HOUSING FINANCE

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CELEBRATING 25 YEARS OF ACUMEN!

January 2023

Who will maintain the edge?

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Who will maintain the edge?

AHFCs are simply credit offtake plays on un/under-served regions/customers. Banks' aversion to highly intensive operations means AHFCs have a long growth runway as long as their customer/distribution edge remains. Hence, AHFC valuations imply >20% growth expectations, 15-20% ROE for next 20 years. However, risks to NIMs and profitable scalability/diversification are being overlooked. Mature HFCs have seen competition-led margin erosion over time. So, AHFCs' high opex (2.7-3.5%) will prohibit operating leverage. Deep distribution/self-employed focus and improving efficiency are success factors. Aavas is best-positioned given focus on less contested market segments, leadership quality and tech/infra investments. Aavas' premium valuation is justified given scarcity of lenders with potential to deliver 20% CAGR for next 20 years. Our earnings growth estimates for Aptus/CANF/HHFC are lower than market expectations as we see risks to margins/opex/credit costs. We also like LICHF as it would benefit in the current upward rate cycle.

Managing growth and profitability will be challenging

AHFCs have an edge in the affordable segment but we see challenges in managing growth along with profitability. Increasing competitive intensity, opex-intensive (2.7-3.5%) nature of operations and higher prepayment rates will lead to PAT growth lagging AUM growth. Historically, in order to achieve growth along with profitability, HFCs have diversified into developer loans (high risk) or small business/MSME loans. Another way to attain scale is increasing ATS, but higher ATS = higher competition (e.g. Can Fin). For AHFCs, we expect PAT growth at 17%, lagging AUM growth of ~20%.

Prepayments are inevitable

When rates are low or various lending venues are constrained for growth, banks become aggressive on mortgages, driving systemic balance transfer (BT) activity. In two instances in the last cycle (FY15-18, FY19-22), AHFCs' repayment rates increased (BT pressure) as SBI cut rates. At scale, we see two likely risks to AUM growth for AHFCs: (1) reducing information asymmetry (credit info required for underwriting) and (2) reducing distribution arbitrage due to deepening reach of banks.

Aavas best placed

Deep distribution, differentiated customer segment focus, sound/strong underwriting and improving productivity would be key success factors for HFCs. Aavas/Aptus are better placed on these parameters as they have 75-86% of branches in tier-3/below locations and 60-72% customer mix is self-employed/informal income. Though, Aptus has higher early bucket stress. Additionally, Aavas' top notch management quality makes it stand out from the rest. We expect EPS CAGR of 22% for Aavas over FY22-25E, higher compared to Aptus/CANF/HFFC.

Valuations expensive. Risks being overlooked.

Despite falling up to 41% from peak, AHFC valuations (3.1-4x/25-27x FY24E BVPS/EPS) are at a 50-100% premium to large HFCs. This implies >20% growth expectations in our view. Given industry's own track record of 15-19% long-term CAGR, we think competitive risks to growth/margins are being overlooked. On our SELLs, our EPS estimates are up to 16% below consensus. Key risk to our SELLs: (1) productivity levels pan out better than expected, resulting in better growth and efficiency and (2) credit information asymmetry/distribution arbitrage remains, resulting in higher margins.

Key Recommendations

Aavas Financiers	**BUY**
Target Price: 2,148	Upside 17%
Aptus Value Housing Finance	**SELL**
Target Price: 245	Downside: 18%
Can Fin Homes	**SELL**
Target Price: 450	Downside: 18%
Home First Finance Company	**SELL**
Target Price: 601	Downside: 17%
LIC Housing Finance	**BUY**
Target Price: 563	Upside: 40%

Valuation-implied ask on growth is too steep!

- Estimate 13-14% industry CAGR for next 2 decades. Affordable segment to grow 200-300bps higher.
- AHFCs well-placed to capture growth opportunity. But high cost of operations (2.7-3.5%) is a hindrance.
- >20% 20-year growth expectations are stretched vs 15-19% industry CAGR historically.

Aavas best-placed due to distinct customer/geographical focus

	Aavas	**Aptus**	**Can Fin**	**HFFC**
Growth	◕	◕	◔	◕
Liability	◕	◔	●	◑
Asset quality	●	◑	◕	◑
Profitability	◕	◑	●	◑
Governance/disclosures	●	◔	◑	●
Overall score	◕	◑	◑	◑

Source: Ambit Capital Research, companies Note: ● - Strong; ◕ - Relatively Strong; ◑ - Average; ◔ - Relatively weak

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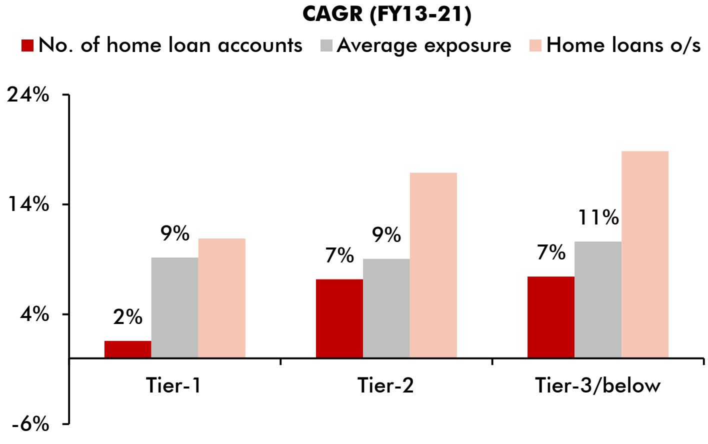
The Narrative in Charts

Exhibit 1: Expect long-term industry CAGR at 13-14%

Particulars	FY22	FY24E	FY25E	FY30E	FY35E	FY40E
HL originations (#mn)	2.4	2.7	2.9	3.8	5.1	6.9
Growth (YoY) (%)	*19%*	*6%*	*6%*	*6%*	*6%*	*6%*
ATS (₹ mn)	3.1	3.4	3.7	4.9	6.5	8.8
Growth (YoY) (%)	*8%*	*6%*	*6%*	*6%*	*6%*	*6%*
HL originations (₹ tn)	7.4	9.3	10.4	18.7	33.5	60.0
Growth (YoY) (%)	*29%*	*12%*	*12%*	*12%*	*12%*	*12%*
HL outstanding (₹ tn)	23.9	32.7	37.6	70.7	127.9	229.5
Growth (YoY) (%)	*10%*	*16%*	*15%*	*13%*	*12%*	*12%*

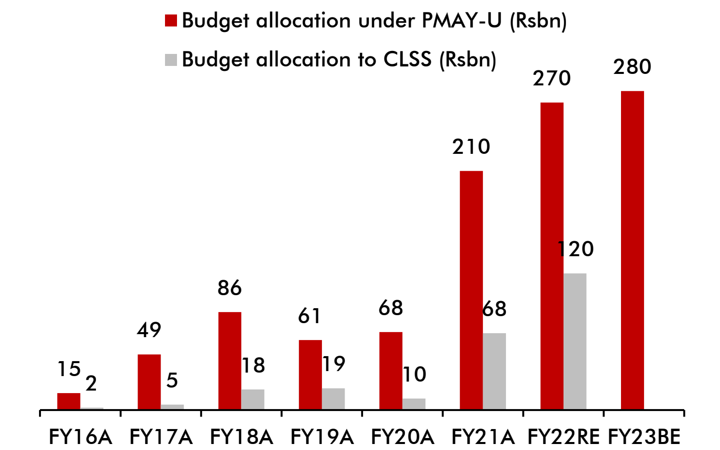
Source: Ambit Capital research, CRIF, RBI, NHB

Exhibit 2: Mortgage growth in tier-2/3 has been higher



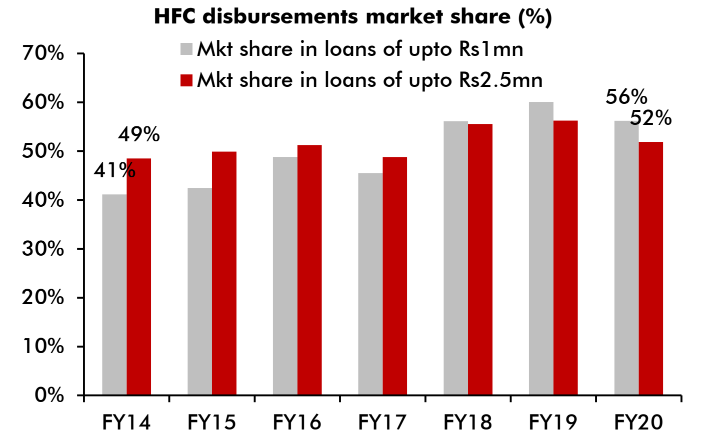
Source: Ambit Capital research, RBI

Exhibit 3: CLSS has ended but it hasn't impact demand for HL



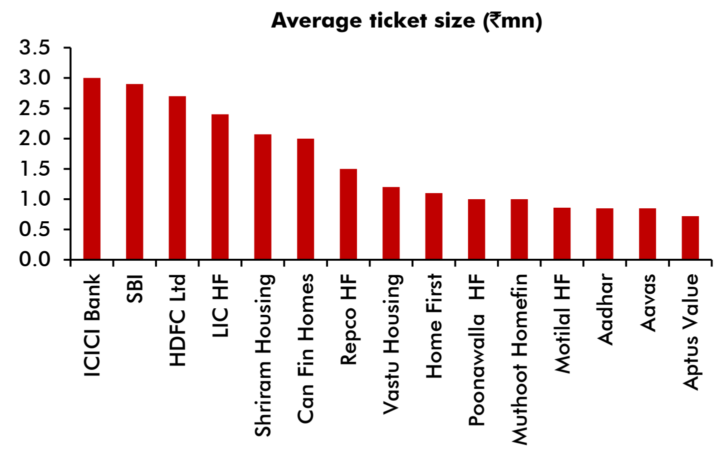
Source: Ambit Capital research, PMAY, NHB

Exhibit 4: AHFCs are better placed to serve the masses…



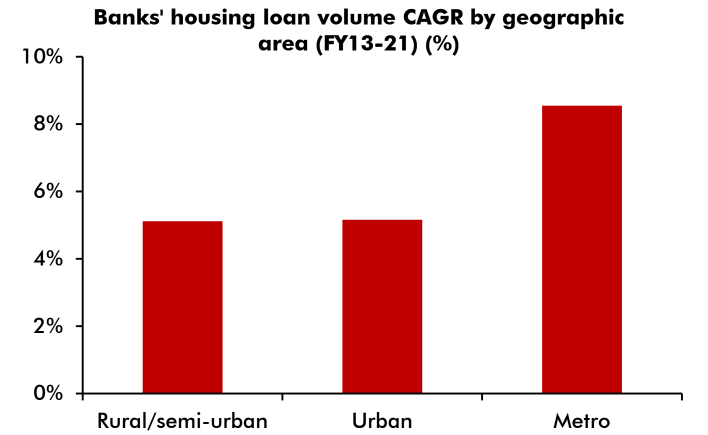
Source: Ambit Capital research, NHB

Exhibit 5: …given their low ATS focus while banks are higher



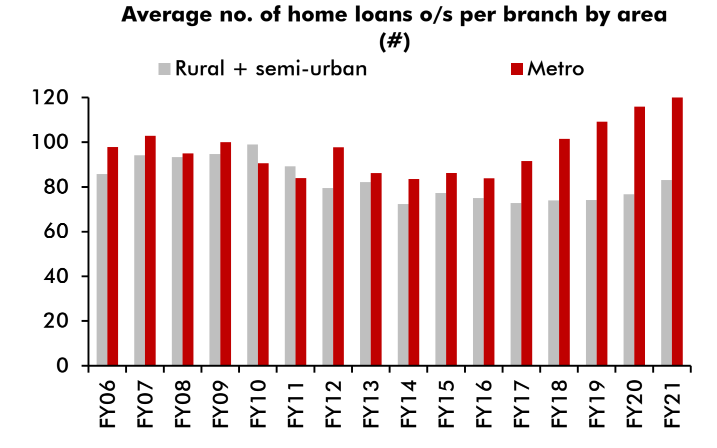
Source: Ambit Capital research, companies

Exhibit 6: Banks' growth in rural/semi-urban unimpressive…



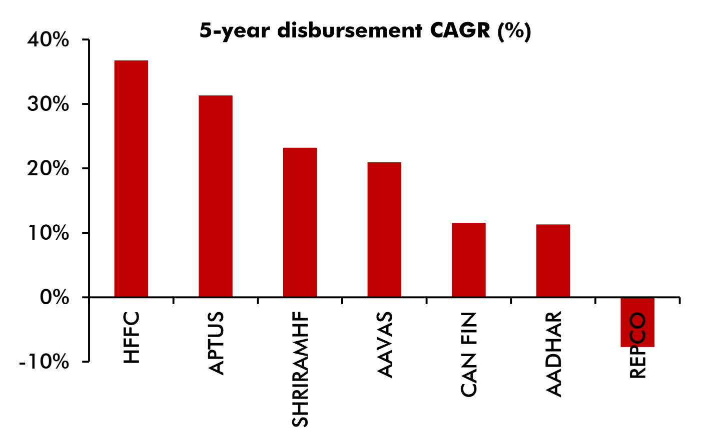
Source: Ambit Capital research, RBI

Exhibit 7: ...as banks focus mostly on metros



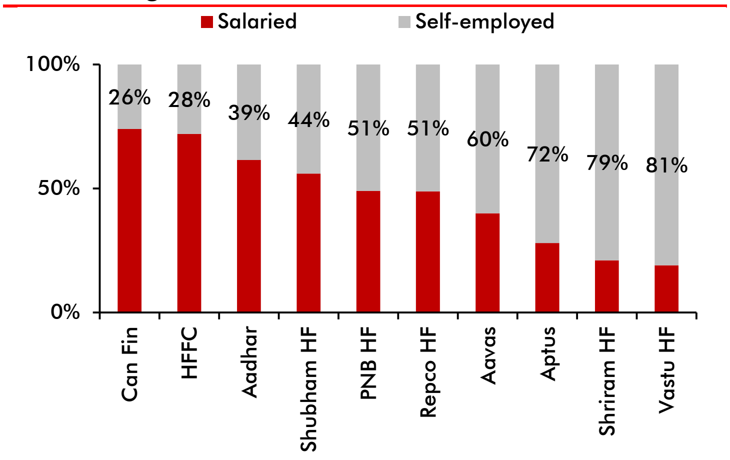
Source: Ambit Capital research, RBI

Exhibit 8: AHFCs are growing strongly



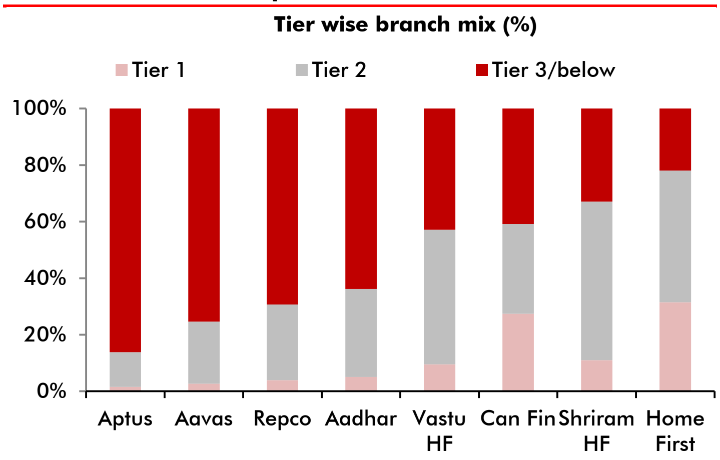
Source: Ambit Capital research, companies

Exhibit 9: Self-employed segment requires specialized underwriting



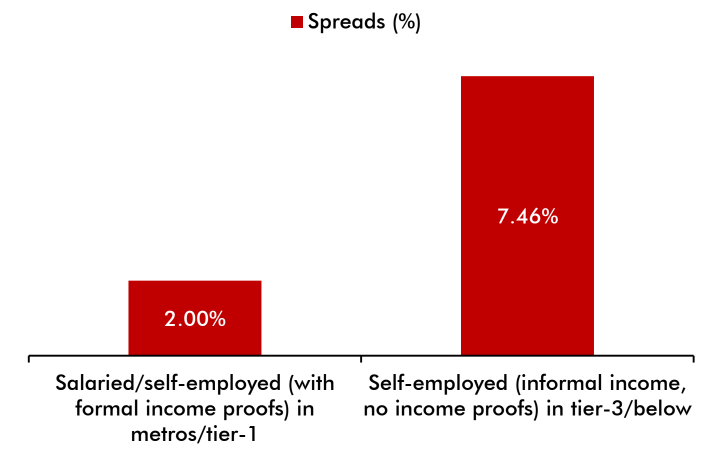
Source: Ambit Capital research, companies

Exhibit 10: AHFCs with higher share of tier-3/below locations indicate deep distribution



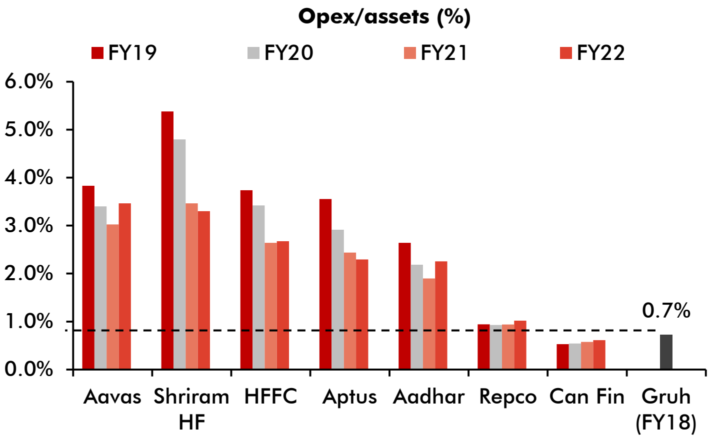
Source: Ambit Capital research, companies

Exhibit 11: Combination of distinguished customer/geographic focus have enabled higher spreads vs large HFCs



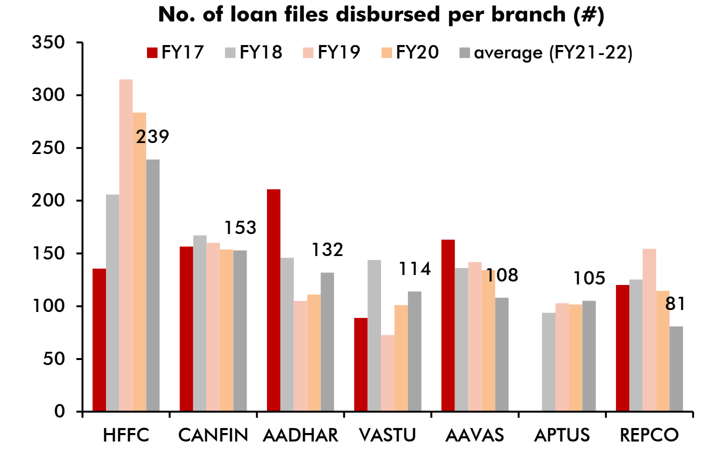
Source: Ambit Capital research, companies

Exhibit 12: But such a distinct focus comes with higher opex ratios given the infra requirements



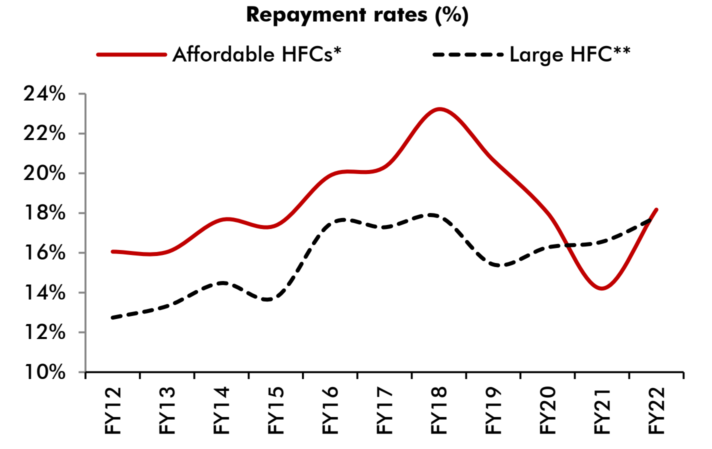
Source: Ambit Capital research, companies

