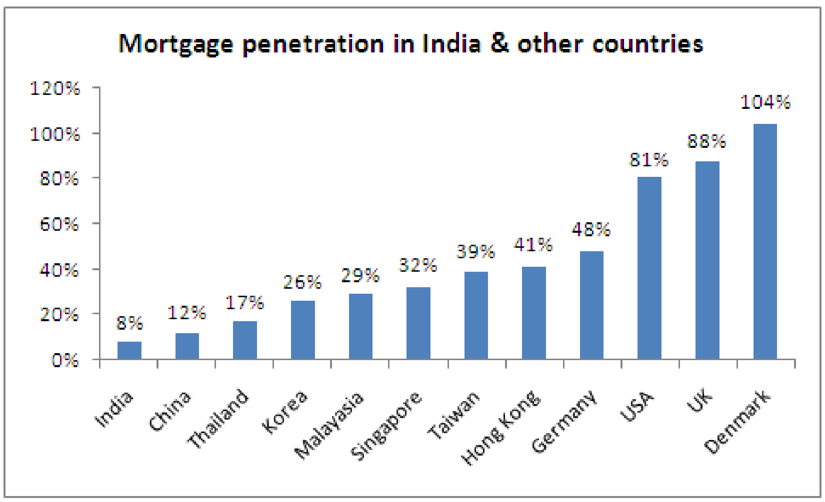
Outstanding Loans – The quantum of outstanding loans is impacted by a combination of disbursements, repayments and pre-payments. As per CRISIL estimates, housing finance outstanding portfolio, i.e. the total loan book of a housing finance player, grew by around 19% Y-o-Y in Fiscal 2012 (to Rs 6,150.5 billion as compared with RS 5,173.6 billion in Fiscal 2011), due to a steady growth in disbursements and lower prepayments.

The housing finance outstanding portfolio is expected to grow at a CAGR of 17% to reach Rs 13,602.8 billion in Fiscal 2017.

HFCs gaining market share – Over the years, the market share of housing finance companies (HFCs) has significantly improved vis-à-vis banks on account of robust growth in disbursements of the former. In recent times, with slowdown in corporate credit, banks are aggressively focusing and competing with HFCs in the home loan segment. However, with strong origination skills and diverse channels of sourcing business, HFCs will continue to gain market share.

Focus on salaried segment, self-employed borrowers ignored – Historically banks and HFCs have largely focused on the salaried class, as can be seen by the fact that salaried borrowers account for 80-85% of the total outstanding loans. The key reason behind this skew towards the salaried segment is the ease in validating the income levels and the repayment capabilities vis-à-vis self-employed persons. Further, lenders have traditionally viewed the salaried segment as one with stable cash flows and, hence, consider it as lower risk.

Demand for Housing loans is here to stay



Mortgage penetration levels i.e. mortgage loans as a percentage of Gross Domestic Product (GDP) is around 7.25% of India's GDP as compared with 12% in China, 17% in Thailand and 29% in Malaysia. In developed countries across the world, this ratio is closer to 70-80% and the market is close to saturation.

Thus, there is huge potential for growth in this segment which will benefit Housing finance companies and commercial banks. But, are high interest rates, courtesy the RBIs aggressive liquidity policy holding back demand for new homes.

Well, according to Mr. Keki Mistry, the MD of HDFC, this is not the case. He believes that for the Indian middle class interest rates do not matter as much as affordability of housing. Another factor that helps determine growth is demographics. In western countries, people in their late 20s buy their own houses. In India, the average age of a customer applying for a loan ranges somewhere in the mid to late 30s. Almost 60% of India's population is below 30 years of age. Within the next 5 to 15 years all these people will need houses and hence housing loans. Presently urban India's shortage of housing amounts to 26.53 million units. Additionally, rapid urbanization is taking place across India. All these factors combined lead to the suggestion that there are ample opportunities for home loans.

The biggest question for home buyers is whether the real estate market is in for a correction. Well, while there is some correction possible in a few pockets of metro cities, overall demand is here to stay especially in tier 2 & 3 cities. At the same time, infrastructure and transport facilities in and between cities need improvement for the demand to catch up elsewhere.

