SECTOR RESEARCH

HOUSING FINANCE

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HFCs redefining their business model to revive growth in FY21

Financial Sector Analysis

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Executive Summary

After witnessing steadfast growth of over 20 per cent in 2014-18, lending by housing finance companies (HFCs) considerably dropped in the second half of fiscal 2019 to less than 10 per cent. This sharp decline was a result of the sector undergoing a severe bout of liquidity crisis as investor confidence dipped post September 2018. Funding to the sector was impaired, and atleast two large HFCs virtually stopped fresh disbursements. Moreover, the slowdown in housing sales further skewed demand for mortgage loans. As traditional borrowing routes of term lending from banks and capital market borrowings shrank, HFCs had to switch to loan securitisation, which witnessed an unprecedented rise in fiscal 2019 and 2020, to manage liquidity and ALM challenges.

As we approach the last leg of fiscal 2020, the funding situation remains fairly grim for HFCs, thereby impacting their loan book growth, estimated at ~2 per cent for the current fiscal. However, with the government and RBI taking steps to improve credit availability in the system, HFCs are expected to return to their growth path in fiscal 2021. We expect loan growth for the HFCs at 10-12 per cent in fiscal 2021 as players redefine their business models in terms of reducing reliance on short-term borrowings, continuing a steady pace on loan securitisation and adopting new strategies such as co-lending with banks. Adopting the co-lending model can be a win-win situation for all stakeholders. Banks can leverage HFCs' geographic reach and benefit from their origination and servicing capabilities without incurring much additional operating cost. Furthermore, HFCs will get access to better-profile clients, require lower capital for deployment, and improve liquidity and profitability, given the fee-based nature of the business.

While HFCs are recreating their business models, asset quality has taken a hit mainly in the non-housing segments. NPAs have witnessed an upward movement owing to stress in the wholesale loan portfolio, predominantly the builder and loan against property (LAP) segments. With realtors still struggling to get refinance, and the lender/investor community shutting-down the funding tap, stress in the real estate sector adversely impacted the asset quality of HFCs. This is expected to deteriorate further in fiscal 2021 due to stress in the developer loan segment as they are piling on a huge quantum of unsold inventory in the market.

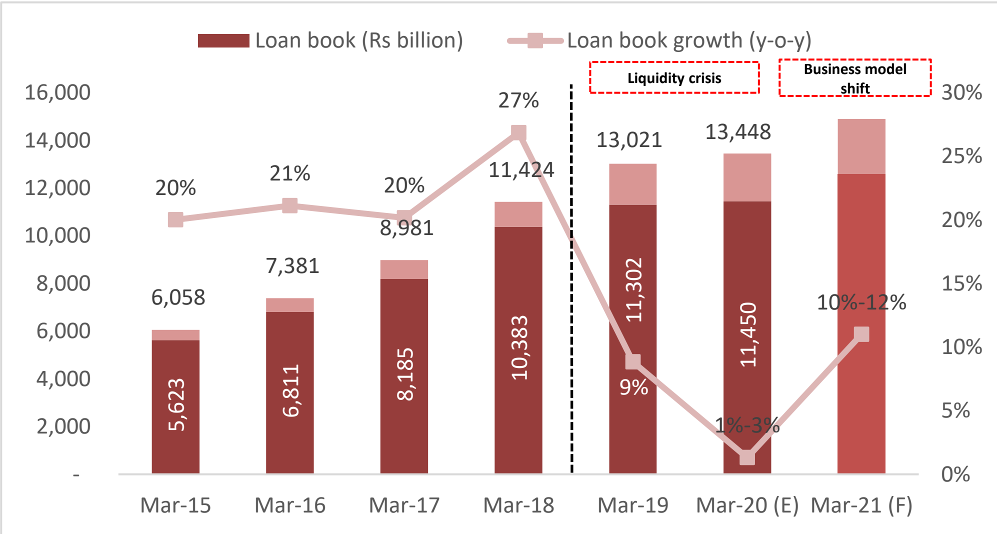
Profitability in fiscal 2021 will continue to be impacted on account of multiple factors. On the asset side, high-yielding products such as builder and LAP loans will be replaced to some extent by relatively lower yield products like affordable housing loans and home loans to self-employed customers. On the liability side, as players reduce their reliance on short-term borrowings, the cost of borrowings is expected to rise. These two factors are expected to result in lower NIMs for HFCs. Furthermore, an increase in NPA levels would result in higher provisioning costs. However, the adoption of the co-lending model could offset some of these concerns over the medium term HFCs' ability to manage asset quality and liquidity, reshape their balance sheets and co-exist with banks will largely determine their sustenance over the medium to long term.