Exhibit 13: Productivity needs to improve to offset high opex ratio



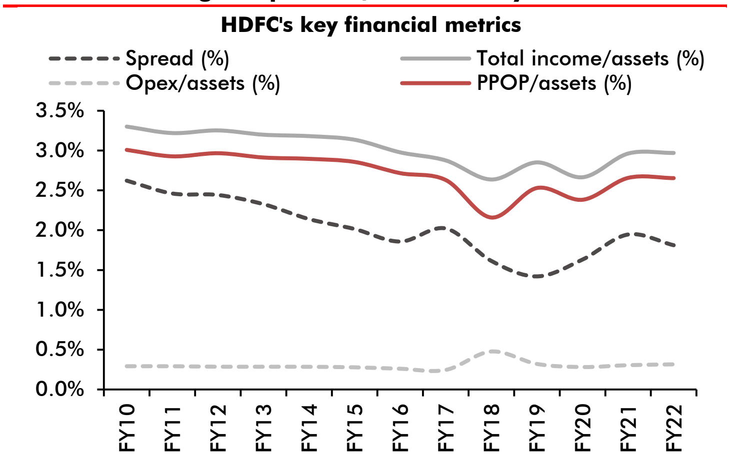
Source: Ambit Capital research, companies

Exhibit 14: Cost of funds disadvantage creates prepayment risk



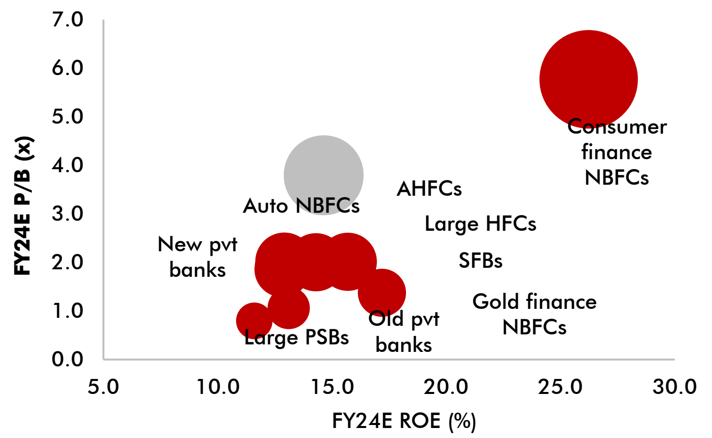
*Source: Ambit Capital research, companies. **HDFC & LIC HF*

Exhibit 15: Over the long-term, profitability will decline due to increasing competition, as shown by HDFC



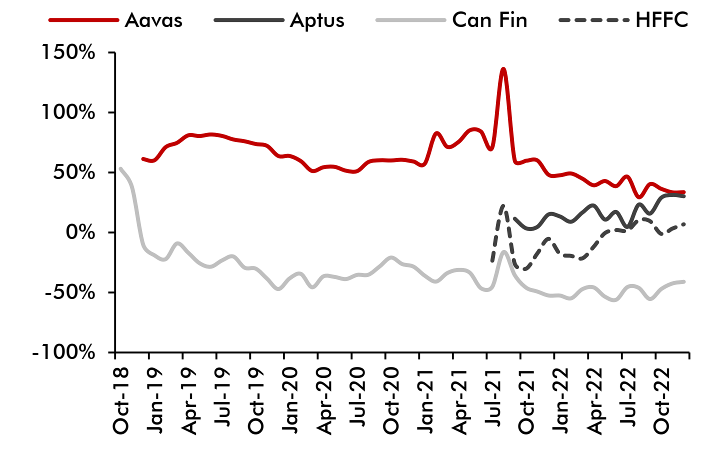
Source: Ambit Capital research, companies

Exhibit 16: Lofty valuations reflect high growth expectations



Source: Ambit Capital research, companies

Exhibit 17: 1-year fwd P/B (x) premium/(discount) to sector – AHFCs are trading at 7-34% premiums



Source: Ambit Capital research, Bloomberg, companies

Exhibit 18: Aavas' collective score based on various parameters is the highest

	Aavas	Aptus	Can Fin	HFFC
Growth	◕	◕	◔	◕
Liability	◕	◔	●	◑
Asset quality	●	◑	◕	◑
Profitability	◕	◑	●	◑
Board governance/disclosure quality	●	◔	◑	●
Overall score	◕	◑	◑	◑

Source: Ambit Capital research, companies Note: ● - Strong; ◕ - Relatively Strong; ◑ - Average; ◔ - Relatively weak

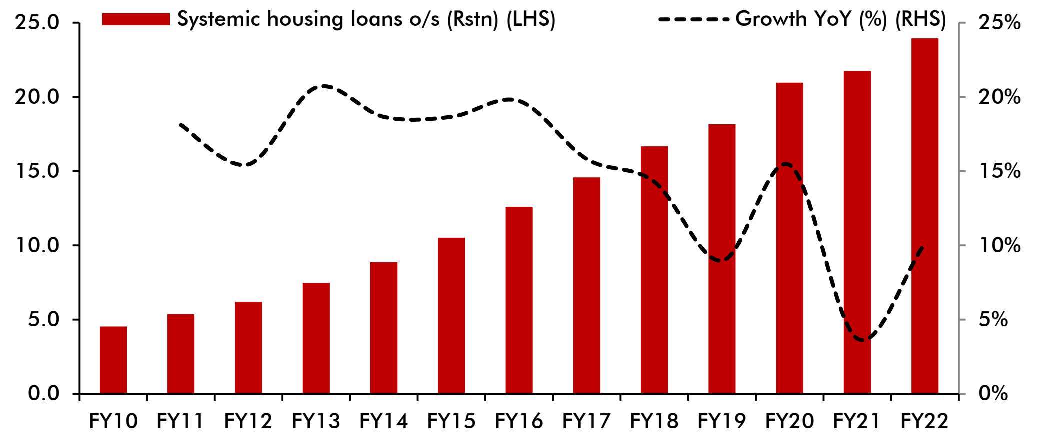
Housing finance is a secular growth story

The current size of the mortgage industry is ₹24tn (15-year CAGR: 17%). Historical correlation between GDP per capita and home loans outstanding has been very strong. In the backdrop of 10% nominal GDP growth for the next 2 decades, mortgages industry is expected to register 13-14% CAGR. Key growth drivers: (1) aspirational demand and (2) improving affordability/healthy household balance sheets. Traditionally, south/west markets have dominated the industry while north/central regions have seen lower penetration. As north/central regions account for ~40% of the total population, these could witness higher growth. In the last few years, central India has shown strong demand traction. Further, growth rates in tier-2/3 districts have been higher than in tier-1.

Current mortgage industry is 10.3% of GDP

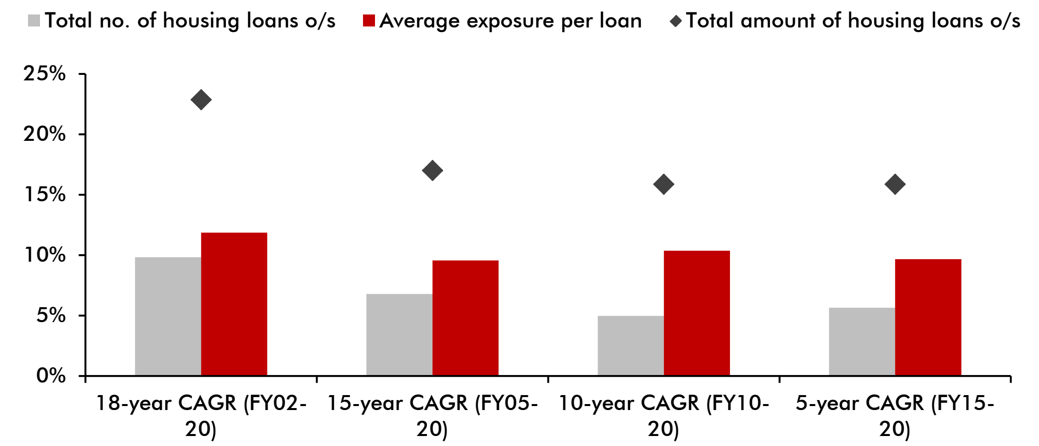
As of FY22, systemic housing loans outstanding (banks + HFCs) were ₹24tn. Pre-pandemic, the industry grew at a 15-year CAGR (FY05-20) of 17% (7% CAGR in number of loan accounts + 10% CAGR in ticket size).

Exhibit 19: Total industry size (₹24tn) is 10.3% of GDP



Source: Ambit Capital research, RBI, NHB

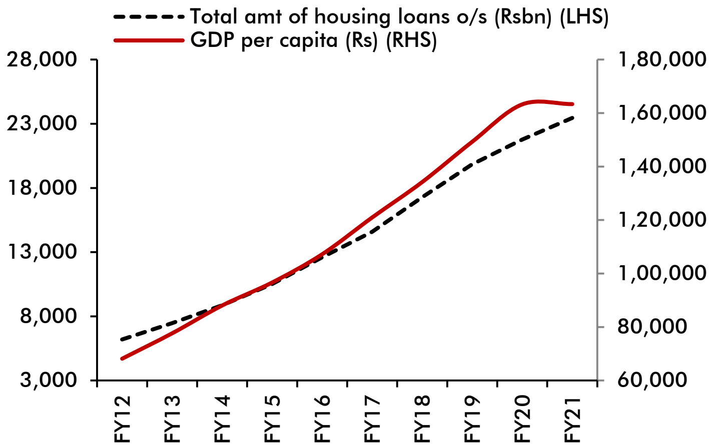
Exhibit 20: Over the last 18 years, average exposure size has risen faster than number of loans



Source: Ambit Capital research, RBI

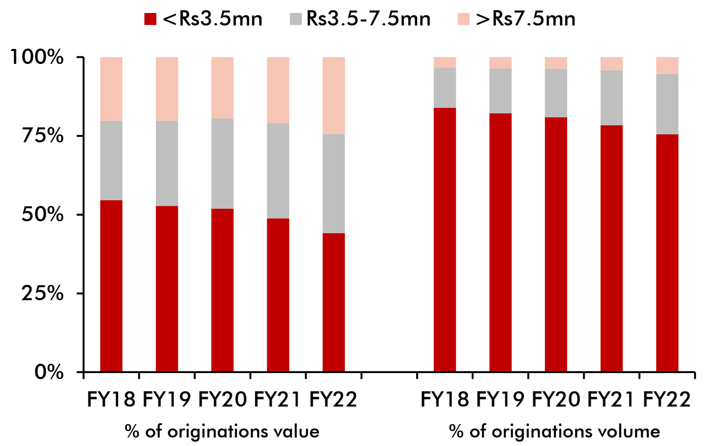
Historically, the trend in systemic home loans outstanding has correlated strongly with GDP per capita (correlation: 1). This indicates that people are likely to invest in housing as prosperity increases. As per CRIF, currently, <₹3.5mn ticket size segment dominates with 44%/76% share in value/volume of loans originated. However, the last 5 years' trends indicate that growth in >₹3.5mn ticket size has been higher.

Exhibit 21: Increasing prosperity augurs well for housing/housing finance demand



Source: Ambit Capital research, MOSPI, RBI

Exhibit 22: <₹3.5mn segment dominates, though its share has been declining

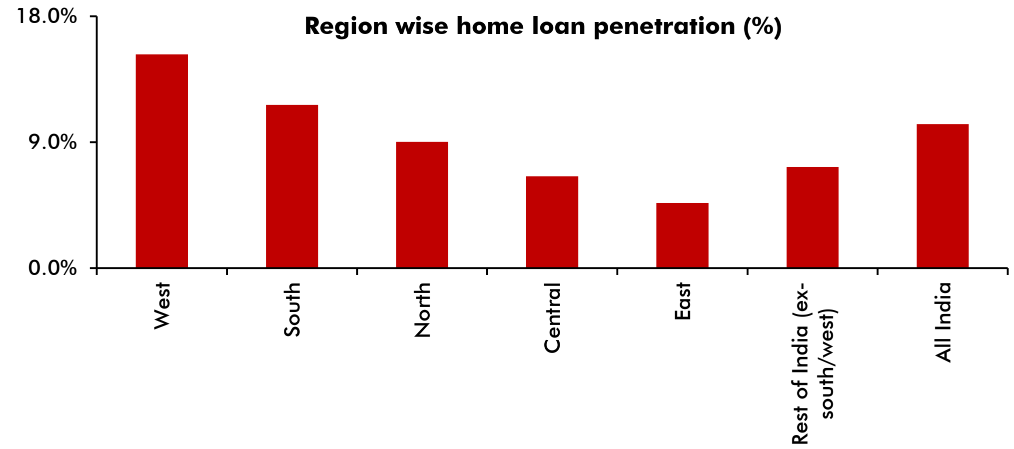


Source: Ambit Capital research, CRIF

Traditional markets dominate; ex-west/south, home loan penetration lower

Traditionally, western/southern states have dominated the industry due to higher per capita income levels. Maharashtra is the largest market (23% share). Aggregate home loan penetration in west/south markets has been higher (13.2%) vs all-India (10.3%) and rest-of-India (ex-west/south) (7.2%). We think that north/central regions have better growth potential for housing given the large population size (collectively 39% of total) and the expected economic prosperity.

Exhibit 23: India ex-west/south has seen lower home loan penetration



Source: Ambit Capital research, RBI

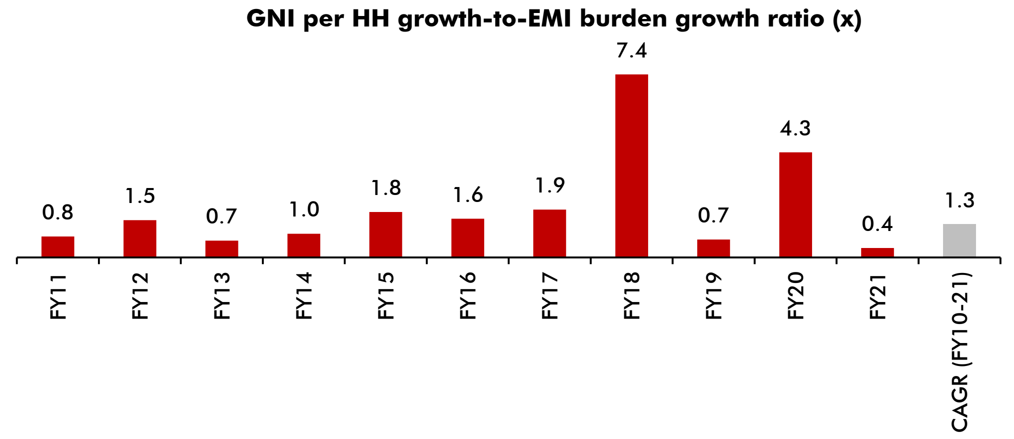
Aspirations will drive demand/sector growth

As per BankBazaar's Aspiration Index, owing a house is one of the most popular material aspirations among young Indians. Currently, India's working age population is 56% (link). RBI's Household Finance Committee report also noted that the average share of real estate in household wealth is expected to increase, which in turn, will also drive mortgages growth.

House is a big-ticket purchase; affordability is not a challenge

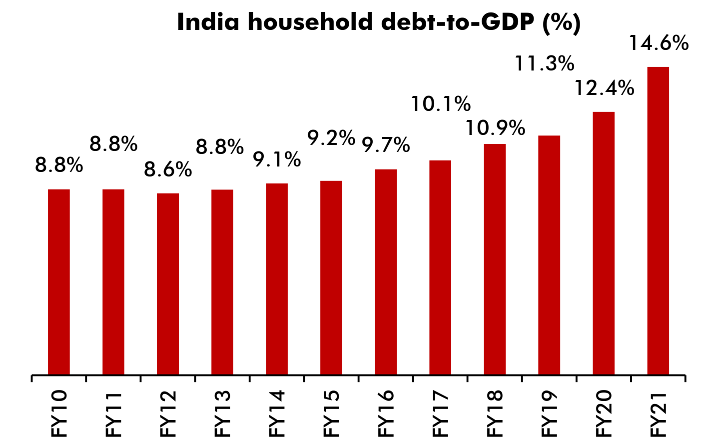
Macro-level indicators show that Indian household balance sheets and income levels are healthy enough to afford home loans. Our calculations indicate that home loan affordability has improved in last couple of years led by: (1) sustained growth in income levels (10% CAGR FY10-21) and (2) decline in home loan rates (down 361bps since FY12), leading to lower EMI burden. We also note that household indebtedness is low in India. Indian household debt (mortgage share: ~30%) is 14.6% (FY21) of GDP, lower than China/US at 62%/66%.

Exhibit 24: Mortgage affordability has been aided by higher income growth and cheaper rates



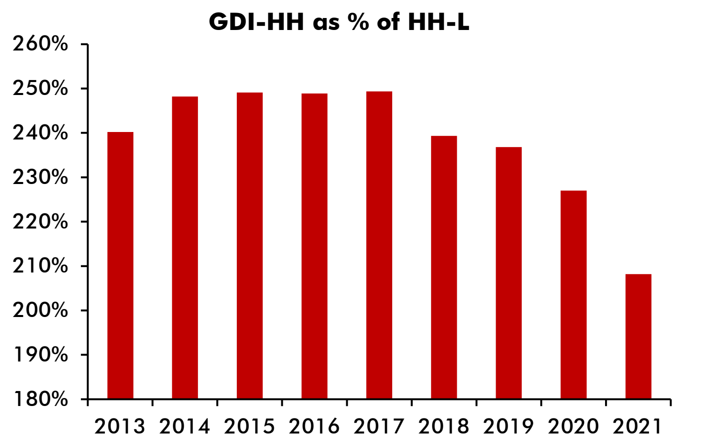
Source: Ambit Capital research, MOSPI, RBI; Note: EMI burden has been calculated based on RBI's disclosure on banks' HL WALR and banks' HL outstanding.

Exhibit 25: Indian households are not excessively leveraged



Source: Ambit Capital research, MOSPI, RBI

Exhibit 26: Household incomes are >2x of their liabilities

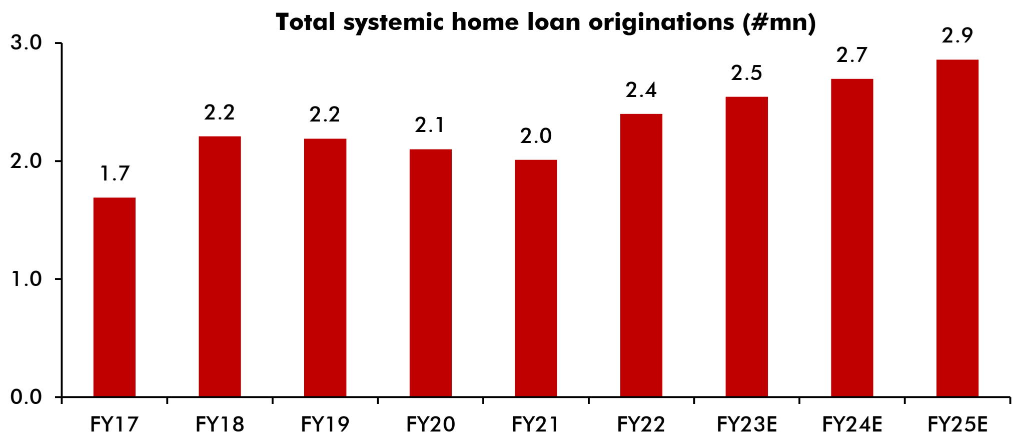


Source: Ambit Capital research, MOSPI, RBI; GDI-HH = Gross domestic income per household, HH-L = Household liabilities

Estimate long-term industry CAGR at 13-14%

In last 5 years (FY17-22), annual systemic home loan originations have ranged between 2-2.4mn (FY17-22 CAGR: 5.5%).