Also, the focus has now shifted to affordable housing, albeit partially and is relatively more stable in terms of growth. With better pricing, India's favorable demographics and low penetration we believe that growth in housing industry will continue to see good traction over the long term.

Further, the Government of India in its Budget for the year 2012-13 extended the scheme of interest subvention of 1% for one more year on housing loans up to Rs 1,500,000 where the cost of the house does not exceed Rs 2,500,000 is a welcome measure as it gives relief to the home loan borrowers of the eligible category.

Housing demand in South India

CFHL has a very strong presence in South with 16% of its branches in Bangalore and 65% in south India and has plans to expand further over there. Hence, the company's growth prospects are directly linked to the growth of the economy, real estate and thereby housing loans demand in South India.

Southern states of India have been major driver of growth in the last decade. With a 20% representation of the country's total population, these states have become centres of manufacturing industries such as textiles, automobiles, defense, aerospace and pharmaceuticals, apart from the progress in IT/ITES sector. The aggregate gross domestic product of Tamil Nadu, Andhra Pradesh, Karnataka, Kerala and Puducherry contributes to nearly 22% of the GDP of all states put together.

As far as real estate is concerned, Southern India has for long been the silent crusader, building and strengthening its real estate development as one of the most sought after destination in the country. Be it the commercial advantage of Bangalore, infrastructural progress in Hyderabad, industrial and residential highlights of Chennai or the emergence of upcoming cities such as Kochi, Coimbatore, Vishakapatnam and Mysore – the region has persistently strived for setting new milestones in the course of its development.

Jones Lang LaSalle carried out Real estate transparency study across 20 major Indian cities during 2011 and marked each city on five core components that include – Availability of market information, Reforms in Urban Local Bodies (ULBs), Progressive Business Environment, Inclusive and Sustainable Development and Protection of Property Rights. True to the character of each of the Southern cities, the findings of the analysis revealed that the three southern states of Andhra Pradesh, Tamil Nadu and Karnataka featured in the top ten ranks across each of the parameters which is indicative of the fact that the environment for real estate development is much more conducive in Southern states than across others.

Real Estate Transparency of Southern States

	Andhra Pradesh	Tamil Nadu	Karnataka
IRETI 2011	1	2	6
Inclusive and Sustainable Development	4	2	9
Protection of Property Rights	2	3	9
Progressive Business Environment	1	9	7
Reforms by Urban Local Bodies	3	2	5
Availability of Market information	5	2	4

Source: Indian Real Estate Transparency Index (IRETI) 2011, JLL

As far as residential markets of South Indian cities are concerned, they have remained resilient in the past few quarters, relative to the significant decline recorded in the sales volume of Mumbai and NCR. While India's residential market continues to be dominated by the huge supply in the North (NCR) and the West regions, the Southern cities have ensured a tough competition through its contribution to new launches in the past few quarters.

Lateral entry of developers from the neighboring states within the region has been a prominent trend in the Southern residential markets, which is not prevalent in other regions of the country.

The geographic expanse of each of the capital cities in South India, rising migrant population with increasing job opportunities, timely implementation of physical infrastructure initiatives in the form of road and rail networks have helped the attractiveness of the region as a favorable residential market.

Further, the fact that the developers have adopted a cautious pricing strategy (major share of the launches priced at less than Rs 4,000 per sq. ft.) since the downturn during end-2008 along with a much streamlined supply has led to a steady rise in absorption rates in the past few quarters.

Bangalore property market: Driven by end-users – As per the report published in Economic Times on 16th Oct'12, Bangalore has been reporting very strong off-take in residential real estate volumes on the back of greater percentage of end users among buyers than in other cities and a relatively moderate price escalation.

As per the property research firm PropEquity, in Q1 FY 13, 15.58 million sq ft of residential space was sold in the city, giving it a total market share of 13.9% and beating other domestic markets in homes sales.

Bangalore and other cities in South India are also leading in terms of loan disbursements and sanctions. In 2011-12, the southern cities including Bangalore contributed nearly 40% to the country's home loan disbursals of Rs 1.95 lakh crore.