Liquidity constraint halts growth momentum for HFCs; business model to undergo shift in FY21 to revive growth

The housing finance industry has grown at a healthy pace in the past few years, supported by growing demand from the populace owing to economic and social development, the government's consistent focus on promoting housing and a benign regulatory environment encouraging growth. Favourable industry dynamics, such as a growing population, low mortgage penetration, rising affordability and the increasing nuclearisation of families, also contributed to the loan book growth of HFCs in the past decade.

HFCs grew at a CAGR of over 20 per cent during 2013-18. Growth and profitability during this period were fuelled by increased lending to high-risk high-yield products such as LAP and builder loans on the assets side. Moreover, on the liability side, the share of short-term borrowings was on the rise.

Trend in AUM & loan book growth of HFCs



E: Estimate, F: Forecast
Note: The growth rate has significantly decreased due to a halt in fresh disbursements from a few large HFCs in FY20. Excluding a couple of these entities, loan book growth would have been close to 9-11% in FY20.
Source: NHB, BWR Research

Following the IL&FS fiasco in September 2018, the lender/ investor community became wary of lending to non-banks, especially to standalone entities with exposure to wholesale lending or wherein the asset-liability mismatch was relatively high with a limited liquidity cushion. These issues resulted in investors losing confidence and funding lines fizzling-out from capital markets and banks. Mutual funds, the major subscribers of non-convertible debentures (NCDs) and commercial papers (CPs) issued by HFCs, refrained from investing in these securities. Furthermore, after the IL&FS default, banks, the largest lenders to HFCs, also turned cautious, leading to a severe liquidity crunch for many HFCs. Smaller HFCs were impacted much more than bigger players were, which resulted in de-growth in the loan portfolio.

This situation further deteriorated in fiscal 2020 as atleast two large HFCs virtually stopped fresh loan disbursements; the slowdown in housing sales further impacted demand for credit during the year, keeping loan growth for HFCs muted.

In fiscal 2021, we expect HFCs to return to their path of growth, given that the players are redefining their business models in terms of reducing exposure to wholesale lending, reliance on short-term borrowings, a higher quantum of securitisation and exploring co-lending with banks. Additionally, government measures in terms of a partial credit guarantee scheme to improve liquidity and support the affordable housing segment will further accelerate growth.

Affordable housing disbursements also impacted but still grew at a healthy pace

Affordable housing, which accounts for roughly 15 per cent of the overall portfolio of HFCs, continued to grow in double digits (10-12 per cent) in fiscal 2019 and 2020; however growth has certainly decelerated from a rate of above 20 per cent in fiscal 2018. Tier 2 and Tier 3 cities are the major growth drivers, especially in western and southern regions.

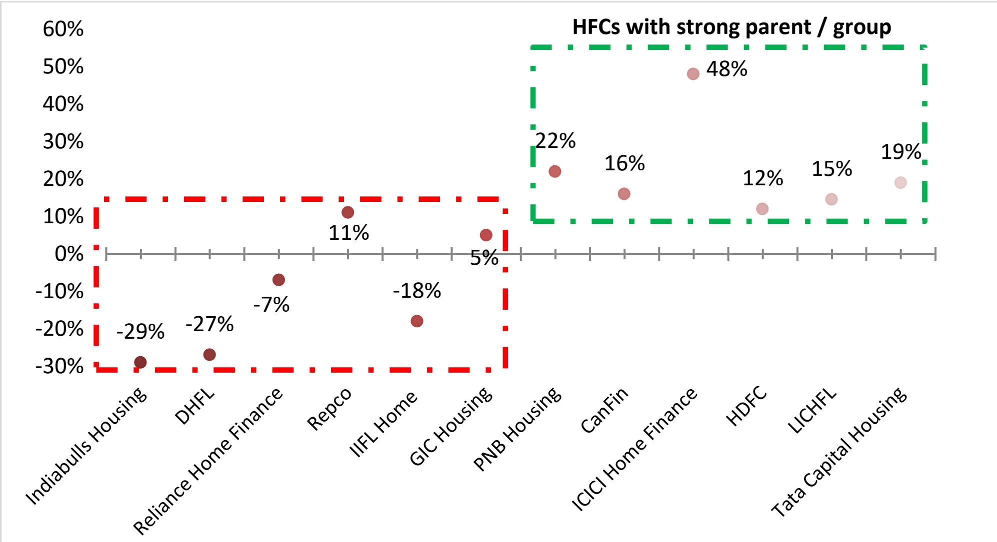
This segment will continue to witness healthy growth in the range of 15-20 per cent in fiscal 2021, assuming liquidity issues are sorted. Furthermore, demand for low-cost housing in the market remains high and will provide required impetus to drive growth in the segment with the government push to affordable housing through the budget announcements.