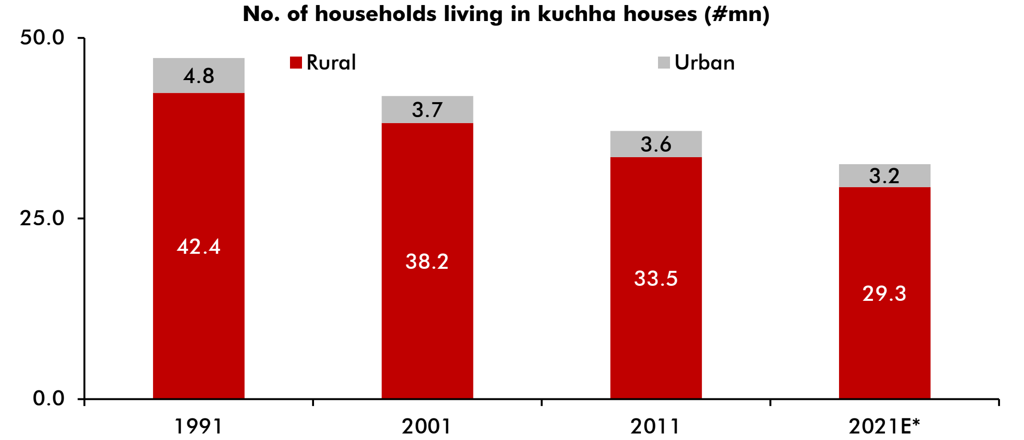
Exhibit 27: Home loan originations have ranged between 2-2.4mn



Source: Ambit Capital research, CRIF

In our long-term industry forecast, we have assumed originations volume CAGR at 6%. Our assumption reflects historical trend wherein for a 10-11% nominal GDP growth, the number of home loan disbursals is estimated to have increased by 5-7% annually. We believe that aspirational demand from households shifting from kuchha to pucca houses and demand for +1 properties/residential assets will drive volume growth. We have pegged ticket size increase to the rate of inflation (6%). Effectively, long-term annual industry CAGR comes to 13-14%. Given that housing is an aspirational asset, ticket sizes increasing at a higher rate over a cycle is likely.

Exhibit 28: Decline in households living in kuchha houses is driven by aspirations/want for better living standards



*Source: Ambit Capital research, MOHUA, *estimated based on 1.3% annual declined since 2011*

Exhibit 29: Long-term housing finance growth model – we expect long-term GDP growth multiplier at 1.2x

Particulars	FY22	FY23E	FY24E	FY25E	FY30E	FY35E	FY40E
Systemic volume of home loan originations (#mn)	2.4	2.5	2.7	2.9	3.8	5.1	6.9
Growth (YoY) (%)	*19%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*
Average ticket-size (ATS) (₹ mn)	3.1	3.2	3.4	3.7	4.9	6.5	8.8
Growth (YoY) (%)	*8%*	*6%*	*6%*	*6%*	*6%*	*6%*	*6%*
Systemic value of home loan originations (₹ tn)	7.4	8.3	9.3	10.4	18.7	33.5	60.0
Growth (YoY) (%)	*29%*	*12%*	*12%*	*12%*	*12%*	*12%*	*12%*
Systemic housing loans outstanding (₹ tn)	23.9	28.2	32.7	37.6	70.7	127.9	229.5
Growth (YoY) (%)	*10%*	*18%*	*16%*	*15%*	*13%*	*12%*	*12%*

Source: Ambit Capital research estimates, RBI, CRIF; Systemic home loans outstanding calculations assume a 17% repayment rate.

Exhibit 30: Long-term CAGR estimated at 13-14%

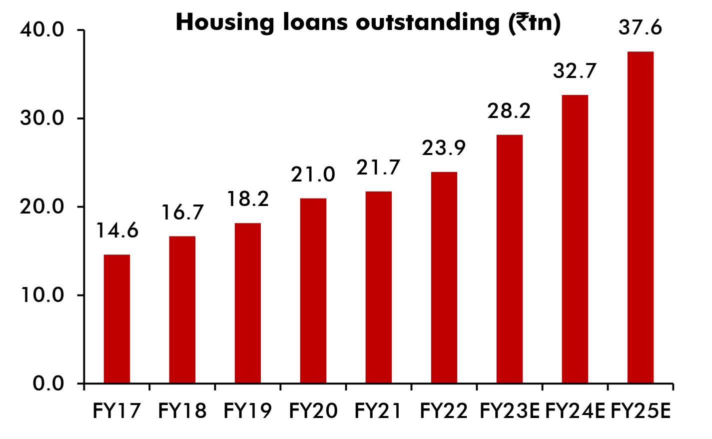
Particulars	FY17-22	FY22-40E
Volume of systemic home loan originations (#mn)	5.5%	6.0%
Average ticket-size (ATS) (₹ mn)	4.5%	6.0%
Value of systemic home loan originations (₹ tn)	9.4%	12.4%
Systemic housing loans outstanding (₹ tn)	10.4%	13.4%

Source: Source: Ambit Capital research estimates, RBI, CRIF

Current growth trends (14-15% p.a.) can sustain over FY22-27E

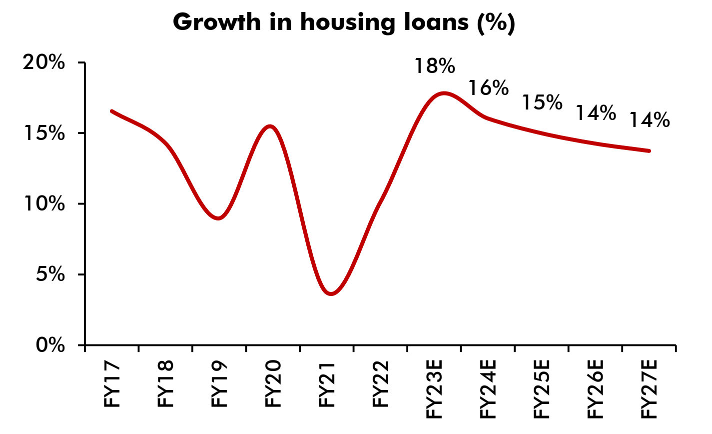
Considering our long-term market growth forecast for housing finance and current quality of household balance sheets/ability to service loans, we believe that the current annual growth momentum of 14-15% can sustain over FY22-27E.

Exhibit 31: Industry size ~2x by FY25E vs FY19/20



Source: Ambit Capital research, RBI, NHB

Exhibit 32: Medium-term, industry growth can sustain at 14-15%

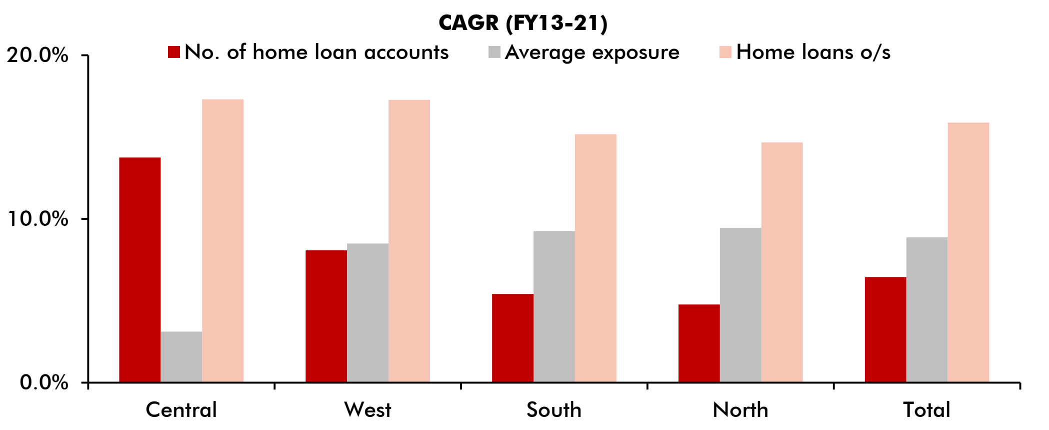


Source: Ambit Capital research, RBI, NHB

Central/west India witnessing strong growth

Among the 4 major regions (north, south, west, central), central India has seen the strongest growth in number of home loan accounts, followed by west. South/north number of home loans outstanding grew slower, at 5% CAGR (FY13-21).

Exhibit 33: Demand has been strong in central/west India

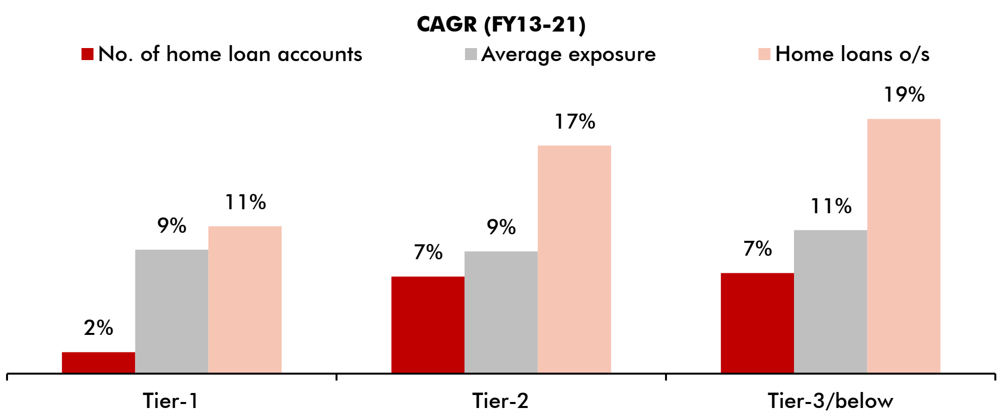


Source: Ambit Capital research, RBI

Volume growth in tier-2/3 locations 500bps higher than tier-1

Pan-India, growth in home loan accounts has been higher in tier-2/3 districts (7% CAGR over FY13-21), suggesting better demand trends in such regions. Growth in tier-1 districts has been relatively lull at just 2% CAGR over FY13-21.

Exhibit 34: Tier-2/3 districts have witnessed higher volume growth, indicating higher demand



Source: Ambit Capital research, RBI

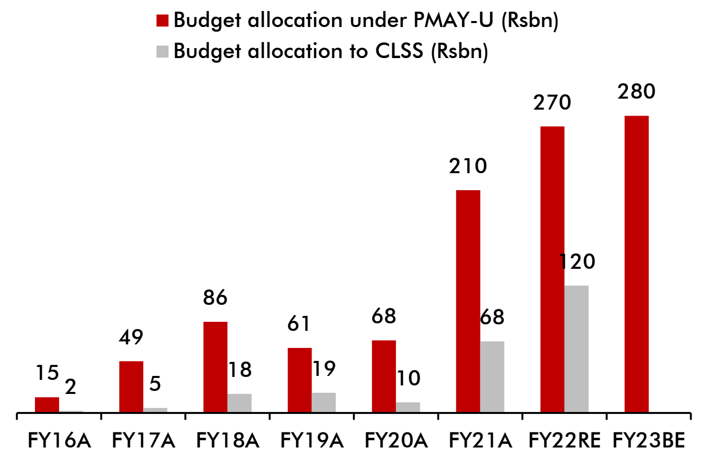
No more CLSS, but demand is holding up

CLSS was a significant factor which helped in converting demand at the bottom-of-the-pyramid as it gave direct financial grants. HFC borrowers were among the largest beneficiaries, accounting for 70% of the total. Among HFCs, HFFC had the highest share of CLSS (~40%), owing to Gujarat being its home state. On the other hand, Aavas had the lowest share of CLSS. State wise, Gujarat/Maharashtra were the largest recipients. Traditional housing markets (west/south) accounted for 2/3rd of the subsidies. Our channel checks indicate that despite the scheme closure (Mar-22), demand is not impacted.

What was CLSS? Why it worked. How did it help the industry?

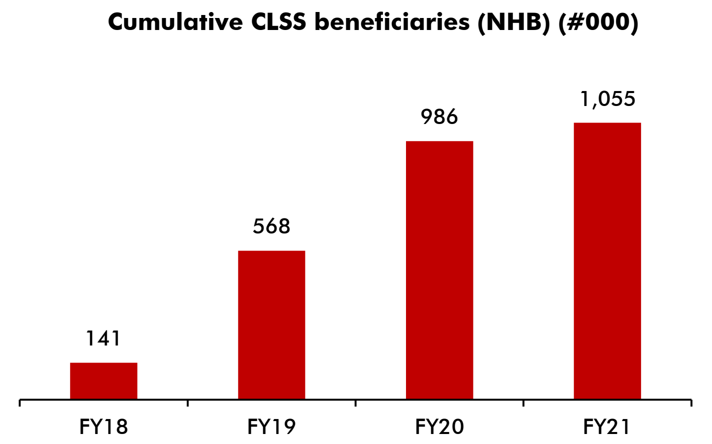
CLSS was a home loan subsidy scheme launched by the central government in Jun-15. Under this scheme, the government provided direct subsidy on home loan interest rates. The scheme worked well as it gave direct financial benefit to the borrower. Effectively, eligible borrowers availed interest rate concessions of 3-6.5%. Given that the scheme was targeted at the lower income strata, the subsidy's relative attractiveness helped in generating housing demand. Low-ticket HFCs benefitted more as they were better placed to cater to the targeted customer segment.

Exhibit 35: Budgetary allocation to CLSS has ended effective FY22



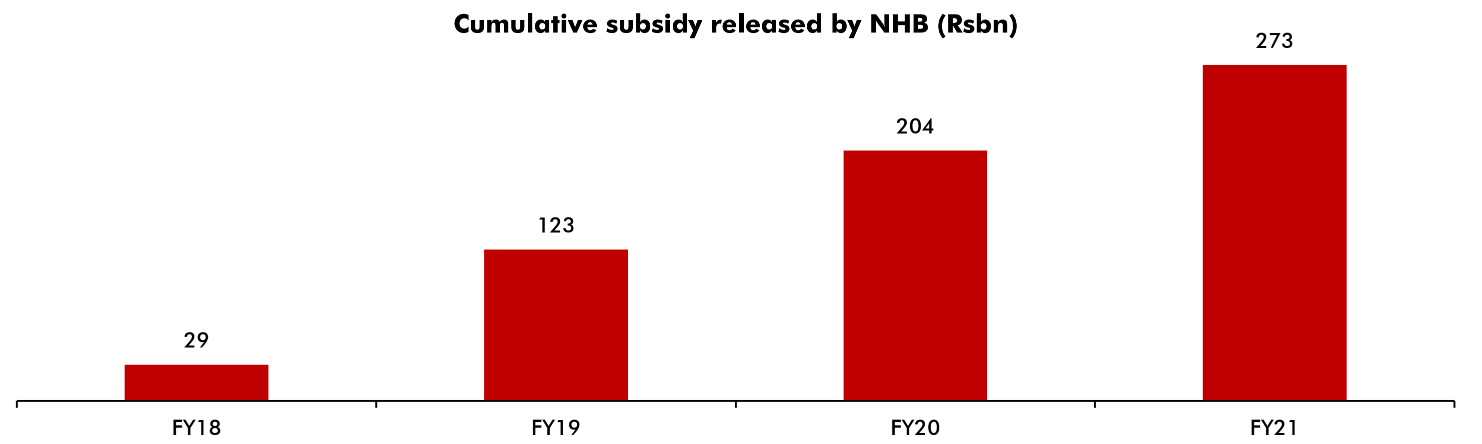
Source: Ambit Capital research, NHB, PMAY

Exhibit 36: Beneficiary count was >1mn



Source: Ambit Capital research, NHB, PMAY

Exhibit 37: Annual subsidy release at ₹70-94bn

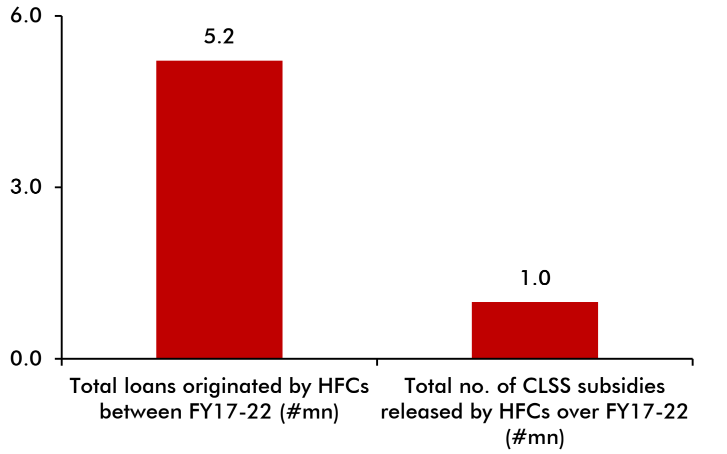


Source: Ambit Capital research, NHB, PMAY

HFCs generated 19% business via CLSS

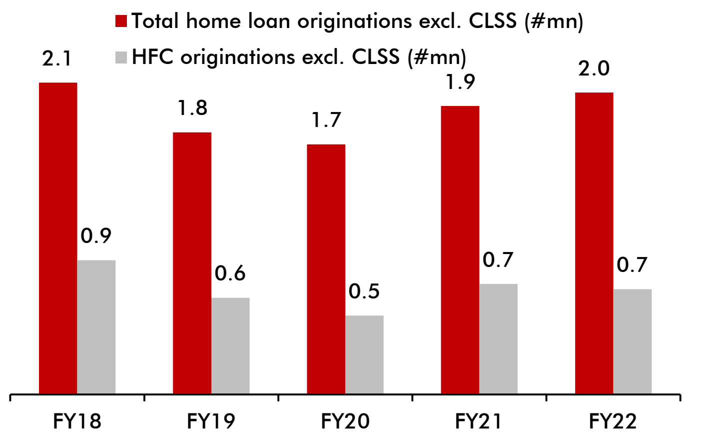
We estimate that over FY17-22, 19% of HFCs' originations availed of CLSS benefits. Since the launch of CLSS, HFC customers have been the largest recipients, accounting for more than 70% of the total beneficiaries.

Exhibit 38: 19% of HFC originations availed of CLSS



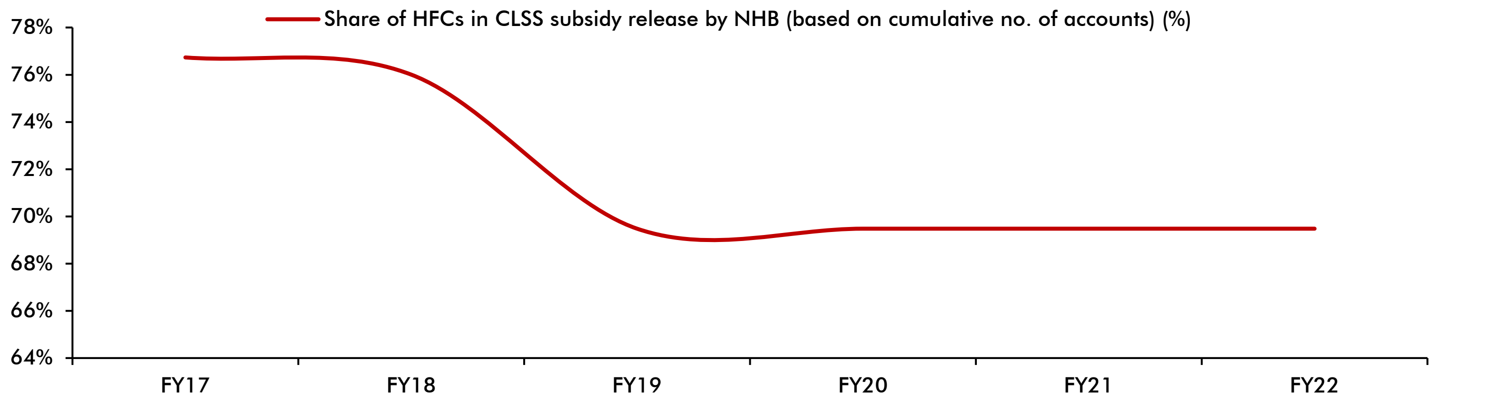
Source: Ambit Capital research, PMAY, CRIF

Exhibit 39: Originations ex-CLSS have been stagnant



Source: Ambit Capital research, PMAY, CRIF

Exhibit 40: HFC customers have availed of CLSS the most*

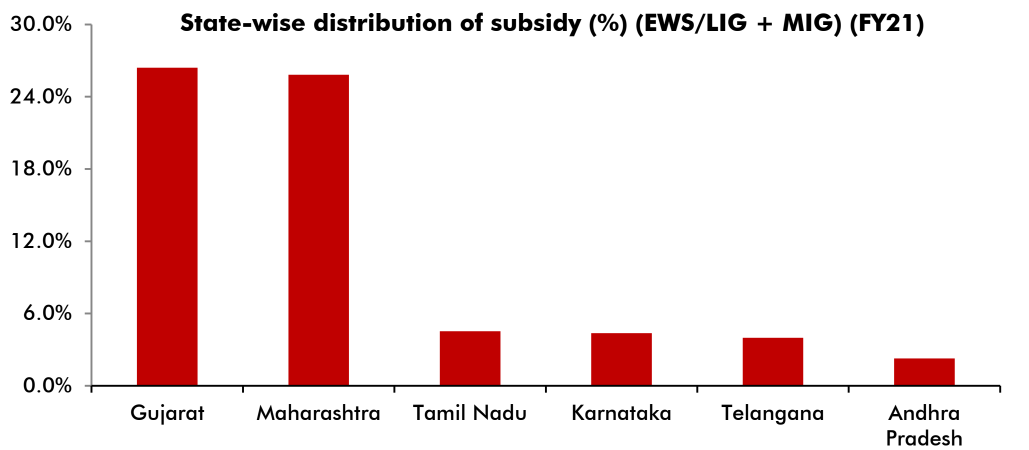


*Source: Ambit Capital research, PMAY, NHB. * FY20/21/22 assumed at 69%*

Gujarat and Maharashtra were largest subsidy recipients

As per NHB data, Gujarat and Maharashtra were the largest recipients of subsidies under CLSS (26% each). Traditional housing finance markets (Gujarat, Maharashtra, Tamil Nadu, Karnataka, Andhra Pradesh, Telangana) accounted for 67% of the total subsidy availed.