The IT capital of India has also moved up the ladder to become the tenth most preferred place in the list of top global investment destinations while Mumbai and New Delhi fell to 15th and 12th places from third and fifth during the same period, as per Urban Land Institute and Price Waterhouse Cooper.

Private equity investors perceive Bangalore market more steady as demand is driven by end users. Some of the private equity transaction that were closed recently include Baring Private Equity Partners India's Rs 500 crore deal with Bangalore-based RMZ Corp, Red Fort Capital's Rs 200 crore investment with Prestige Group, Xander's Rs 150 crore investment in Mantri Developers retail project and Government of Singapore Investment Corporation's Rs 105 crore investment in the Brigade Enterprise-HUL land deal.

Performance Snapshot

Particulars (in cr.)	FY 13	FY 12	FY 11	FY 10	FY 09	FY 08
Interest Income	**384.69**	**279.9**	**226.32**	**210.58**	**217.64**	**217.07**
Fees & Other charges	8.00	6.93	4.97	5.86	5.27	4.40
Total Income from Operations	**392.69**	**286.83**	**231.29**	**216.44**	**222.91**	**221.47**
Finance Cost	283.01	195.53	154.13	145.00	166.66	170.75
Net Interest Income	**101.68**	**84.37**	**72.19**	**65.58**	**50.98**	**46.32**
Operating expenses & Depreciation	35.97	22.98	17.2	16.6	12.42	13.0
Provisions	-1.38	7.33	1.45	0	0	0
Profit Before tax	**75.09**	**60.99**	**58.52**	**54.84**	**43.83**	**37.68**
Tax	20.97	17.21	16.5	15.65	12.31	9.28
Profit After tax	**54.12**	**43.76**	**42.01**	**39.19**	**31.53**	**28.4**

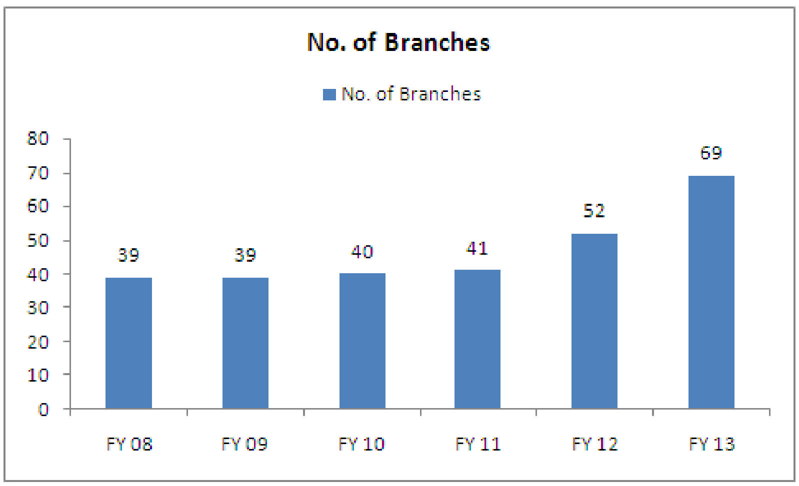
As can be observed from the above illustration, the interest income of Can Fin Homes recorded a growth of 30.5% on annualized basis (226.32 crore to 384.69 crore) from FY 2011-2013; however the Net Interest Income (NII) recorded 18.5% CAGR (72.19 crore to 101.68 crore) during the same period due to consistently rising interest rates and the company's inability to pass it all in the competitive environment.

However, over the next 2-3 years, we expect the interest cost to decline. Recently in September 2012, National Housing Bank (NHB) signaled a reduction in interest rates for housing finance companies (HFCs) by reducing its prime lending rate from 10.5% to 10% and its CMD mentioned that in future there could be more such cuts to prop up the demand in the industry.

CFHL derives 67% of its funding from banks and 26% from NHB. Moderation in interest rates would directly reduce re-finance cost of CFHL and will further strengthen NII growth of the company as it is unlikely to pass the benefit to its customers in one go. Hence the proportion of decrease in the average yield on advances is likely to be lower than the decrease in the average cost of funds for CFHL.