HFCs with a strong parent outpace other HFCs; small HFCs worst-affected by liquidity crunch

HFCs having strong parentage (either bank or public sector undertaking or large conglomerate group) have recorded faster growth than other HFCs have in the first half of fiscal 2020 as they continued to receive funds when market borrowings had dried up. These HFCs were also able to sell-down their portfolio easily as the backing parent was mostly a bank that was also an investor for such instruments.

HFCs with a strong parent, especially backed by a bank, have been insulated from liquidity shocks faced by the sector. These companies continued to grow their books; however, economic slowdown and issues in the real estate sector restricted growth to some extent.

Loan portfolio growth – H1 FY20



Source: Company Report, BWR Research

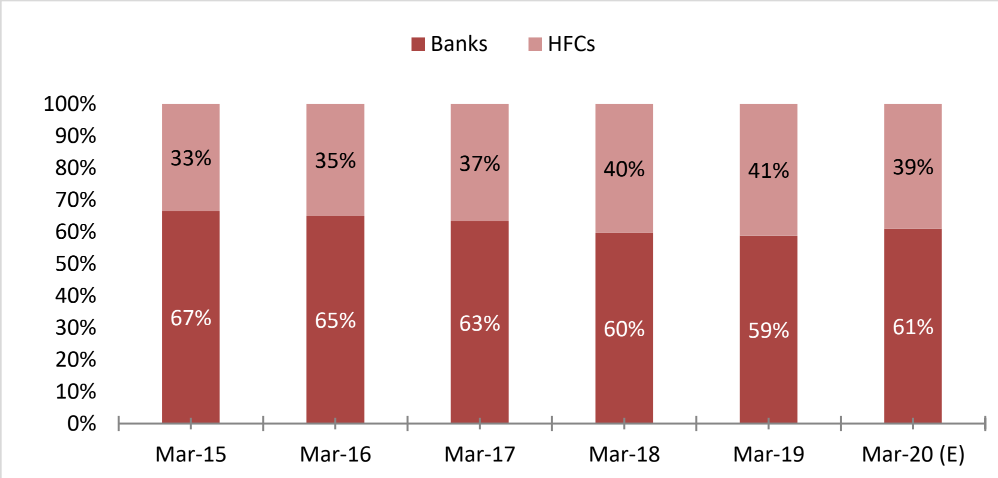
Other HFCs, especially smaller ones, struggle to get funds from the market and banks, resulting in disbursements being curbed and portfolio sell downs to meet funding requirements.

HFCs growing prominence in housing finance market halted

Banks are the largest housing credit lenders in India and accounted for ~60 per cent of the market as of March 2019. However, their market share declined from ~70 per cent in March 2014 as HFCs gained share on the strength of its service proposition of fast turnaround time, coupled with a narrowing price difference between banks and HFCs and presence in relatively high-growth segments such as affordable housing and self-employed customers.

HFCs have gained market share from banks over the years on account of their extensive reach and better customer service. However, spurred by the liquidity crisis, banks have regained their share as HFCs slowed-down their disbursements to maintain adequate liquidity to fulfil their liabilities.