Exhibit 41: Gujarat/Maharashtra have been the largest recipients

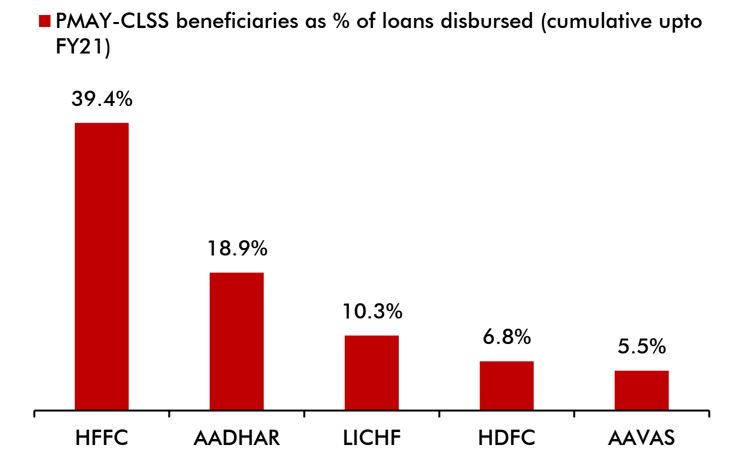


Source: Ambit Capital research, PMAY, NHB

HFFC's share of CLSS highest among peers

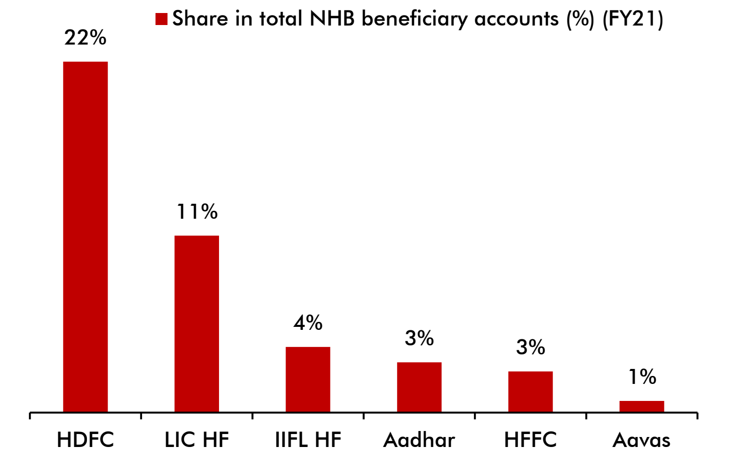
HFFC's share of CLSS (39%) was highest among peers. Aavas had the lowest dependence on such schemes. In the past, Aavas has stated that it does not depend on government subsidies/schemes to assess a loan proposal. Rather, it assesses each business proposal based on its own merit. HDFC and LICHF are two of the largest participants, accounting for 22%/11% of the total beneficiaries. However, their reliance on CLSS as a growth-driver is lower given their large size.

Exhibit 42: HFFC has been the biggest beneficiary among peers



Source: Ambit Capital research, PMAY, NHB, Companies

Exhibit 43: HDFC/LICHF two biggest players in CLSS (FY21)



Source: Ambit Capital research, PMAY, NHB, Companies

CLSS is not a growth enabler anymore. But demand is holding up!

CLSS ended in Mar-22, effectively stopping the financial subsidies given to EWS/LIG/MIG households. Our industry interactions indicate that the receipt of financial grants was a significant motivator for EWS/BPL households to take home loans. Post scheme closure, there has been some debate around sustainability of demand. We gather that the underlying demand remains strong enough to support high growth. Our industry interaction indicates that despite housing demand/opportunity being large, the growth will be gradual.

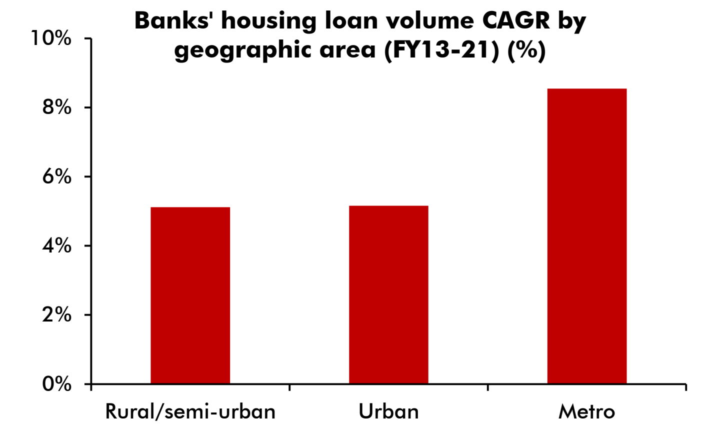
AHFCs better-placed to serve the masses

AHFCs are better-placed to serve the masses. Given banks' large balance sheets, chasing small-ticket loans don't fetch them optimal returns. Hence, banks' home loan volume growth in rural/semi-urban districts is lower (FY13-21 CAGR: 5%) than metros. Banks' share of PSL-compliant mortgages (proxy for affordable housing loans) has also declined. We think that the demand-supply gap in rural/semi-urban areas will be bridged by AHFCs given their deep distribution and specialised underwriting. Though HFCs' long-term average market share has been stable, they are faring better in <₹1mn ticket-size segment. HFCs focusing on tier-3/below locations and serving self-employed face least competition. North/central India offer attractive growth opportunities as highlighted before. Post NBFC liquidity crisis, larger AHFCs (Aavas/Aadhar) have gained market share and are better placed for growth.

Large bank balance sheets and lower ticket sizes are incompatible

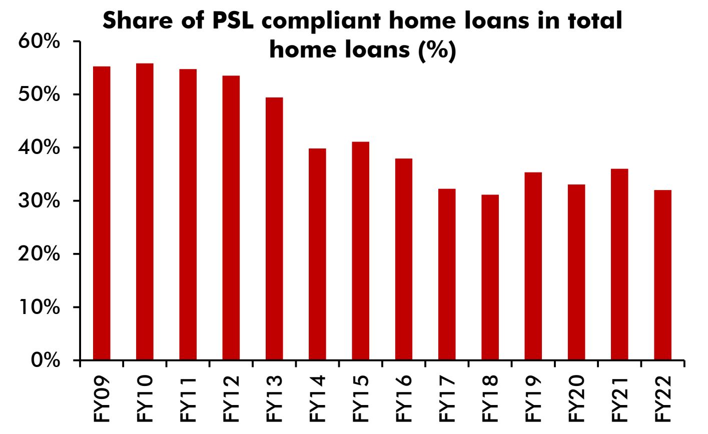
For a given level of growth, lower ticket sizes (vs higher) are a deterrent as they imply higher business acquisition costs for large-size banks (think of shoe-leather costs). Banks' home loan volume CAGR (FY13-21) in rural/semi-urban areas at 5% has lagged metro volume CAGR of 9%. Further, large banks' share of PSL-compliant residential mortgages (proxy for affordable home loans) has declined over the years. We note that banks' annual growth rates for affordable housing loans tend to fluctuate much more than non-affordable mortgages. This likely indicates a rather less-serious stance towards the former.

Exhibit 44: Banks' housing loan volume growth has lagged in rural/semi-urban regions



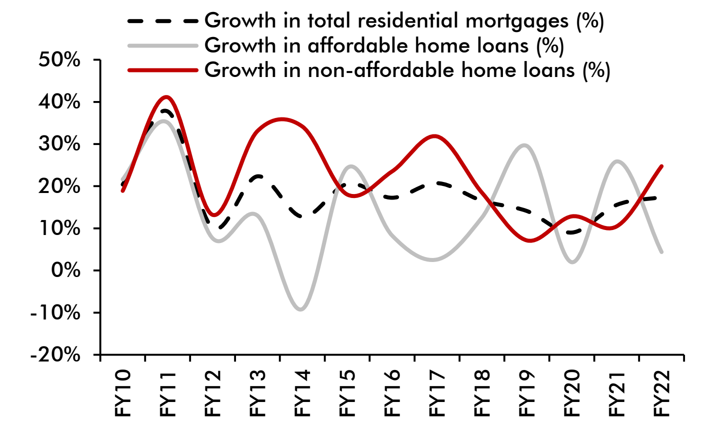
Source: Ambit Capital research, RBI

Exhibit 45: Affordable/PSL-compliant home loans haven't had much attention from banks



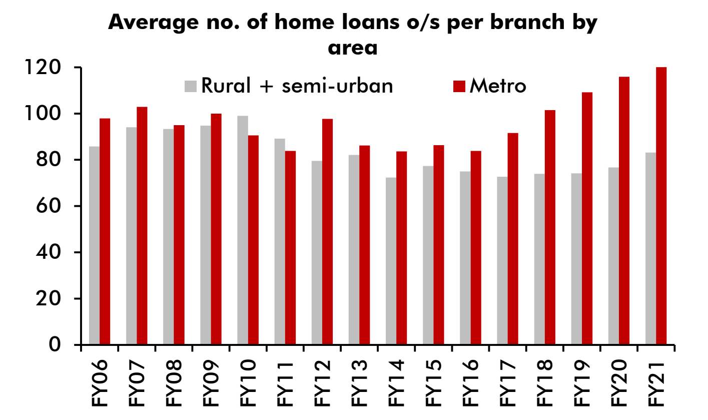
Source: Ambit Capital research, Banks considered are ICICI Bank, Axis Bank, SBI

Exhibit 46: Banks' growth in affordable segment has fluctuated, indicating a rather less-serious stance



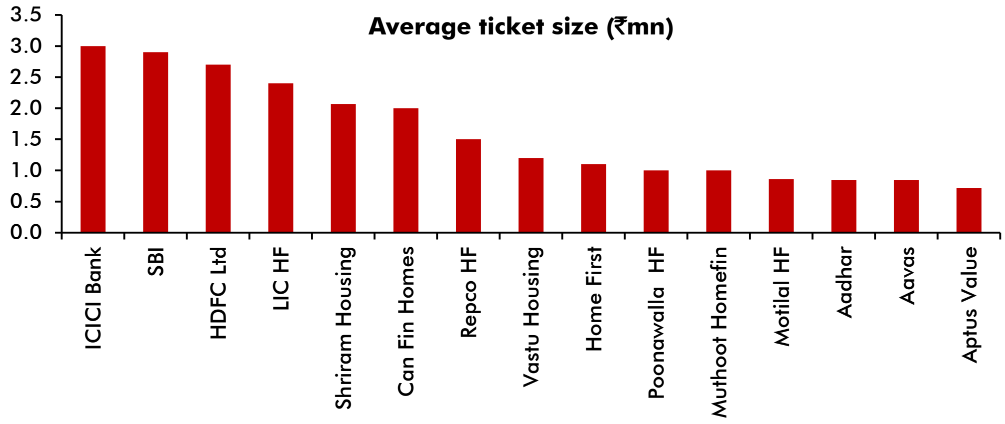
Source: Ambit Capital research, Banks considered are ICICI Bank, Axis Bank, SBI

Exhibit 47: Rural/semi-urban branch productivity has been stagnant



Source: Ambit Capital research, RBI

Exhibit 48: Aavas/Aptus are at the lowest spectrum of the ticket-size range

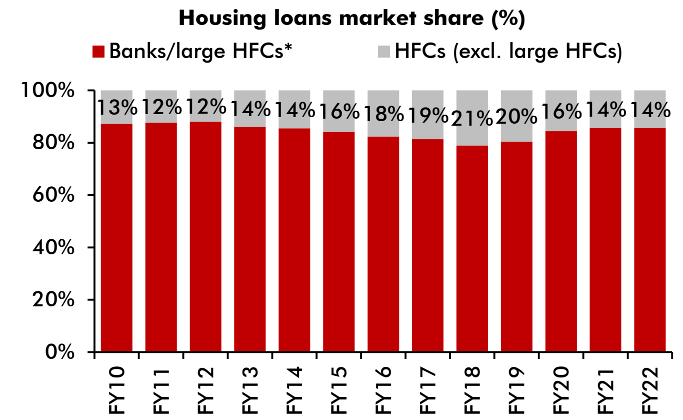


Source: Ambit Capital research, Companies

Market share split stable; HFCs faring better in <₹1mn segment

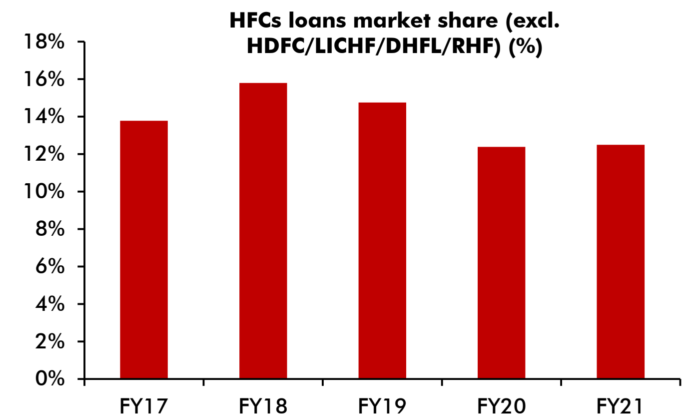
Over a cycle, mid/small-size HFCs have held a stable market share of 14-16% on average. Since FY19, there has been some market share erosion owing to NBFC liquidity crisis, which led to funding constraints for the non-bank sector. However, in the <₹1mn ticket segment (affordable housing), HFCs have increased disbursements market share. This reflects HFCs' specialized nature of operations and deeper distribution. 4 AHFCs (Aadhar, Aavas, HFFC, Aptus) accounted for 47% of the total disbursements in the <₹1mn ticket segment in FY21. This indicates supply-side concentration and a probable explanation for pricing-power.

Exhibit 49: Long-term market share for HFCs stable at 14-16%



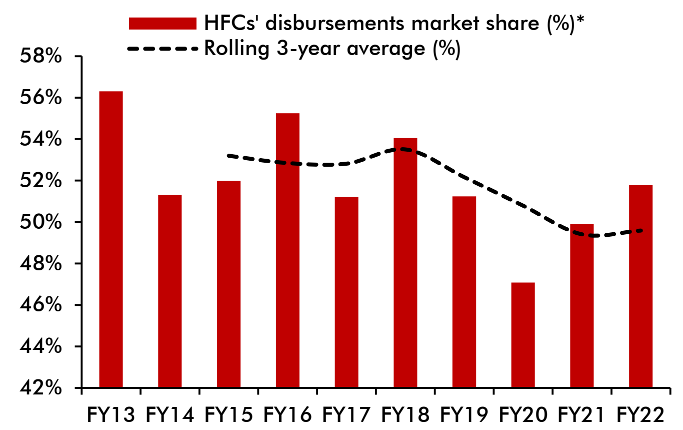
*Source: Ambit Capital research, RBI, NHB; *large HFCs = HDFC, LICHF*

Exhibit 50: NBFC crisis impacted market share due to constrained funding environment



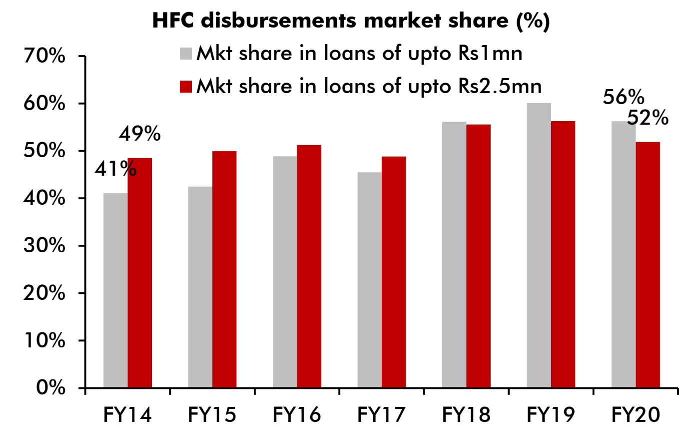
Source: Ambit Capital research, RBI, NHB

Exhibit 51: HFCs' disbursements market share (%)*



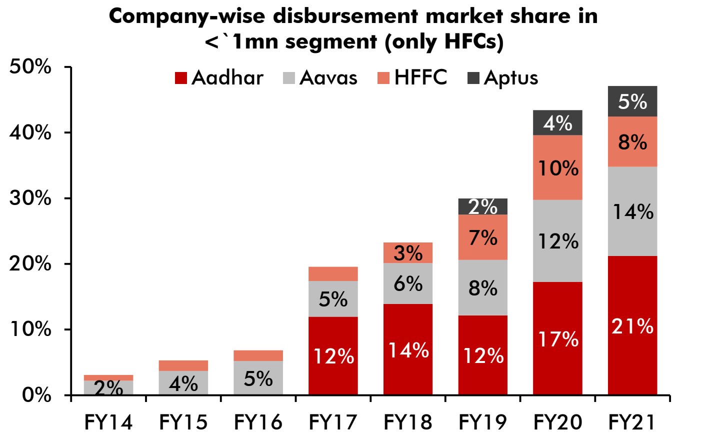
*Source: Ambit Capital research, NHB; *Disbursements taken for PSBs, HFCs*

Exhibit 52: HFCs gained market share in <₹1mn segment



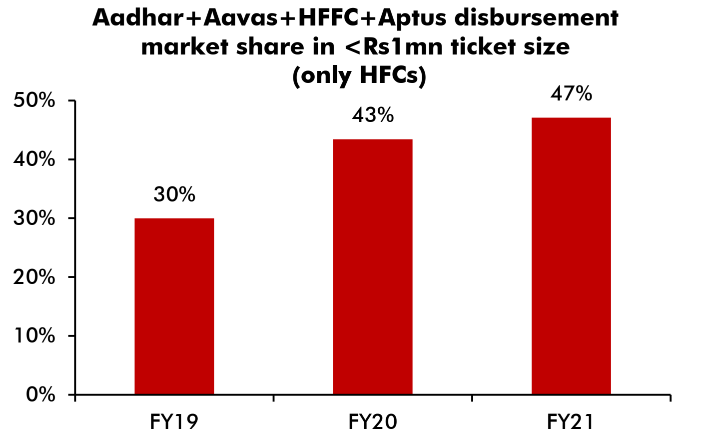
Source: Ambit Capital research, NHB

Exhibit 53: Aavas/Aadhar gained market share in <₹1mn segment. HFFC's market share stable.