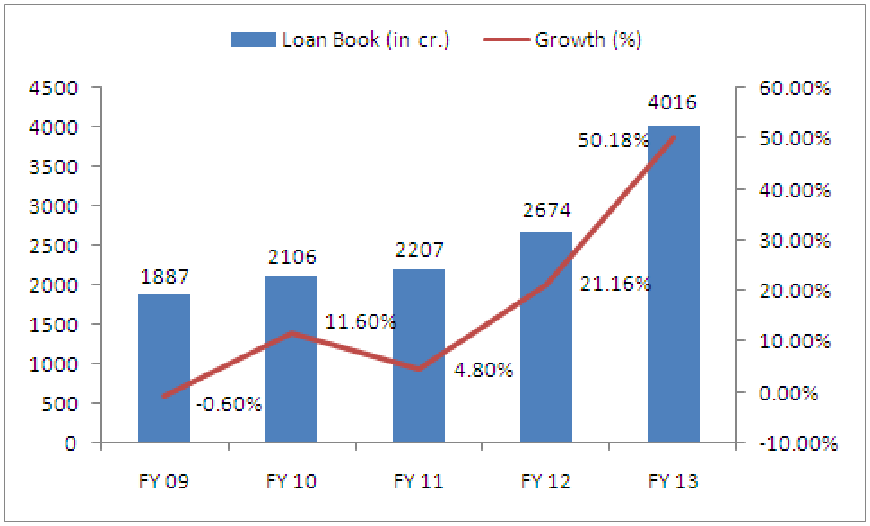
We therefore expect Net Interest Income of the company to record 20-22% CAGR between FY 13-15 and net interest margins to settle at around 3%.

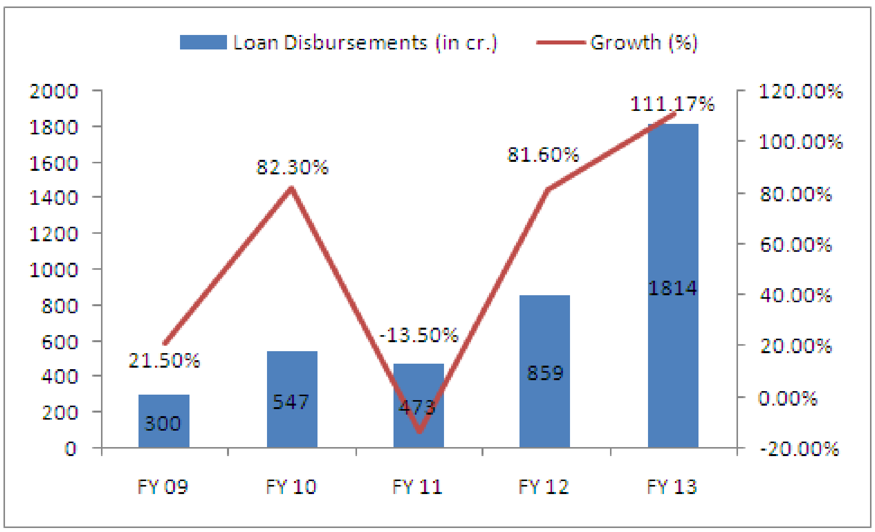
Is sluggish growth of Can Fin a thing of past – Until 2010-11, Can Fin had been recording a steady but a slow growth rate of 7-8% annually; however appointment of Mr. C. Ilango as the MD of the company in Apr'11 has probably infused optimism and aggression in the company, as the company has been aggressively rolling out branches, disbursing loans and thereby growing its loan book at a decent pace since the last 2 years.



As can be observed from the above illustration, the company added just 2 branches between FY 08 and FY 11; however since FY 11 it has added 28 branches in just 2 years.