Share of banks and HFCs in housing loan

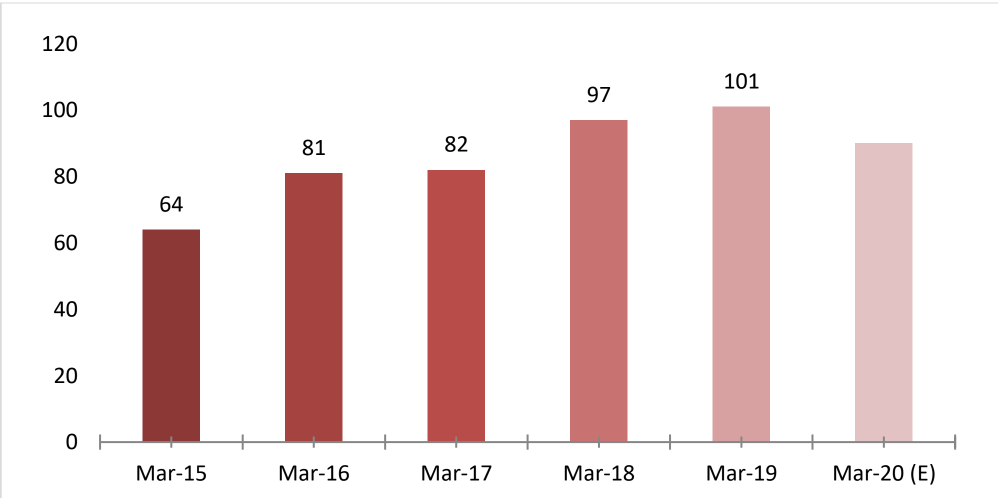


E: Estimate
Source: RBI, NHB, BWR Research

The last one year of liquidity crunch has halted HFCs' growth momentum and banks were able to capitalise and increase their market share in fiscal 2020. Going forward, banks' share is expected to increase further owing to the increased adoption of the co-lending model in the industry.

This growth potential has resulted in more players entering the market. The past couple of years have witnessed a large influx of new players, with the number of HFCs reaching 101 as of March 2019.

Number of registered HFCs



Source: NHB, BWR Research

HFCs redefining business models to revive growth

The funding crisis faced by HFCs has been prolonging for over 15 months. The market place, along with investors and lenders, is now keen on HFCs reducing their excessive use of short-term borrowings to create long-term assets and correct their asset-liability mismatches before resuming investing in/lending to them. This has given rise to a liquidity crisis in the industry. HFCs are opting for securitisation to reduce their proportion of short-term borrowings. Furthermore, growth and profitability were historically fuelled by increasing exposure to high-yield products such as LAP and builder loans. This strategy had a dampening effect on asset quality as these products have higher delinquencies in times of distress. HFCs are now facing a double whammy of lower dependence on cheaper short-term borrowings and reduced exposure to such high-yielding products, resulting in decline in profitability.

To offset the impact on profitability and revive business, HFCs are now exploring alternate routes, such as co-origination and portfolio sell downs. While sell downs accelerated in fiscal 2019, co-lending has also started gaining traction in the current fiscal. With the introduction of the co-lending model, HFCs facilitate the origination and collection of the housing loan, and banks provide the balance sheet strength to house the major portion of the loan (80 per cent in bank's balance sheet and 20 per cent in that of the HFC). This model is in its early stage of adoption, and a few tie-ups have already happened between banks and HFCs. The major challenge is integrating the credit and risk management systems and processes of partner banks and HFCs.

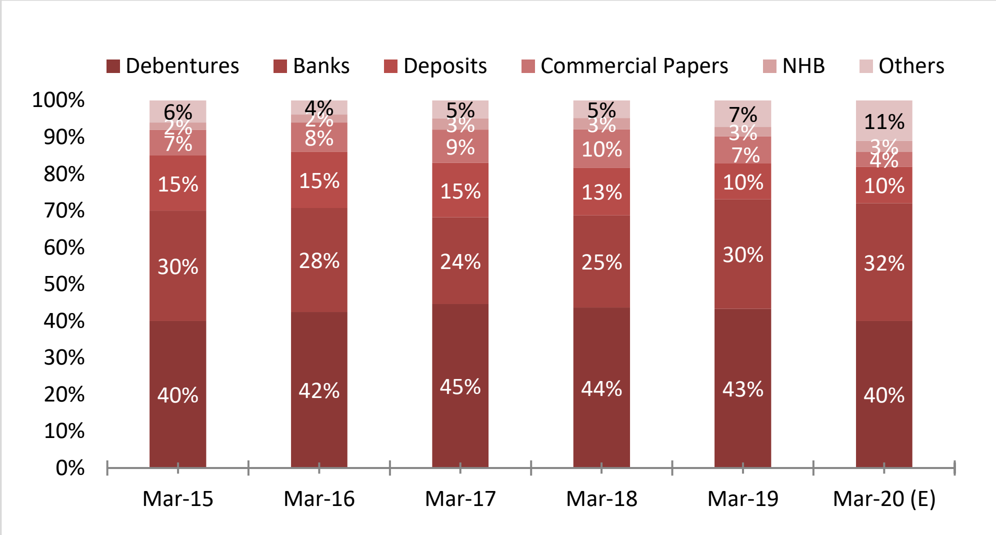
HFCs had excessively used the short-term funding route and raised funds through a large quantum of commercial papers (CPs) and short-term non-convertible debentures (NCDs) in the recent years. As these companies were raising money through short-term debt and were lending credit to longer-term projects, it led to asset liability mismatches and liquidity issues, given the impending maturity of CPs and NCDs.