Source: Ambit Capital research, NHB

Exhibit 54: Aggregate market share in <₹1mn segment dominated by 4 AHFCs

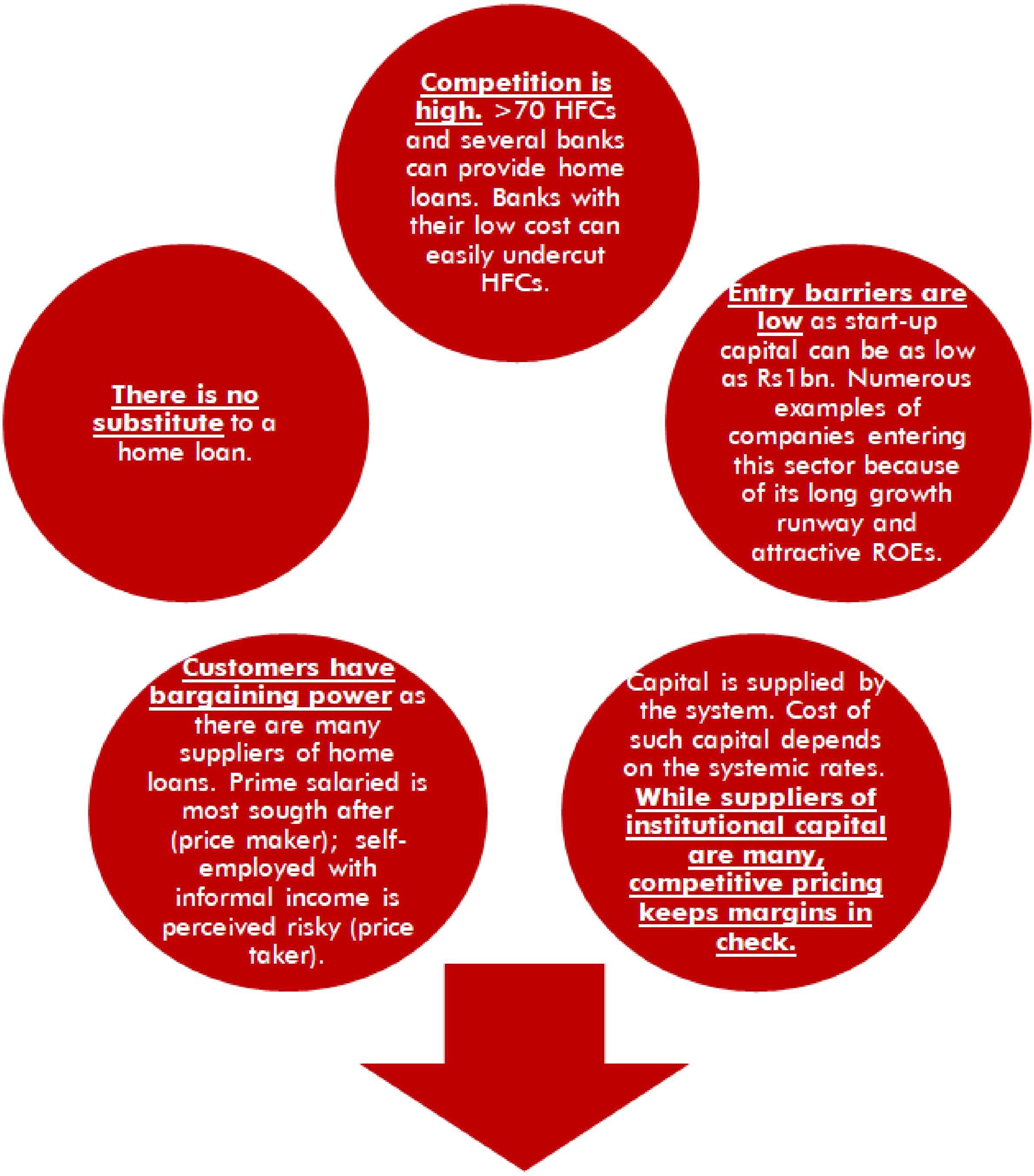


Source: Ambit Capital research, NHB

Distribution/customer focus key to business model strength

Home loan, as a product/service, is a highly competitive one. There are more than 100 financiers (banks, HFCs) which can offer the same product without any differentiation. We see the broad industry through Porter's Five Forces framework and conclude that: (1) competition is high, (2) entry barriers are low, (3) competitive pricing keeps margins in check, (4) prime customers have bargaining power and (5) there is no threat of substitute product/service. Given these traits, industry economics look weak. However, AHFCs created a niche by being geography/customer-centric.

Exhibit 55: Looking at the HFC industry through Porter's five force framework



High competition, low entry barriers, customers' bargaining power, prima facie, indicate weak industry economics. Yet, companies have been able to create niches by being geography and customer-centric.

Source: Ambit Capital research

Despite the commoditized nature of the product, companies have been able to create niche in terms of distribution reach and customer profile. For example, AHFCs such as Aavas/Aptus mostly operate in tier-3 and lower cities with majority of customers being self-employed where underwriting is based on subjective cashflow assessment as formal income proofs are non-existent/inadequate. Since banks mostly operate in tier-1 locations, they are not able to fully cater to the demand in tier-3/below locations, despite the strong demand. In this context, we adopt the following framework to handily assess a company's likely competitive advantage/industry positioning.

Exhibit 56: Aavas/Aptus have a distinguished customer/geographic focus

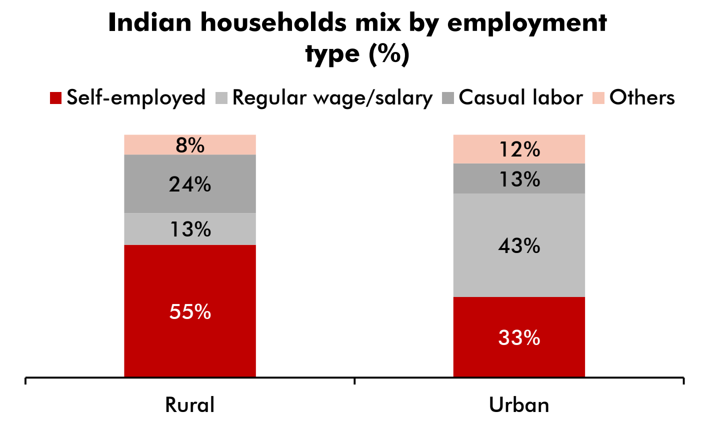
		Geographical profile	
		Metros/Tier-1	**Tier-3/below**
Customer occupation profile	**Salaried/self-employed (with formal income proofs)**	**Highly competitive** due to presence of numerous suppliers. **Players: HDFC, LIC HF, Can Fin**	**Moderate-to-highly competitive**. Underwriting the customer is easy but distribution is a challenge (though DSA can help).
	Self-employed (informal income, no income proofs)	**Moderately competitive**. Potential number of suppliers is large but many are averse to such customer profiles.	**Least competitive** as number of players catering to such locations and customer profile is low. **Players: Aavas, Aptus**

Source: Ambit Capital research

Exhibit 57: Aavas/Aptus/Shriram focus on self-employed

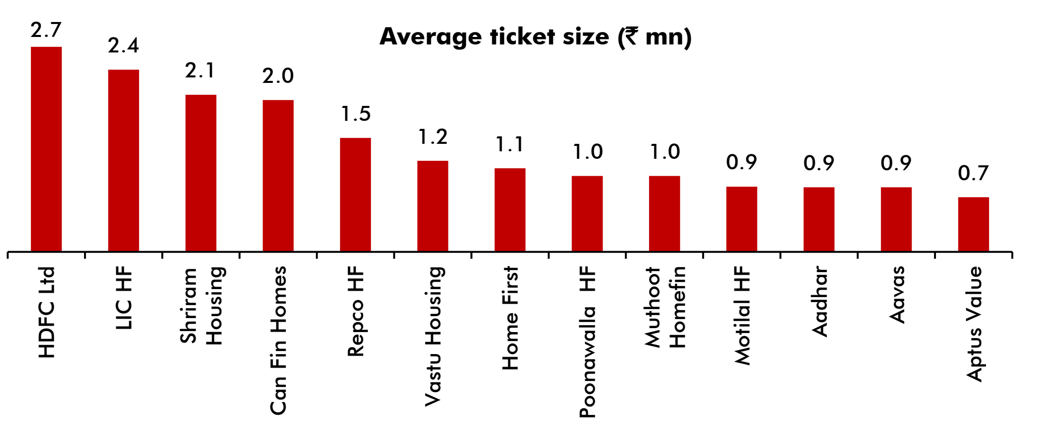
Source: Ambit Capital research, companies

Exhibit 58: Rural is inhabited by self-employed/casual labour



Source: Ambit Capital research, PLFS

Exhibit 59: Small-ticket AHFCs with tier-3/self-employed orientation are better-placed to serve the masses

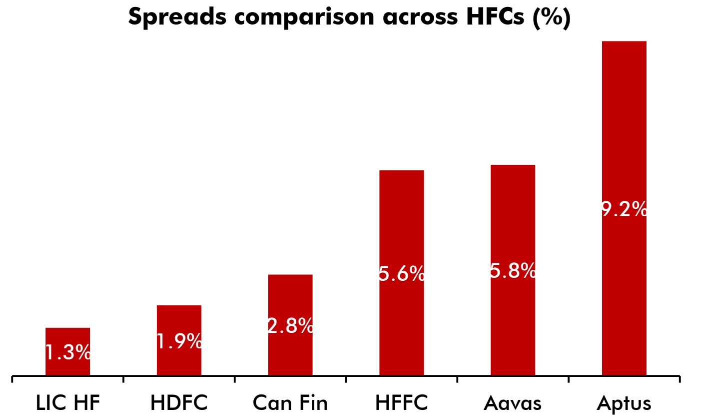


Source: Ambit Capital research, companies

Higher spreads compensate for distribution reach and underwriting risk

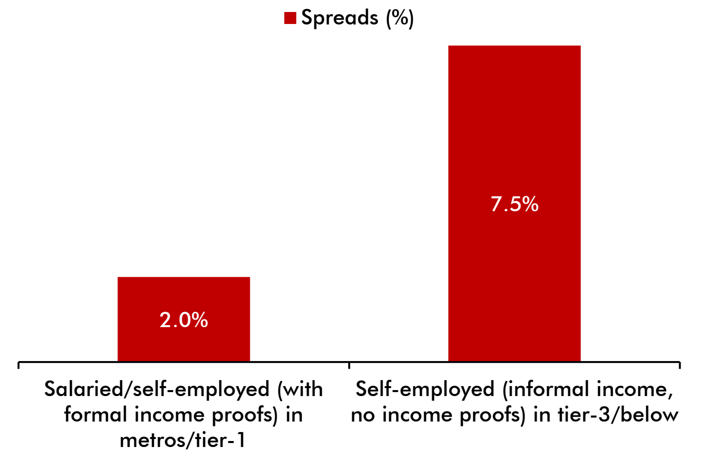
AHFCs focusing on self-employed with informal income make higher spreads as they assume higher distribution costs and underwriting risks compared to HFCs focusing on formal income/salaried in metros/tier-1 cities.

Exhibit 60: Aptus/Aavas are able to charge premium for distribution reach/specialized underwriting



Source: Ambit Capital research, companies

Exhibit 61: Higher spreads in informal income category reflects pricing for distribution and underwriting risk



Source: Ambit Capital research, companies

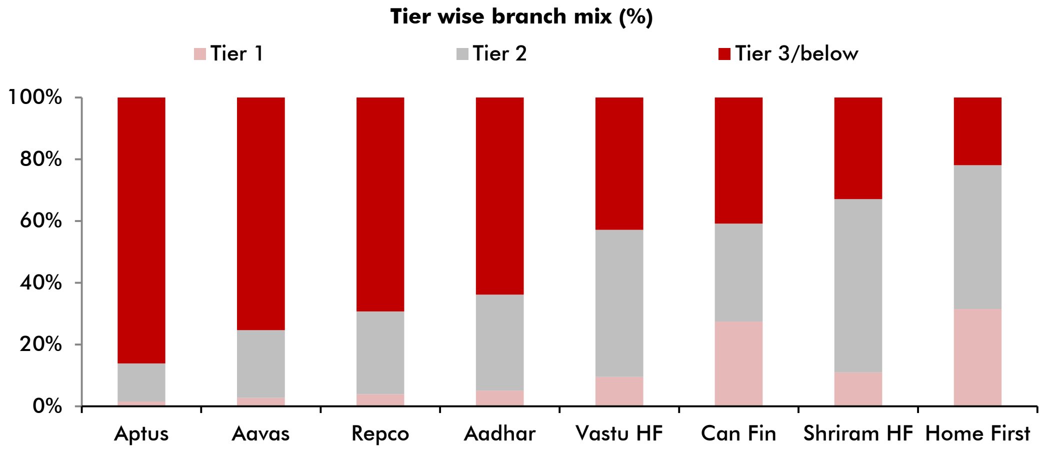
Aavas and Aptus are better-placed

Some AHFCs have been able to create a niche by focusing on un/under-serviced geographic and customer segments. This is clearly reflected in their spreads which are 3-5x of large HFCs. Based on geographical and customer segment differentiation, we find Aavas/Aptus better-placed than peers as 75-86% of their branches are located in tier-3/below locations and self-employed/informal income customers account for 60-72% of AUM. Further, we find Aavas better than Aptus due to its execution track record, low cost of funds and higher geographical diversification. Aavas' asset quality ranks among the best and credit costs are lower.

Aavas/Aptus' distribution is deeper than peers

Aavas/Aptus are focused on serving deeper geographies (75-86% branches in tier-3/below) compared to players like HFFC/Can Fin (22-33% branches in tier-3/below). We believe higher exposure to tier-3/below locations gives a company longer growth runway. Intuitively, competition would take longer to reach such areas compared to peripheries of tier-1/tier-2.

Exhibit 62: Tier-3/below exposure is highest for Aptus/Aavas

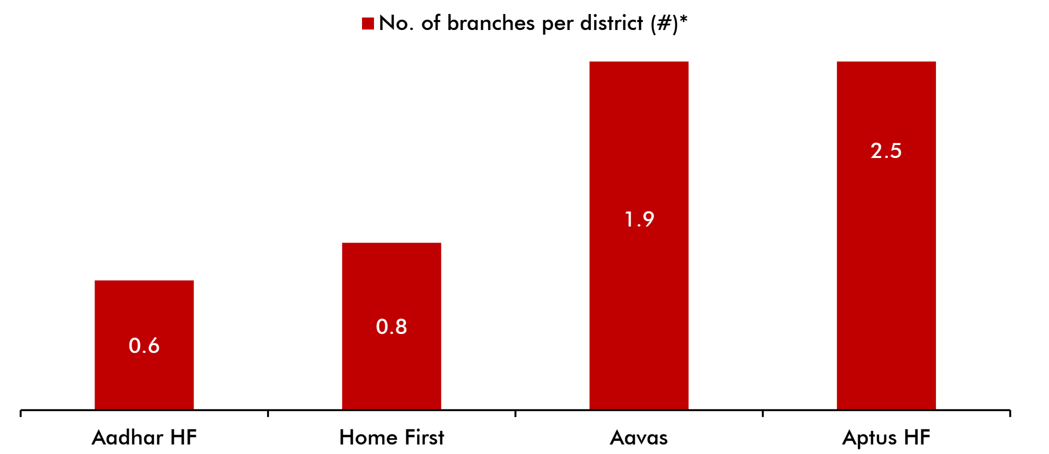


Source: Ambit Capital research, companies

District coverage indicates deeper penetration by Aavas/Aptus

Based on number of branches per district, Aavas/Aptus are following a branch-led/physical presence-heavy strategy with the objective of deepening their district presence and customer relationships. Data indicates that Aavas/Aptus have multiple branches in each district. Aadhar/HFFC are covering 1-2 districts per branch (an asset-light strategy).

Exhibit 63: Aavas/Aptus have deeper presence per district

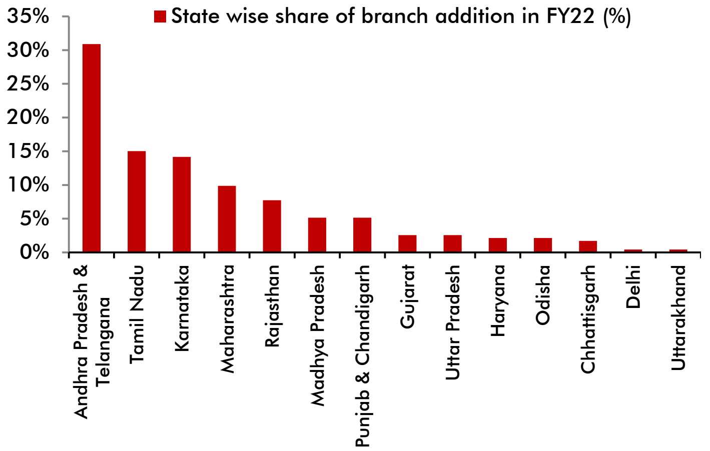


*Source: Ambit Capital research, companies; *Value of >1 indicates that each district has more than 1 branch, implying deeper penetration per district. Value of <1 indicates that one branch caters to more than 1 district.*

Traditional markets are focus areas

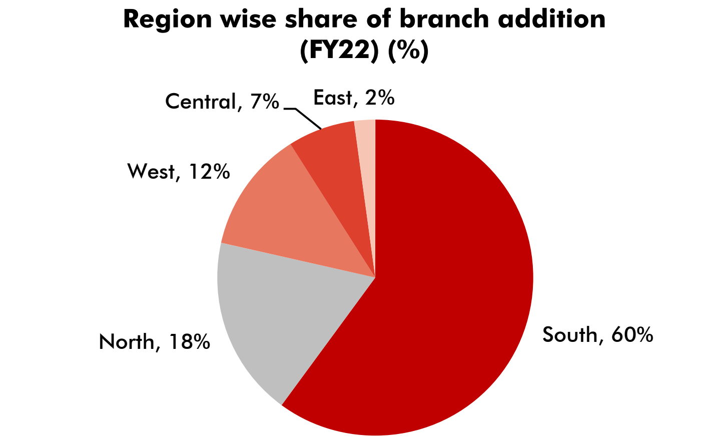
Most HFCs focus on south/west as these were the most prosperous markets. In FY22, south India accounted for 60% of total branch expansion by HFCs. Given the large population size of north/central India (collectively 39%) and the expected economic prosperity and housing demand, these regions can accommodate more players. Currently, only a handful of players (Aavas, Aadhar) are focusing on these regions while most remain focused on south/west as indicated by branch expansion trends.