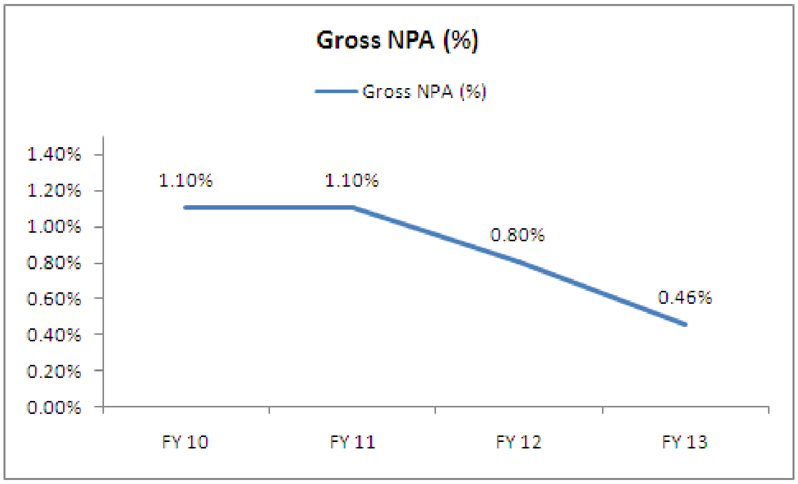
Roll out of new branches in new locations has also resulted in substantial improvement in disbursements and thereby the loan book of the company.





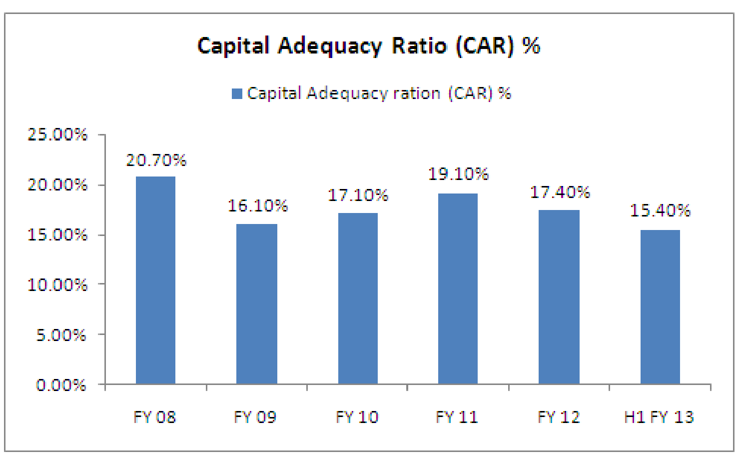
From FY 08 to FY 11, the loan book of the company recorded just 5.2% CAGR to grow from Rs 1899.5 crores to Rs 2207 crores; however since then it's been a complete turnaround with loan book of the company recording 34.9% CAGR between FY 11 and FY 13. We believe the company's increasing focus on growth and recent aggressive expansion of its branch network has put it on a high growth path for the next few years. The moderation in the interest rates is likely to increase demand for fresh loans and enable CFHL to maintain its growth momentum in the loan disbursements.

Asset Quality – As mentioned in the opening sections of this report, about 98% of the company's loans is to individuals (salaried and self-employed) and about 2% is in the corporate segment. Higher contribution of retail loans lends robustness to the asset quality of the company as the recovery rate is high in retail loans as compared to developer loans.



At the same time, the recovery efforts of the company have been effective in bringing down the absolute levels of Gross NPA from ~ Rs 24 crores in FY 11 to Rs 15.66 crores at the end of FY 13. The Net NPA of the company is **NIL**.

Capital adequacy (CAR): Well above the prescribed level of 12% – NHB prescribes 12% as the minimum capital adequacy ratio for the Housing Finance companies and for the last 4-5 years Can Fin has consistently been able to maintain its CAR above 15%.



However, with the strong growth recorded by the company in the last 2 years, its CAR has reduced from 19% at the end of FY 11 to around 15% at the end of FY 13. At the moment there's sufficient cushion over NHBs prescribed 12%, however we believe that by mid FY 15 the company may have to dilute its equity to raise funds to maintain its growth rate.

Peer Comparison

Particulars (FY 13)	Can Fin	LIC Housing	Dewan Housing	GIC Housing	Gruh Finance
ROAE	14.63%	17.11%	17.14%	16.22%	33.28%
Cost to Income ratio	32.80%	22.13%	40.18%	37.87%	20.01%
Net Interest margins*	3.00%	2.20%	2.60%	2.70%	4.70%
Gross NPA Ratio	0.46%	0.60%*	0.60%*	2.10%*	0.32%
Net NPA Ratio	0.00%	0.30%*	0.00%*	0.00%*	0.00%
CMP	143.3	261.95	167.75	111.55	234.4
Book Value per share (Rs)	191.44	129.46	252.46	102.26	27.51
P/BV	0.75	2.02	0.66	1.09	8.52
P/E	5.43	12.91	4.38	7.06	28.73

* - Source: HDFC Securities

As can be observed from the above illustration, Can Fin commands lowest valuations amongst all its peers at P/BV of 0.75 (There are certain corporate governance issues with Dewan Housing and therefore very low valuations).