The adoption of the co-lending business model can be a win-win situation for all participants. Banks can leverage the geographic reach of HFCs, along with their origination and servicing capabilities, without incurring significant additional operating costs. HFCs can maintain higher liquidity, better manage their ALM profile and generate higher profitability due to the fee-based nature of the business. The biggest advantage for HFCs will be that it will require lesser capital deployment, and the credit cost could be lower as HFCs will now have access to a better profile of customers who have traditionally always been with banks.

With shrinking market borrowings, HFCs opting for securitisation to redeem debt and build liquidity

For HFCs, close to 30 per cent of their funding is from bank loans, and 40 per cent is from debentures and commercial papers. HFCs faced challenges in fiscal 2019, raising funds from the capital market and banks as banks have become conservative in lending to these companies after the IL&FS imbroglio and DHFL's financial stress. Furthermore, funds from markets have shrunken as mutual fund houses are not keen on placing their money in instruments issued by HFCs due to the risk of asset liability mismatches.

Trend in funding profile of HFCs



Note: Others include securitisation and ECBs

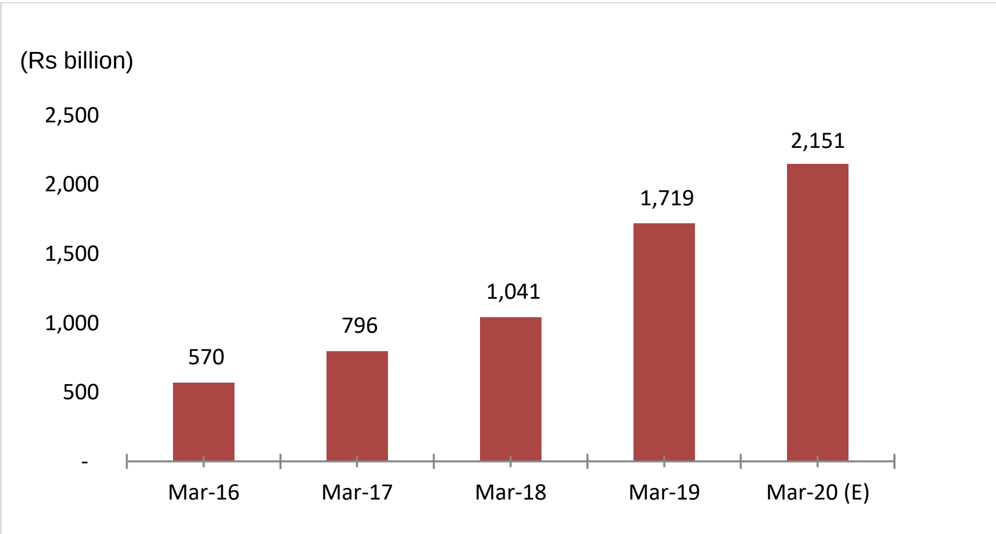
E: Estimate

Source: NHB, BWR Research

HFCs have obtained a large portion of their funding in the second half of FY19 and FY20 through the securitisation route. These securitisation transactions were generally via direct assignments (DAs) primarily to banks.

As the traditional borrowing route for HFCs in the form of bank loans, bond issuances and commercial paper issuances has dried-up, an unprecedented increase is being witnessed in the securitisation of loan portfolios to manage liquidity and ALM challenges. The overall securitised loans outstanding of HFCs is estimated to cross Rs 2 lakh crore in fiscal 2020.