Exhibit 64: Most HFCs are focusing on southern states



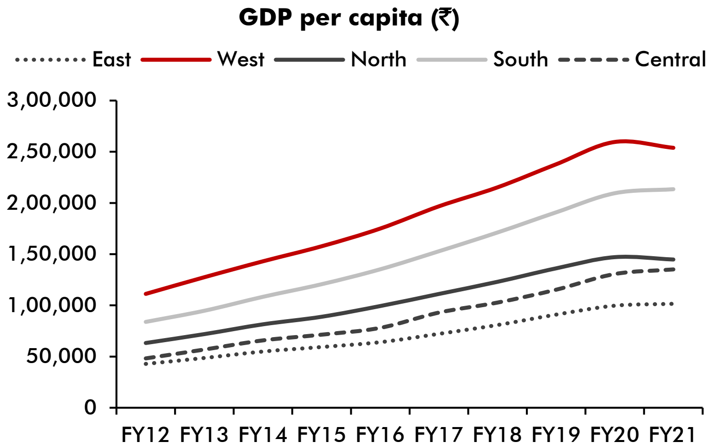
*Source: Ambit Capital research; *based on branch additions for Aavas, Can Fin, Repco HF, HFFC, Aptus, Aadhar, IIFL HF, Shriram HF, Vastu HF.*

Exhibit 65: South accounted for majority of new branch openings



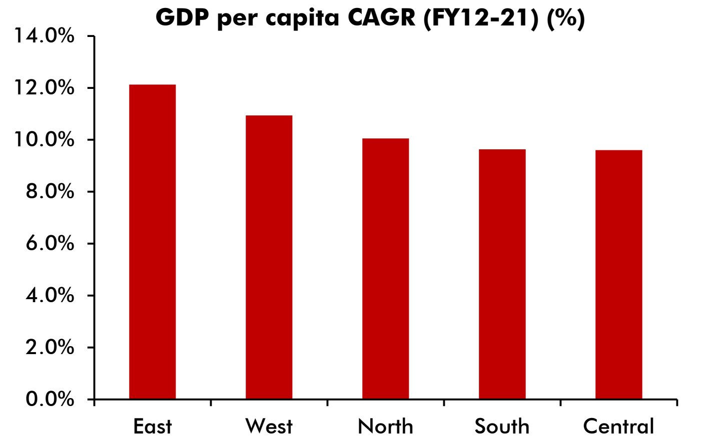
*Source: Ambit Capital research; *based on branch additions for Aavas, Can Fin, Repco HF, HFFC, Aptus, Aadhar, IIFL HF, Shriram HF, Vastu HF.*

Exhibit 66: Income levels have been on the rise



Source: Ambit Capital research, RBI, MOSPI

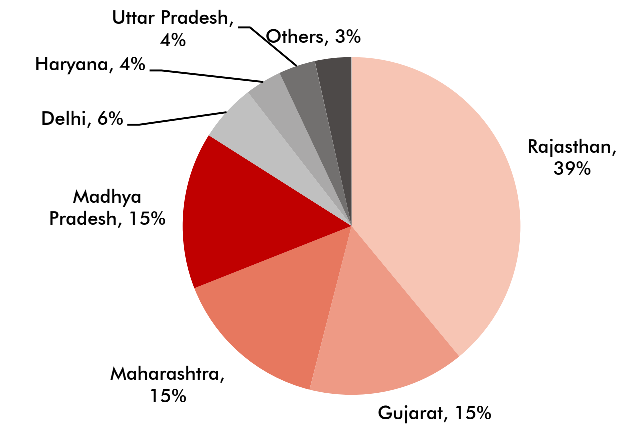
Exhibit 67: East/west have seen the highest growth



Source: Ambit Capital research, RBI, MOSPI

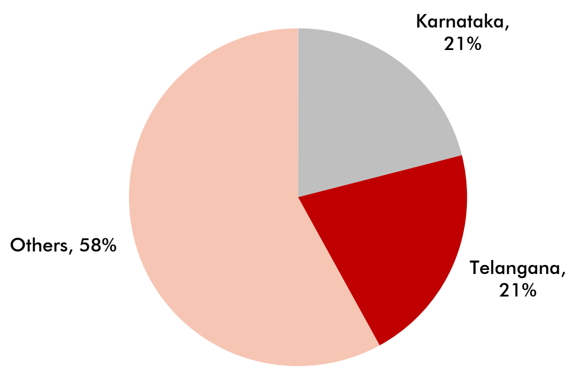
Geographical AUM mix for HFCs

Exhibit 68: Aavas focuses on north, central India



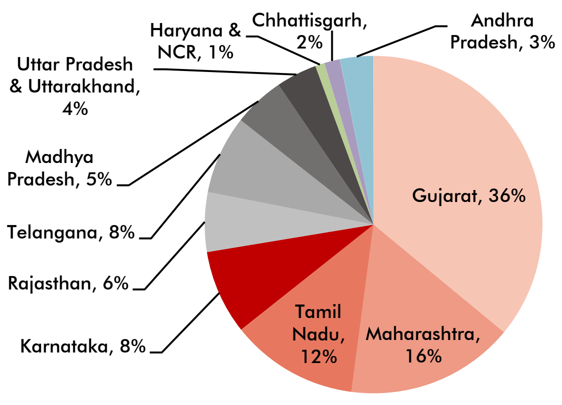
Source: Ambit Capital research, company

Exhibit 69: Can Fin focuses on south India



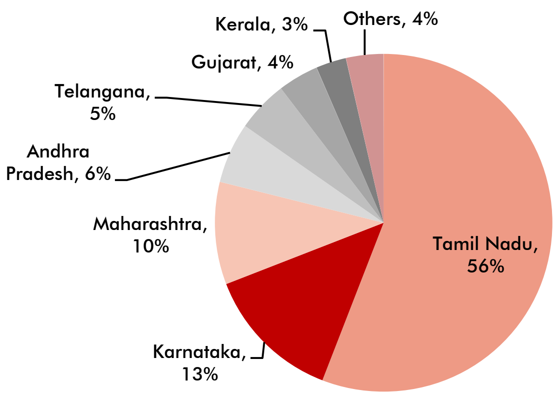
Source: Ambit Capital research, company

Exhibit 70: HFFC focuses on west, south India



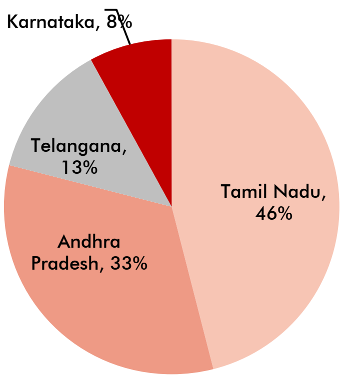
Source: Ambit Capital research, company

Exhibit 71: Repco focuses on south India



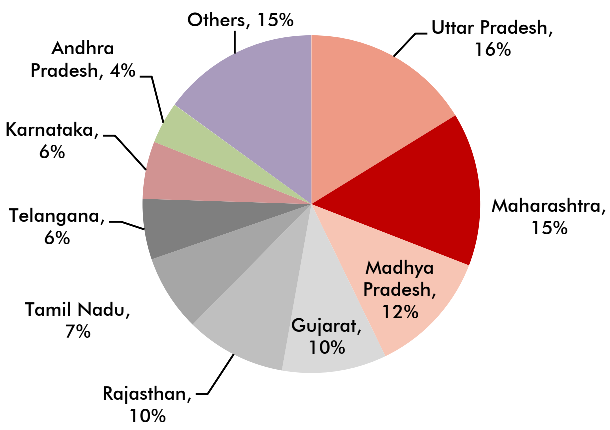
Source: Ambit Capital research, company

Exhibit 72: Aptus entirely focused on south India



Source: Ambit Capital research, company

Exhibit 73: Aadhar is most diversified



Source: Ambit Capital research, company

Summary of growth strategies of various HFCs

Exhibit 74: Aavas/Aptus better-placed with focus on self-employed in tier-3/below locations

Description	AAVAS	APTUS	CANFIN	HFFC
Targeted customer profile	Self-employed with undocumented/informal income proofs	Self-employed with undocumented/informal income proofs	Salaried (mostly formal salary)	Salaried (higher reliance on formal salary)
Average ticket size (₹ mn)	0.9	0.7	2.2	1.0
Borrower income assessment	Subjective cashflow assessment (checking raw material invoices, estimating daily/weekly customer footfalls/sales), market intelligence, personal discussions	Subjective cashflow assessment (estimating daily/weekly customer footfalls/sales), market intelligence, personal discussions	Documented income proofs; does not consider surrogate or undocumented income.	Formal income proofs, banking/investment/tax-related data, vehicle ownership
Targeted geographies	Tier-3 and below	Tier-3 and below	Peripheries of tier-1 cities/towns and tier-2 cities and towns.	Tier-1 peripheries; urban/increasing urbanisation; high per capita income/GDP areas
Branch mix (classified by tier)	75% in tier-3 and below	86% in tier-3 and below	27%/32%/41% in tier-1/2/3, resp.	32%/47%/22% in tier-1/2/3, resp.
Product preference	Home loans; majorly self-construction. Also does non-housing loans but not to existing home loan customers.	Home loans; majorly self-construction	Home loans; majorly self-construction and small builder flats. Recently started targeting higher value apartments for growth.	Home loans; higher focus on flats/apartments. Recently started targeting self-construction.
Distribution	Branch and employees led. Nearly 100% sales/originations are generated in-house.	Nearly 100% sales/originations are generated in-house.	50% sourcing is through DSAs; rest in-house.	Does not have in-house sales team. Relies on external resources (connectors, other strategic alliances) for sales/originations.
Functions:				
- Lead generation	In-house	In-house	Hybrid (in-house, DSAs)	Outsourced
- Sales/origination	In-house	In-house	Hybrid (in-house, DSAs)	In-house
- Underwriting	In-house	In-house	In-house	In-house
- Valuation/technical/legal	In-house	In-house	Outsourced	Outsourced
- Collections	In-house	In-house	Hybrid	In-house

Source: Ambit Capital research, companies

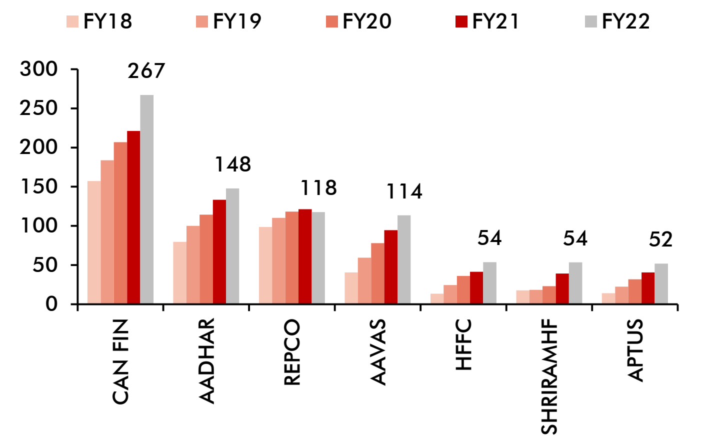
Exhibit 75: Aavas scores highest due to distinct geographic/customer focus and disclosure quality

	Aavas	Aptus	Can Fin	HFFC
Growth	◕	◕	◔	◕
Liability	◕	◔	●	◑
Asset quality	●	◑	◕	◑
Profitability	◕	◑	●	◑
Board governance/disclosure quality	●	◔	◑	●
Overall score	◕	◑	◑	◑

Source: Ambit Capital research, companies Note: ● - Strong; ◕- Relatively Strong; ◑- Average; ◔- Relatively weak

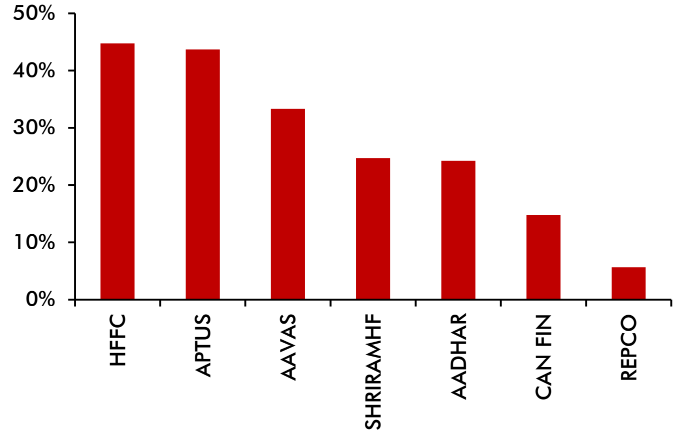
AUM/disbursements have been growing rapidly for HFCs

Exhibit 76: AUM of HFCs (₹ bn) – Can Fin is the largest among the small/mid-size HFCs



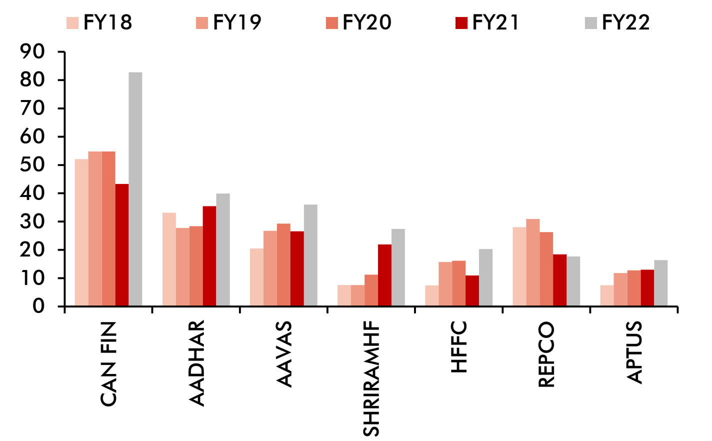
Source: Ambit Capital research, company

Exhibit 77: 5-year AUM CAGR (%) – Aptus/HFFC have seen the highest growth owing to a low base



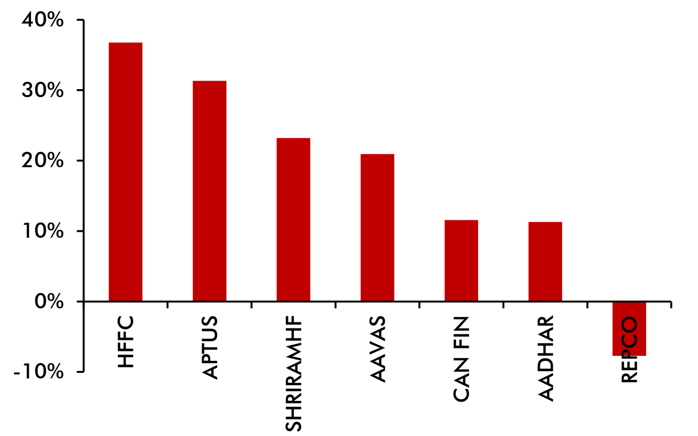
Source: Ambit Capital research, company

Exhibit 78: Disbursements by HFCs (₹ bn) – Owing to competitive pressures, Repco has reported decline YoY



Source: Ambit Capital research, company

Exhibit 79: 5-year disbursements CAGR (%) – Barring Repco, all HFCs are registered positive CAGR



Source: Ambit Capital research, company

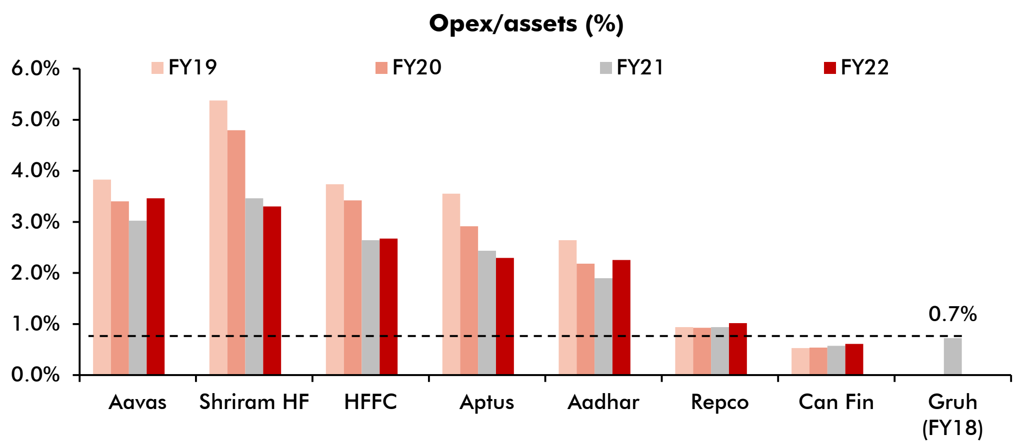
Productivity and scalability are intertwined

AHFCs are not productive enough yet. Opex ratios are high (2.7-3.5%) given the operationally intensive nature of small-ticket loans. Long-term profitability will be an outcome of how productively AHFCs can operate. Gruh's levels (opex/assets: 0.7%) remain unmatched by a distance. Historically, foraying into developer loans has been the most common way to achieve diversification and scalability but fatality rate is also high. A few AHFCs have adopted small business/MSME loans as their 2nd/3rd product. Other possible ways are increasing the ticket size (Can Fin) and DSAs as an additional sales channel. Even as opex/assets reaches 0.3% (mature stage) over the long term, ROA will settle lower due to higher competition (at scale) and higher leverage.

Current cost structures are too high and value-dilutive in the long-term

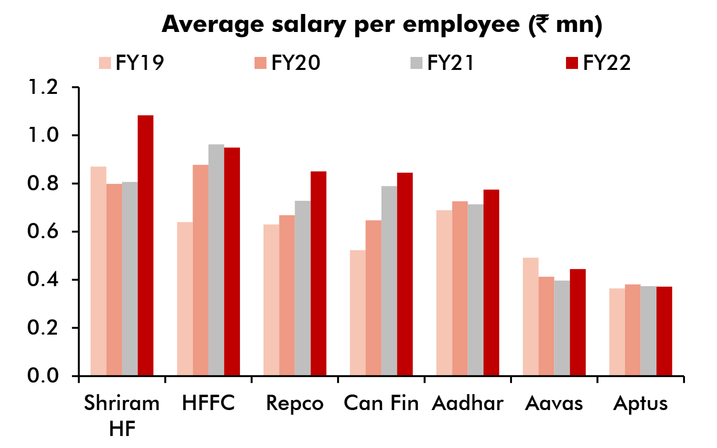
Mortgages is a highly sought-after asset as it gives AUM stability and aids recurring revenue (long-tenor asset). Given its competitive nature, spreads are low (HDFC/LIC HF make ~2% spread). In light of such thin spreads, AHFCs' current opex structure is too high (opex/assets: 2.7-3.5%). 100% in-house sourcing and focus on small-ticket loans have led to high reinvestments in new branches and manpower.

Exhibit 80: Gruh's opex ratios remain unmatched by current small-ticket AHFCs



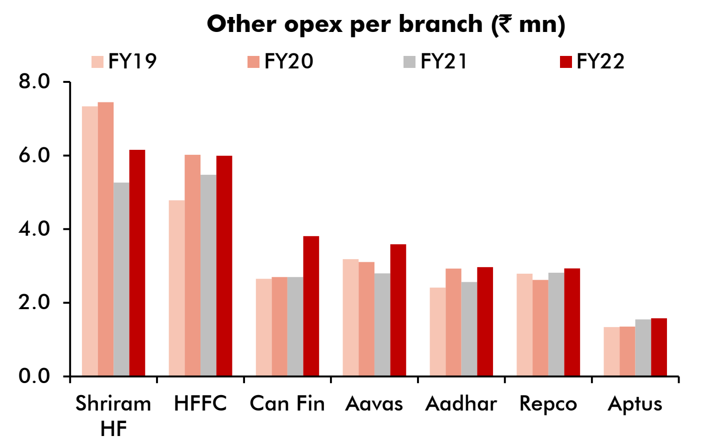
Source: Ambit Capital research, companies. Black dotted line represents Gruh's FY18 opex/assets of 0.7%

Exhibit 81: Aavas/Aptus have the lowest salary levels



Source: Ambit Capital research, companies

Exhibit 82: Aptus operates on a very lean branch set-up

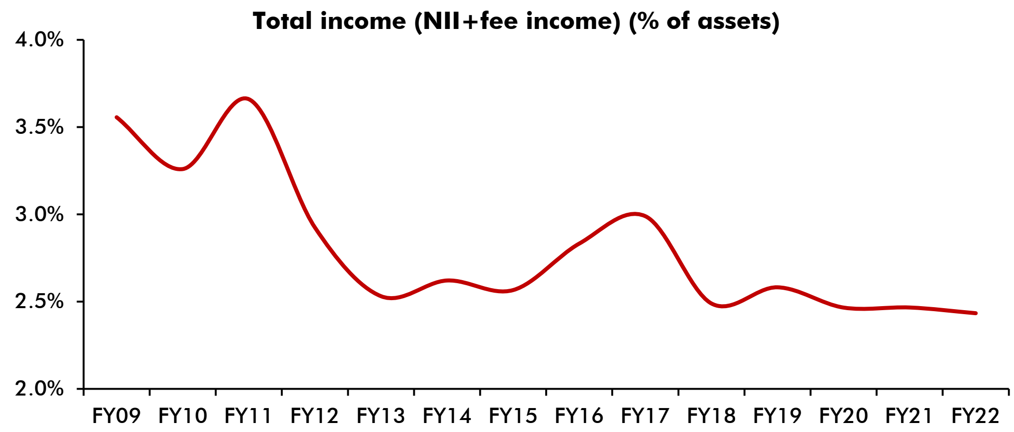


Source: Ambit Capital research, companies

Long-term profitability will be difficult unless productivity improves

As AHFCs grow in size and banks deepen their distribution reach, AHFCs' spreads will continue to decline over time. We saw this in the case of large HFCs over the last decade. For example, net income (NII + fee income) of LICHF has declined from 3.7% in FY11 to 2.4% in FY22.