The valuations of Can Fin are low because it delivered poor growth in comparison to all the above companies before FY 11 and it's only for the last 2 years that the company has been reporting strong growth. However, Can Fin's performance on other parameters such as asset quality, net interest margins, operational efficiency, and return on equity has been better or at par with other companies.

We believe, if the company is able to maintain the growth momentum for the next 2 years or more, there's a very strong case for re-rating of the company from current P/BV range of 0.7-0.8 to around 1.00-1.25.

If the company delivers 18% CAGR in book value for the next 2 years and the stock gets re-rated to 1.1 times book value, the stock price will be Rs 293 i.e. 37% annually compounded return. The above scenario is hypothetical, however at the same time it is highly probable as well.

Shareholding pattern

	Mar'13	Dec'12	Sep'12	Jun'12	Mar'12
Promoter and Promoter Group	**42.38%**	**42.38%**	**42.38%**	**42.38%**	**42.38%**
India	42.38%	42.38%	42.38%	42.38%	42.38%
Foreign					
Public	**57.62%**	**57.62%**	**57.62%**	**57.62%**	**57.62%**
Institutions	1.26%	1.49%	5.04%	5.04%	5.04%
FII	0.62%	0.62%	0.62%	0.62%	0.62%
DII	0.64%	0.87%	4.42%	4.42%	4.42%
Non-Institutions	56.36%	56.13%	52.58%	52.58%	52.58%
Bodies Corporate	25.51%	25.10%	21.89%	21.86%	21.14%
Custodians					
Total	**2,04,85,250**	**2,04,85,250**	**2,04,85,250**	**2,04,85,250**	**2,04,85,250**

Can Fin Homes Ltd (CFHL) was promoted in 1987 by Canara Bank in association with reputed financial institutions including HDFC and UTI.

Can Fin is the first bank sponsored HFC in India and Canara Bank holds 42.4% stake in the same.

Dividend Policy

Dividend Payout ratio						
	Mar'08	Mar'09	Mar'10	Mar'11	Mar'12	Mar'13
Dividend Payout ratio	18.03%	13.00%	10.46%	12.18%	14.01%	15.15%

CFHL has consistently been distributing ~14-15% of its net profit in the form of dividends. Till FY 05, the dividend payout used to be 23-25%, however from FY 05 to FY 10 the company reduced the dividend payout as it could not deliver much growth in profitability.

Since FY 11, the company has again started increasing dividend payout with 15% dividend payout for FY 13.

We believe 15% dividend payout is apt for a company like Can Fin as at the end of the day we would also not want the company to dilute its equity very frequently to maintain the capital adequacy ratio above 12%.

Risks & Concerns

CFHL draws its top management through deputation from the parent organization and also witnesses frequent change in the MD of the company. We believe, Mr. Ilango, the current MD of the company has been instrumental in infusing the much needed aggressiveness and thereby propelling the company on the path of fast growth. If he gets replaced by someone else, the company may again fall back on the path of tepid growth.

Growth of IT Industry has been one of the major contributing factors in the growth of real estate market in South India. Any slowdown in IT industry will have its ramifications on the housing industry as well.

The problem of inflation has been lurking for some time now. Considering the slowdown in the overall economy it is unlikely that RBI will again raise interest rates, however the interest rates are still high and if they remain stable at current levels for long the demand for real estate and thereby housing loans may get impacted.

Katalyst Wealth – Alpha/Alpha + Portfolio

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Katalyst Wealth **Alpha/Alpha + Portfolio** service is focused on helping individual investors/institutions beat market returns by a wide margin without taking large risks through in-depth research, analysis and follow up on the stock.

For more information on **Can Fin Homes Ltd**, discuss with **Ekansh Mittal**

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