Trend in securitised loans outstanding of HFCs



E: Estimated

Source: NHB, BWR Research

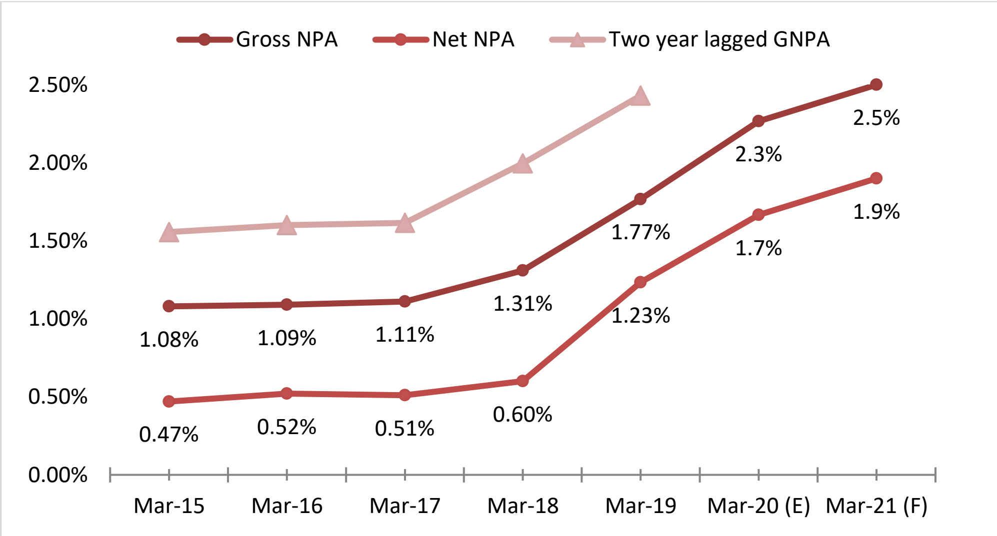
Asset quality could deteriorate further in FY21 owing to stress in real estate sector

The gross non-performing assets (GNPAs) ratio for the overall housing finance sector witnessed an upward trend over the last three fiscals, with a higher upsurge in fiscal 2019. GNPAs in fiscal 2019 increased to 1.77 per cent from 1.31 per cent in fiscal 2018. The highest impact was seen in the wholesale loan book of HFCs, predominantly the LAP and builder loan portfolio. While the GNPAs for retail home loans were less than 1.0 per cent, the LAP and builder loans GNPA was around 4 per cent at the end of fiscal 2019.

Increasing exposure to non-housing loans had a dampening effect on the asset quality of HFCs. With the economic slowdown, coupled with stalled projects in the real estate space, the asset quality of HFCs particularly in the builder loan portfolio will be a cause of concern.

HFCs have also grown their portfolios in the massive untapped market of affordable housing. This focus on small-ticket-size loans, along with increased lending to self-employed borrowers, has led to an increase in NPA levels in retail home loans as well.