Exhibit 83: Since FY09, LICHF has witnessed compression in overall revenue yields (NII+fee) due to increasing competition



Source: Ambit Capital research, company

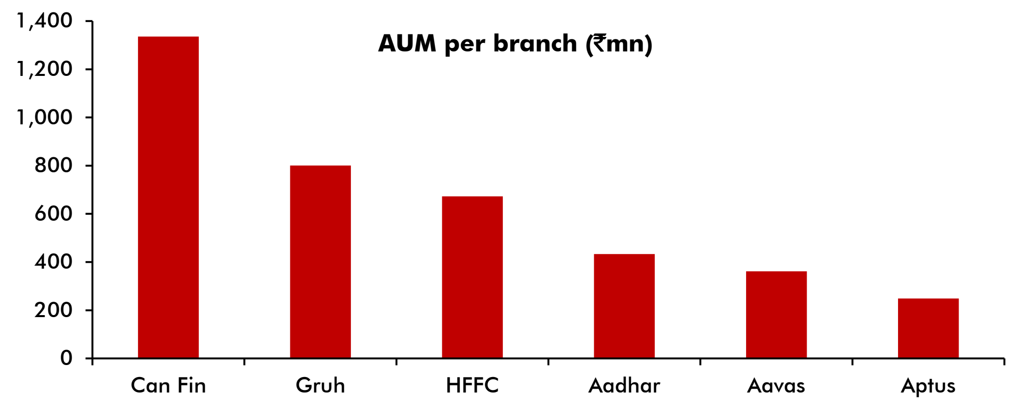
Therefore, in order to mitigate the profitability impact due to spread compression, improving productivity is critical in the long term. Doing mostly small-ticket housing loans with nearly 100% in-house sourcing, in an increasingly competitive market, hampers profitable scalability due to the high-opex structure. In order to gain scale, we see two inevitable trends: (1) selling non-home loan/mortgage products like MSME and developer loans and (2) increasing share of external/DSA sourcing. Increasing ticket size is another way to tap scalability. Our recent interactions clearly indicate that managements are considering other scale-accretive products as they acknowledged profitable scalability challenges presented by small-ticket loans.

- Currently, among the HFCs, only Aptus has meaningful business coming from business loans.
- Aavas has given strong indications that it wants to do MSME loans more meaningfully.
- HFFC has indicated that it would increase its share of LAP loans to 15% over time.
- Can Fin has increased its ATS to ₹2.2mn (up 19% since FY20) and will be increasing it further to ₹2.5-3mn in next 2-3 years. The company is also looking at developer loans to build balance sheet scale.

Gruh's benchmarks remain unmatched

Compared to Gruh (now merged with Bandhan), productivity levels (AUM per branch) for current set of AHFCs are poor (16-69% below Gruh's). Even the large players like HDFC/LIC HF have very low opex/assets, which is essential to delivering decent profitability.

Exhibit 84: Low opex ratios for Gruh were led by very high business productivity

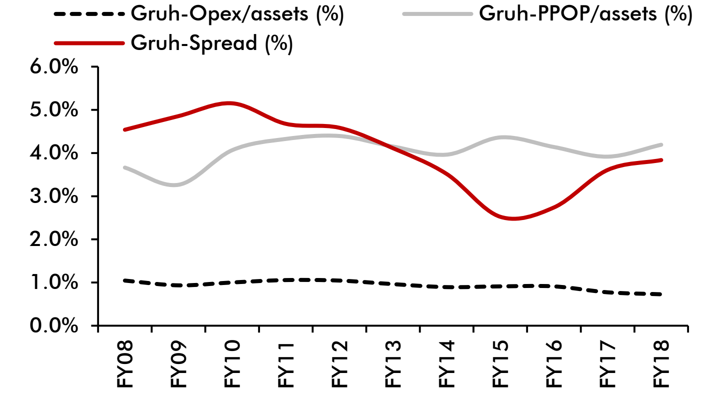


Source: Ambit Capital research, companies

Gruh, which saw its spreads compress by 75bps over FY12-18, was able to bring down its opex/assets by 36bps due to productivity improvement. Despite this, Gruh witnessed its PPOP margin erode by 20-50bps. Key notable trends at Gruh between FY12-18:

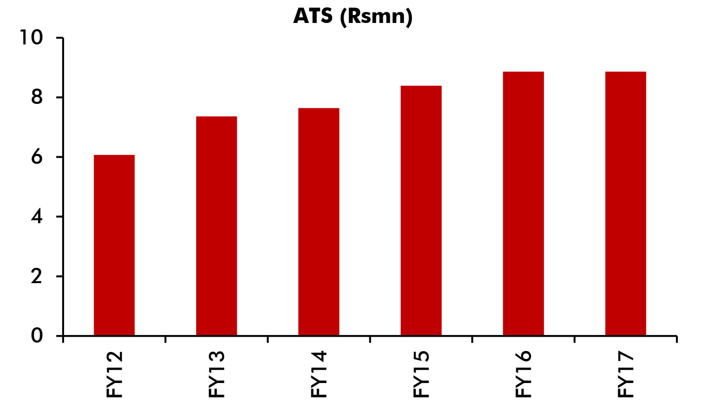
- Increasing share of high-yielding developer loans led to spread improvement between FY15-18.
- Ticket size increased at 7% CAGR over FY12-18, contributing to asset growth. AUM per branch increased at 16% CAGR over FY12-18.
- Number of home loans managed per branch increased at 7% CAGR over FY12-17. Business sourced through third-party channels was >70%.

Exhibit 85: Impact of declining spreads was mitigated by improving opex efficiency/productivity



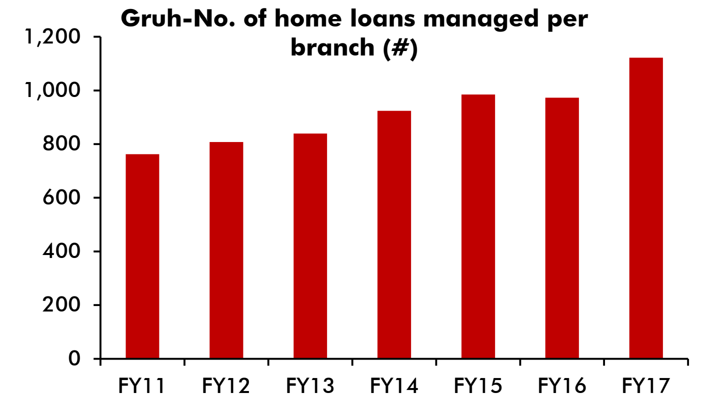
Source: Ambit Capital research, company

Exhibit 86: Part of scale build-up for Gruh came from increase in ticket sizes



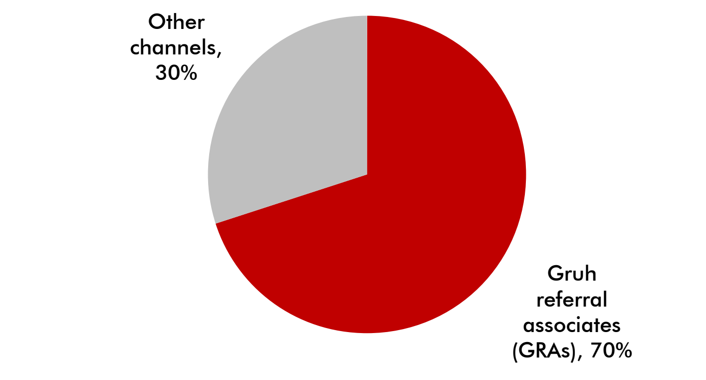
Source: Ambit Capital research, company

Exhibit 87: Sales productivity was enhanced by outsourcing originations



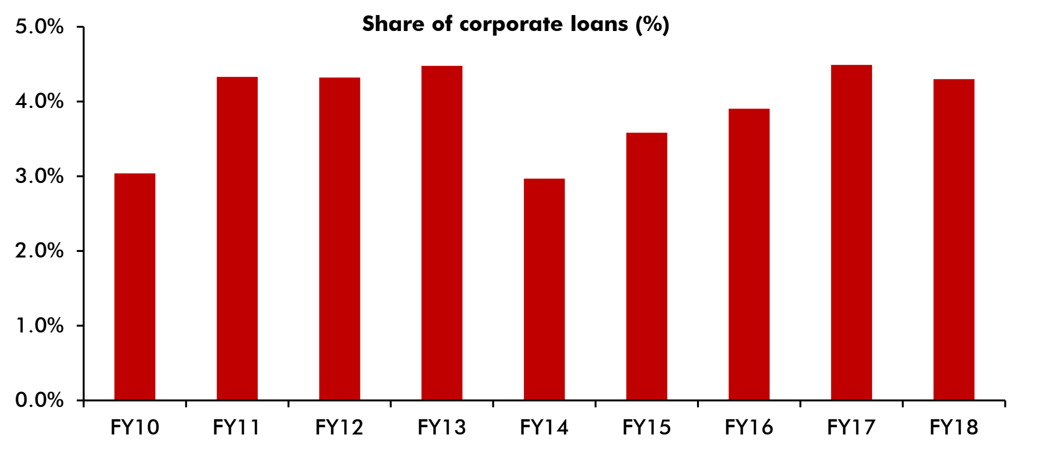
Source: Ambit Capital research, company

Exhibit 88: Gruh was sourcing 70% externally. Keeping origination entirely in-house means constant reinvestment.



Source: Ambit Capital research, company

Exhibit 89: Even Gruh had to do developer loans to build scale

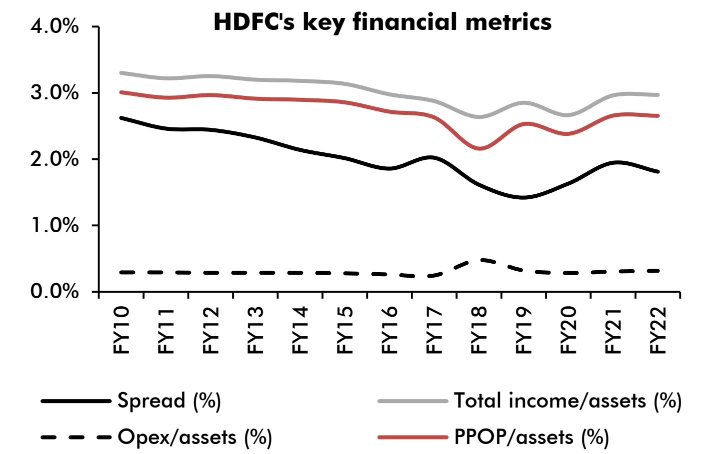


Source: Ambit Capital research, company

Productivity improvement has an endgame too

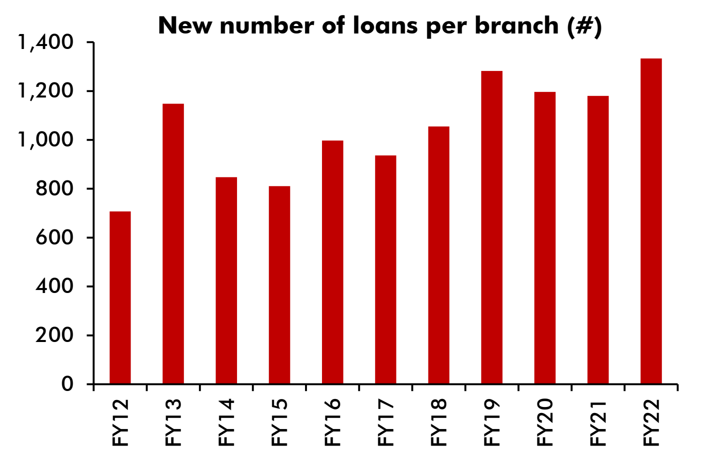
In case of HDFC (most mature mortgage lender), to mitigate spread compression of 80bps since FY10, the company has focused on improving productivity. This is highlighted by increasing AUM per branch as well as increasing number of loans disbursed per branch. This was also aided by having fair bit of corporate loans. Increasing share of external sourcing has also helped. However, despite the productivity improvement, the company has only managed to limit PPOP/assets decline to 30bps since FY10.

Exhibit 90: In the long term, even the mature lenders could not mitigate profitability impact due to spread compression



Source: Ambit Capital research, company

Exhibit 91: Growth in HDFC's new loans generated has slowed, indicating size challenges and productivity maxing out



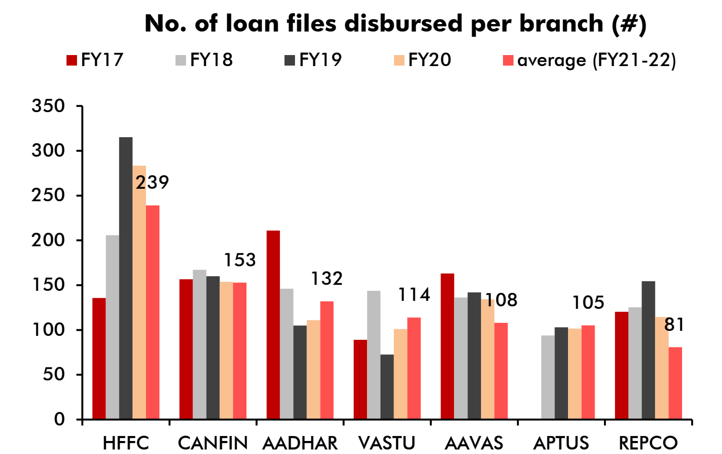
Source: Ambit Capital research, company

The conclusion we draw from Gruh/HDFC is that after a point, even productivity cannot stop PPOP margin erosion. This behavior is almost entirely explained by the highly competitive nature of the mortgage market. Therefore, as HFCs gain scale and the turf becomes more competitive, structural profitability will inevitably decline.

HFCs have disappointed on productivity

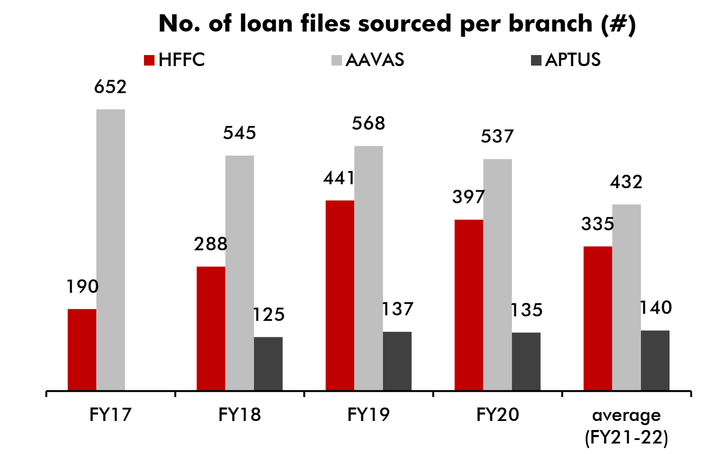
We look at each company's productivity on per branch basis mainly as each of them follows a different sourcing strategy (DSA sourcing varies from 0-80% across companies), which determines their in-house manpower requirement. We note that Aavas/Repco faced deterioration in branch productivity, as indicated by declining number of files sourced/disbursed per branch. Aadhar/Vastu have reported improvement and Can Fin/Aptus seem to have maintained their productivity.

Exhibit 92: Only Aptus showed improvement in productivity



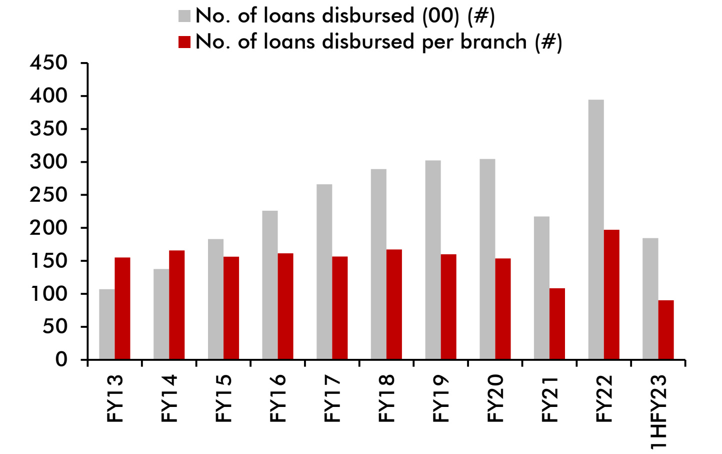
Source: Ambit Capital research, companies

Exhibit 93: Frontline sales productivity still below pre-Covid



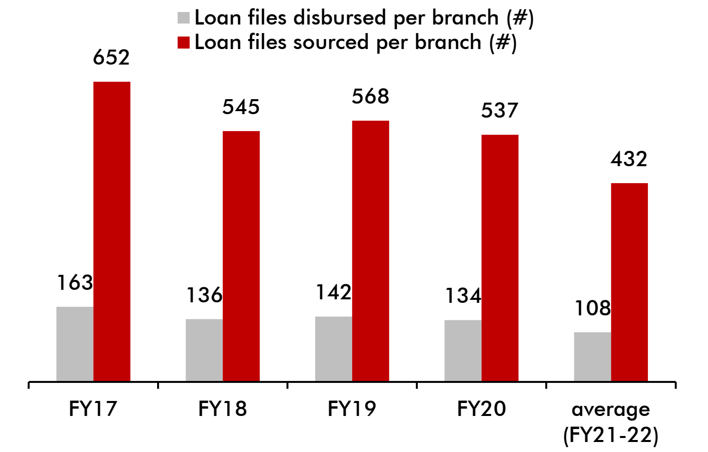
Source: Ambit Capital research, companies. Sourced files based approval/rejection rates disclosed by each company.

Exhibit 94: Can Fin's branch productivity stagnated



Source: Ambit Capital research, company

Exhibit 95: Aavas' branch productivity metrics disappointed



Source: Ambit Capital research, company. Sourced files based approval/rejection rates disclosed by each company

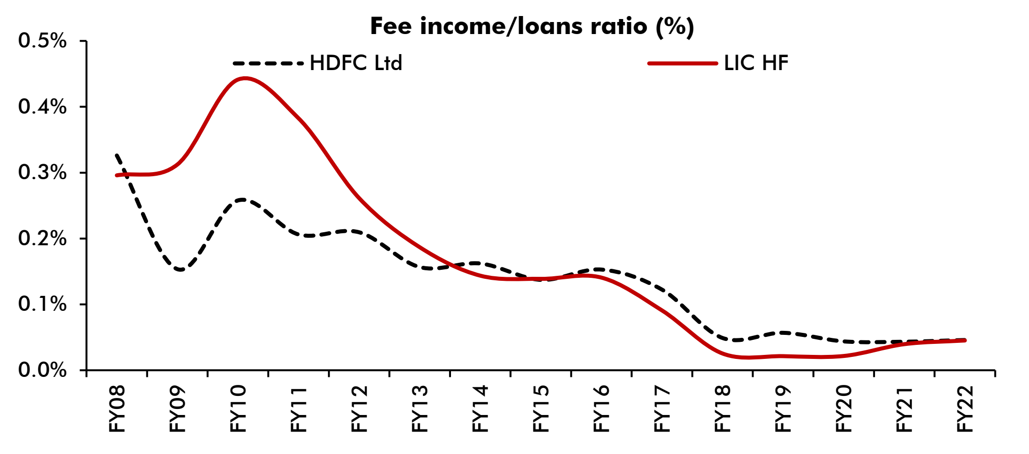
Prepayments are inevitable

Besides improving income levels, heightened balance transfer (BT) activity drives prepayments rates higher and impacts growth. When rates are low and various lending venues are constrained for growth, banks become aggressive on mortgages. SBI drives the sector pricing behaviour and thus, the systemic BT activity. In two instances in the last cycle (FY15-18, FY19-22), SBI's rate cuts drove AHFCs' repayment rates higher, putting pressure on growth. We estimate that loans are most vulnerable to BT-out between 24-36 months post origination and at a repricing differential of >200bps. Currently, AHFCs are indicating lower BT pressure compared to last year. Given that the underlying fundamental reason for BT is more efficient pricing of credit risk, we see challenges for AHFCs' growth/profitability. As competition increases and in order to mitigate BT risks, AHFCs will have to make a trade-off between AUM growth and NIMs.