Trend in asset quality of HFCs



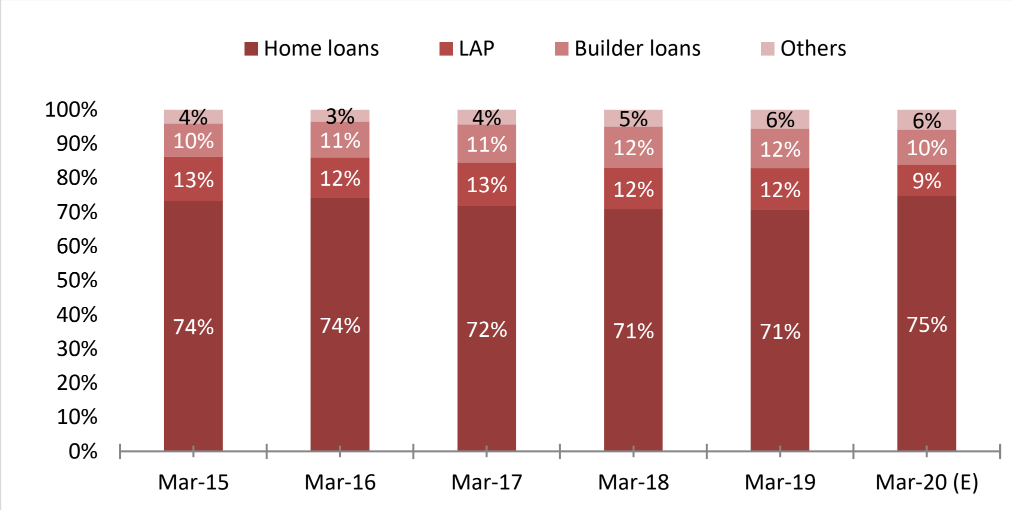
E: Estimate, F: Forecast

Source: NHB, BWR Research

The asset quality is expected to deteriorate further due to stress in the builder loan and LAP segment. The builder loan portfolio has been witnessing severe stress due to refinancing challenges and also a huge inventory of unsold homes stock in the market. While the government is taking measures to support the sector, until demand revives, this will not yield desired results. Moreover, NPAs in the LAP segment have also been under pressure due to stress in the SME sector, which is the main borrowers' segment for LAP products.

While HFCs are pruning their proportion of LAP and builder loan in the overall loan portfolio, hence the same is estimated to come down in fiscal 2020 and fiscal 2021, HFCs will have to prudently manage the outstanding loans in these portfolios to avoid any large delinquencies.

Segmental breakup of loan book



E: Estimate

Source: NHB, BWR Research

Now with the regulation of HFCs being passed over to the RBI, stricter asset quality reviews are expected. HFCs are taking necessary slowdown in loan disbursements to the wholesale segment and are increasingly focusing on granular retail lending. Considering these two factors, the asset quality of HFCs is set to improve over the medium to long term.

Suggestions to ease stress in real estate sector –

Demand side issues remain unaddressed….

The Government of India's announcement of establishing an Alternate Investment Fund (AIF) worth INR 250 billion that is aimed at priority debt financing for the completion of stalled housing projects in the affordable and middle-income housing sector will go a long way in providing much-needed relief to developers having funding requirements. It will also provide relief to homebuyers having investments in these projects. However, on a broader level, this may not completely address the urgent need of the sector plagued by huge unsold inventories.

The need of the hour is to stimulate demand among homebuyers, which itself would then provide cash in the hands of developers to finish other stalled projects. In fact, the completion of these projects will only add to the already huge pile of unsold apartments to the tune of ~4.5 lakh units (Source: Knight Frank); this problem is lesser in the affordable housing segment. The answer may lie in a leaf taken out of the negative interest rate mortgages being handed-out by banks in Europe. India should look at offering home loans on completed projects or projects being completed in the next six months at a much discounted rates of 2-4 per cent. The subvention will need to be provided by lenders in these projects and the government. The moral hazard of bailing-out developers can be avoided by linking the subvention to price cuts being offered by developers to get their skin in this scheme.

In lieu of the discount provided by lenders, they will get prime borrowers, resulting in low default rates. This will result in the developers otherwise in default or likely to default to see an improvement in their credit profile, thereby resolving stress. With this, the government will also address issues related to growth in linked sectors, ultimately kick-starting the economic growth engine.

Multiple factors to impact HFCs profitability going forward

After September 2018, the cost of borrowings increased due to a liquidity crunch in the market and accordingly, companies raised their lending rates to maintain the same spread. The situation prevailed in fiscal 2020 as well with respect to the lending and borrowing rates. Other income increased during the last couple of years due to high levels of securitisation transactions. In addition, with the economic slowdown and stress in the real estate sector, provisioning has witnessed a spike during fiscal 2020.

Profitability Indicators

	FY15	FY16	FY17	FY18	FY19	FY20 (E)
Interest income	11.3%	11.2%	10.7%	10.3%	11.4%	11.5%
Interest expenses	8.1%	7.8%	7.5%	7.0%	7.7%	7.7%
Net interest margin	**3.2%**	**3.4%**	**3.2%**	**3.3%**	**3.6%**	**3.8%**
Opex	4.5%	4.1%	4.3%	5.5%	6.3%	6.3%
Other income	5.0%	4.5%	4.9%	5.5%	5.9%	5.9%*
Provisions	0.1%	0.3%	0.3%	0.6%	0.4%	0.7%
Net profit margin	**3.5%**	**3.5%**	**3.4%**	**2.7%**	**2.9%**	**2.7%**

Note: The above financial figures represent the aggregated data of eight HFCs (listed in Annexure -page 14); FY20 data does not include Gruh Finance and DHFL

* Adjusted for one time impact of gain on sale of company

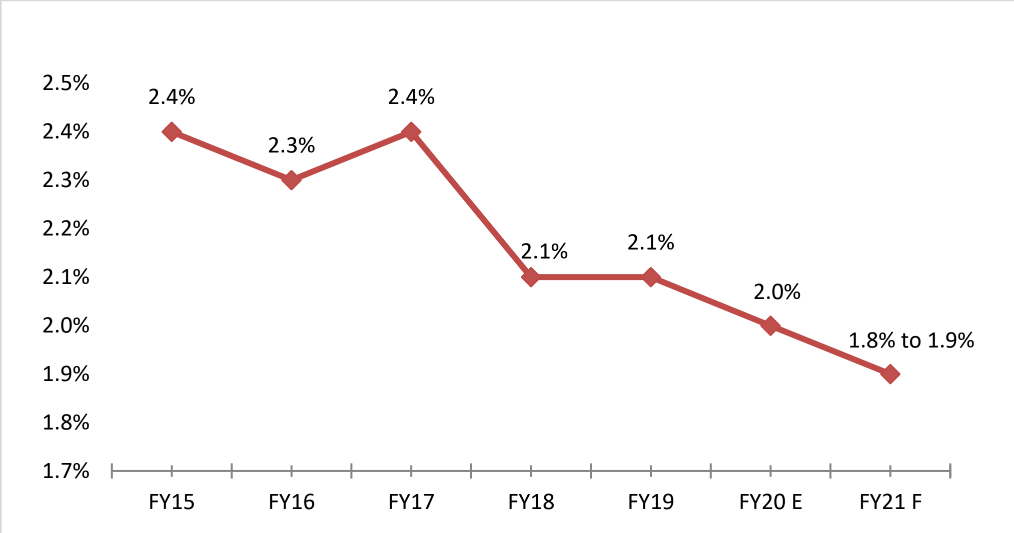
Source: Company Report, BWR Research

In fiscal 2021, multiple factors will impact the HFCs' profitability. On the asset side, high-yield products such as builder loans and LAP will be replaced to some extent by affordable housing and home loans to self-employed customers, which also have better yield compared with retail home loans. This will partially offset decline in yield.

On the liability side, as players reduce their reliance on short-term borrowings, the cost of borrowings is expected to surge, which will result in lower NIMs.

However, the adoption of the co-lending model will offset some of these concerns. It will help the players grow their loan book in this time of tight liquidity, along with earning origination fees and servicing fees over the period of the loan. It will also result in lowering credit cost as HFCs will now have access to the segment of customers traditionally with banks. The extent of adoption of the co-lending model is still uncertain; if it is adopted extensively, the increase in other income and a lower credit cost will help players maintain the Return on Assets in the range of 2 to 2.2 per cent in the medium term.

Trend in Return on Assets of HFCs



E: Estimate, F: Forecast

Source: Company Report, BWR Research

Government measures kept HFCs afloat

The government, along with the regulator, has been taking steps to ease stress in the sector by announcing various measures to address the liquidity crunch for NBFCs and provide relief to stalled real estate projects. The measures include -

- Providing a partial credit guarantee to public sector banks for purchasing the high-rated pooled assets of financially sound NBFCs
- Making the RBI a regulator for HFCs
- Relaxing the minimum holding period for which assets needs to stay on the books before it is eligible for securitisation
- Establishing an alternate investment fund (AIF) worth Rs 25,000 crores aimed at priority debt financing for the completion of stalled housing projects

Annexure- Financials of Eight major HFCs

Name of HFC	Loan book (Rs crore)	Growth (y-o-y)	Gross NPA	Interest Income (Rs crore)	Net Profit (Rs crore)
HDFC Ltd	4,06,600	13%	1.2%	46,825	16,232
LIC Housing Finance Ltd	1,94,646	17%	1.5%	17,264	2,434
Indiabulls Housing Finance Limited	92,298	-16%	0.9%	14,856	4,091
Dewan Housing Finance Corporation Limited	89,758	-2%	2.7%	12,307	-983
PNB Housing Finance Limited	74,023	30%	0.5%	6,793	1,089
CanFin Homes Ltd	18,381	17%	0.6%	1,700	301
Gruh Finance	17,408	12%	0.7%	1,972	447
Repco Home Finance Limited	11,037	12%	3.0%	1,163	234

Note: Data is for FY19
Source: Company Report, BWR Research

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