Waiving pre-payment penalty was game-changer

The Indian home loan market is on floating rate. Interest rates chargeable to borrowers move in tandem with changes in systemic rates. Earlier, HFCs were allowed to charge customers prepayment penalties, which was a deterrent to BT-out. In 2011, NHB disallowed HFCs from charging such penalties, thereby removing a major constraint for the customer. Since then, not only have HDFC/LIC HF's spreads contracted, their fee income/assets ratio also came down. Further, pressure to maintain AUM growth via higher disbursements kept opex ratios constant. Overall, the decline in ROAs for HDFC/LIC HF since the waiver of pre-payment penalty can be attributed to higher pricing competition from low cost banks. Anecdotally, HFCs have raised voices about bringing back pre-payment charges as a deterrent to BT activity by bank (link).

Exhibit 96: After prepayment penalty disallowance, fee income/loans has declined



Source: Ambit Capital research, companies

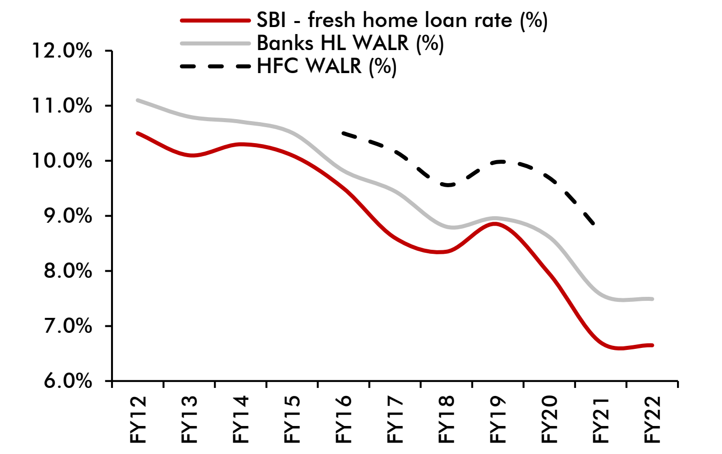
BTs are part-and-parcel of the rate cycle. SBI is the price-maker.

AHFCs tend to face prepayment/BT pressure during times of low interest rates and lower credit deployment opportunities. During such times, banks become aggressive with their home loan pricing, leading to growth pangs for HFCs. This market behavior was observed at least twice in the last decade (FY12-22).

- Between FY15-18 (demonetization, structural bump-up in systemic liquidity, corporate stress build-up), SBI cut its home loan rate by 195bps. Between FY17-18, SBI cut its home loan rate by 115bps vs 94bps reduction by HFCs.
- Similarly, post corporate NPA clean up and amid Covid (FY20 onwards), SBI cut its home loan rate by 215bps vs 128bps reduction by HFCs.

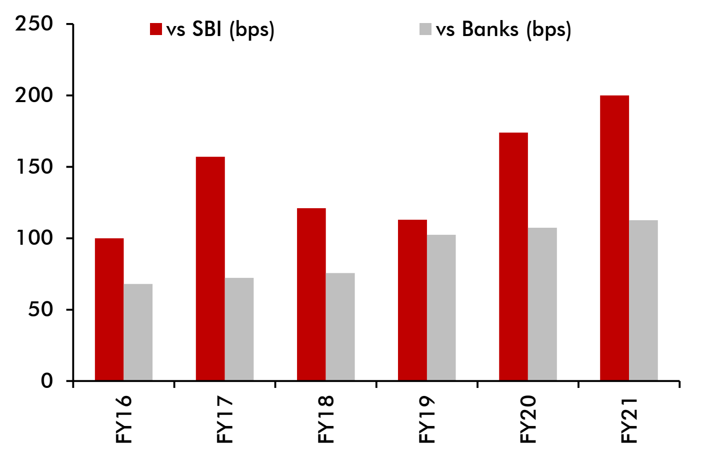
Over time, SBI exhibited price-maker behavior given its superior advantage on cost of funds. In the latest cycle, we learn that SBI/HFC/ICICI were the major players taking over loans.

Exhibit 97: SBI tends to act as the price-maker in low-rate scenarios



Source: Ambit Capital research, companies, RBI

Exhibit 98: HFCs' WALR spreads vs SBI/banks have been expanding, making them relatively expensive



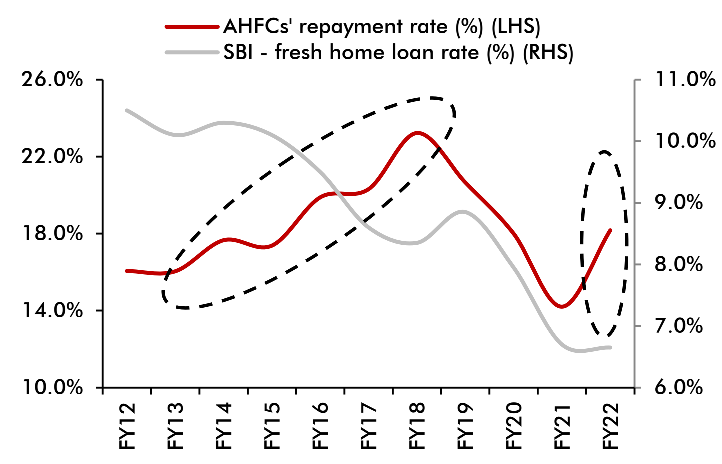
Source: Ambit Capital research, companies, RBI

Exhibit 99: HFCs face repayment pressure when price-competition is high

Read-through across last two cycles
FY15-18
SBI dropped rates from FY15 to FY18. But HFCs did not drop rates as much as SBI as indicated by expanding HFC WALR spread over SBI HL rate. Over FY15-18, repayment rates for AHFCs increased from 17.4% (FY15) to 23.2% (FY18), likely due to price-competition from banks.
FY19-22
In FY19, SBI/banks increased HL rates and so did HFCs. As price-competition abated to some extent, HFCs' repayment rates eased but have still remained higher than pre-FY15 levels. In FY22, as SBI/banks dropped rates further, HFCs faced BT pressure, resulting in higher repayment rates.

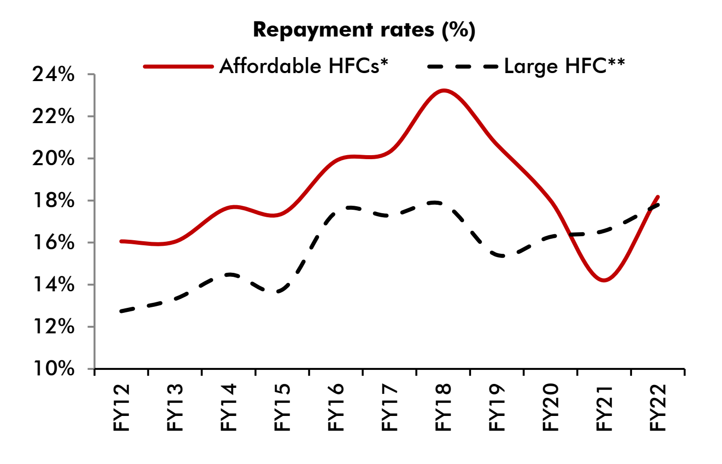
Source: Ambit Capital research, companies

Exhibit 100: AHFCs' repayment rates tend to increase when SBI (price-maker) reduces rates



Source: Ambit Capital research, SBI, RBI

Exhibit 101: Rising income levels, BTs, CLSS subsidies have led to higher repayment rates for small/mid-size HFCs



*Source: Ambit Capital research, RBI, companies; *Affordable HFCs = Aavas, Home First, Aptus, Can Fin, Repco, Shriram HF, Aadhar; ** large HFC = LIC HF*

Loans are most vulnerable 18-24 months from origination and at >200bps differential

Our analysis of mortgage repayment schedule indicates that a loan given at higher rates is most exposed to balance transfer risk 24-36 months after origination since by then it has established a satisfactory repayment track record. However, the rate differential needs to be >200bps for potential savings on interest payments to be incentivizing enough, after accounting for various fees/charges. We learn balance transfer usually happen where origination interest rates are at 9-10% during a low rate environment. Loans originated at 11-13% don't see as much transfer pressure.

Exhibit 102: Estimated savings under BT* aren't enticing enough unless re-pricing is at least 250-300bps lower

Total interest paid on original loan (assuming no BT)	1,045,874
Total interest assuming BT after 24 months	991,222
Processing charges during BT	15,000
Savings (% of original interest paid)	3.8%

*Source: Ambit Capital research; Ambit estimates; *Assuming that loan is transferred 24 months after origination and re-priced 200bps lower. Principal loan amount assumed is ₹1mn with origination interest rate of 11%.*

There is no escaping high repayments rate

High repayment rates are a part-and-parcel of the low rate regime. Over the long-term, we see two likely risks for AHFCs which can challenge customer/asset retention: (1) generation of digital financial footprints can remove information asymmetry (credit info needed for underwriting) and (2) deepening reach of banks (through own branches or DSAs) can remove distribution arbitrage.

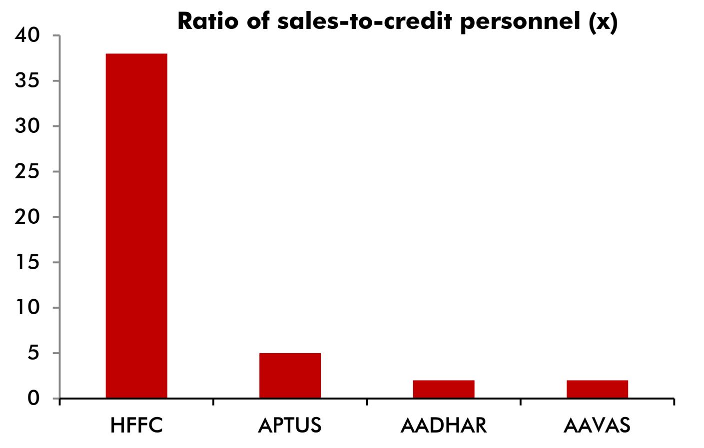
Sales focus > underwriting is bad for asset quality

Sales being dominant over underwriting/collections can have negative repercussions. We have noticed negative outcomes of such an organisation structure in multiple cases (DHFL, RHF, PNB HF, Aspire HF). The industry is of the opinion that keeping sales separate from underwriting and collections is a better design. Overall, Aavas/Can Fin are better-placed than peers on overall asset quality assessment. Given the addressable customer profiles, long-term credit costs for AHFCs will settle higher at 25-35bps higher vs large HFCs (20-25bps).

Sales-dominated organizations suffer on asset quality

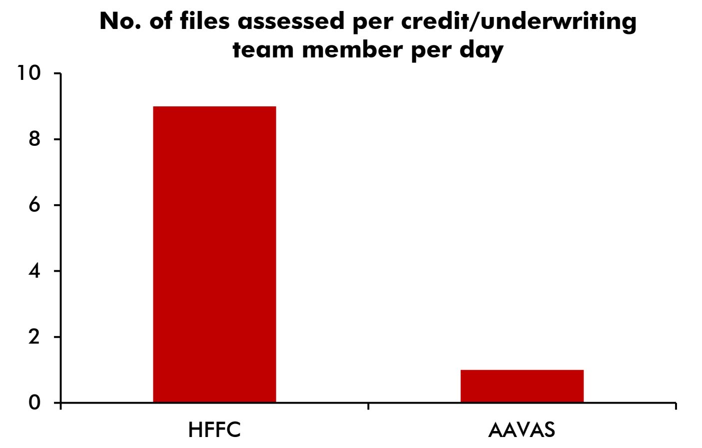
Our industry interactions suggest that organizations where sales function dominates credit/underwriting suffer on asset quality. Aggressive focus on sales with relative under-investment in underwriting capabilities can be a recipe for disaster. A crude way to gauge sales aggressiveness is to look at sales-to-underwriting staff ratio (1 underwriter supports how many sales officers?). However, since this ratio does not adjust for the business model construct (centralized/decentralized underwriting), it cannot be looked at in isolation. Based on number of files sourced and approval/rejection ratio, we estimate that HFFC's one credit underwriting officer goes through 8-9 files per day compared to 1-2 each for Aavas. This is because HFFC follows a centralized underwriting model, whereas Aavas follows a decentralized one.

Exhibit 103: HFFC's ratio of sales/credit personnel is an outcome of its centralized approach



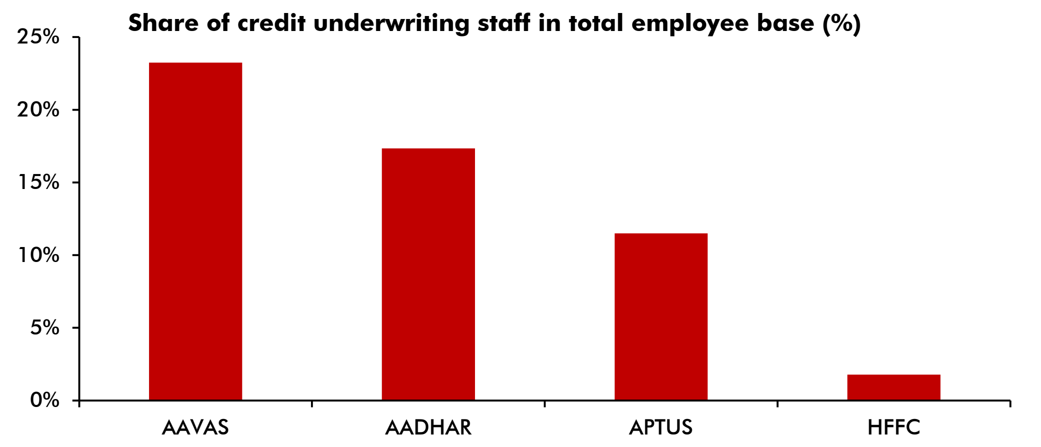
Source: Ambit Capital research, companies

Exhibit 104: Self-employed/informal income cases take more time due to higher degree of subjective assessment



Source: Ambit Capital research, companies

Exhibit 105: Aavas has the highest share of credit officers due to decentralized model, HFFC lowest

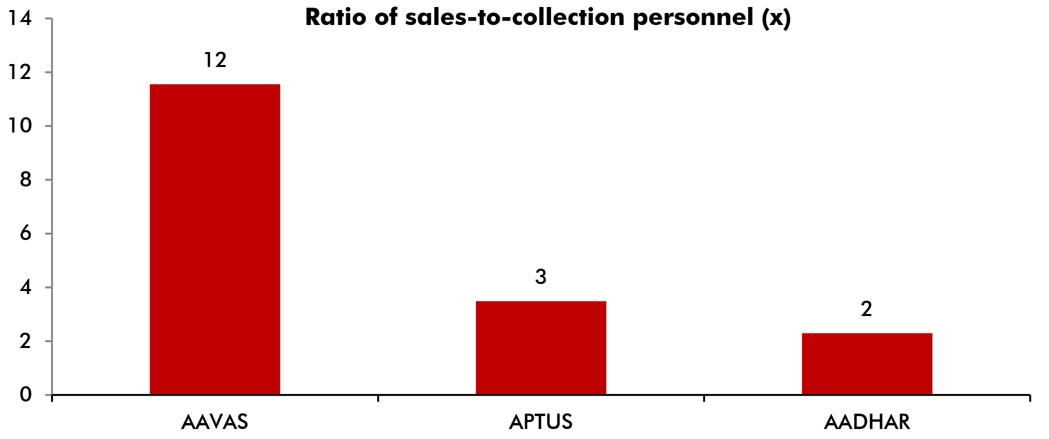


Source: Ambit Capital research, companies

Collection function is equally important

Collection is one of the most critical functions in any lending business. At Gruh, employees would first look at their recovery performance in the morning. If it was lagging, people were directed to focus on improving collections before generating new business. Among the listed AHFCs, 1 collection officer supports 12/3/2 sales staff at Aavas/Aptus/Aadhar. In case of HFFC, the relationship manager, who does sales, doubles up as collections officer. Based on our interactions and observations across industry/business models, we believe domain experts are a necessary requirement. Clubbing sales and collections with the same person may not be an optimal design as neither of the functions would receive laser focus. Worst case would be that sales/growth happens at the cost of poor/dropping collections. Hence, we believe that sales and collections should be separate functions.

Exhibit 106: Granular ATS requires high investment in collections infra. Segregation from sales is necessary so as to avoid misalignment of incentives.

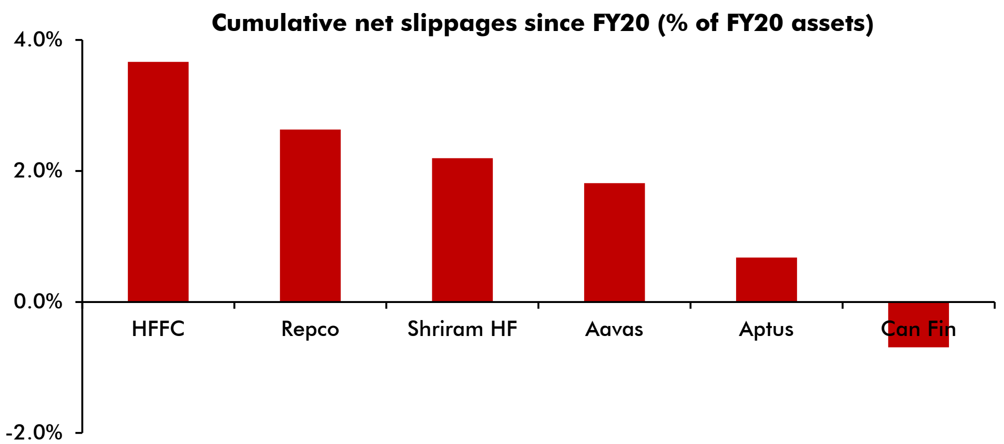


Source: Ambit Capital research, companies. Note: In case of HFFC, sales RM performs the collections function too.

Aavas/Can Fin better-placed on asset quality

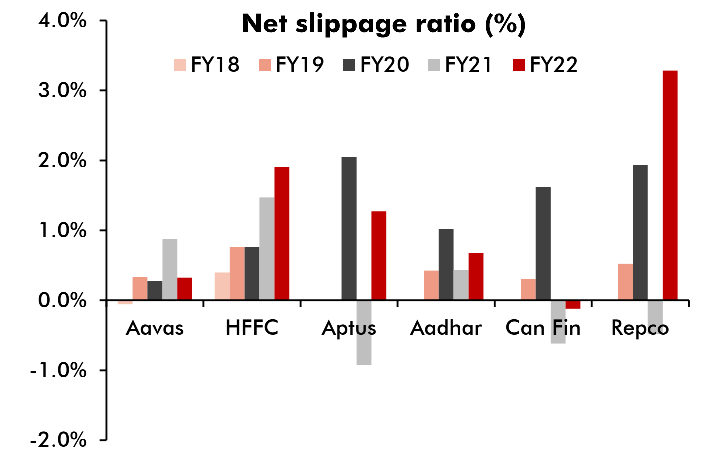
Aavas/Can Fin have demonstrated better asset quality outcomes compared to peers. On a 2-year lagged basis, Aavas/Can Fin's GNPAs are lower than peers. On the other hand, HFFC/Repco HF have seen higher stress formation. We believe Aavas' superior asset quality control is an outcome of its strong focus on careful underwriting and collections. Can Fin's asset quality outcomes can be attributed to its stringent underwriting criteria (it does not take into account any undocumented income).

Exhibit 107: Pandemic was a test of asset quality (as indicated by cumulative stress formation)



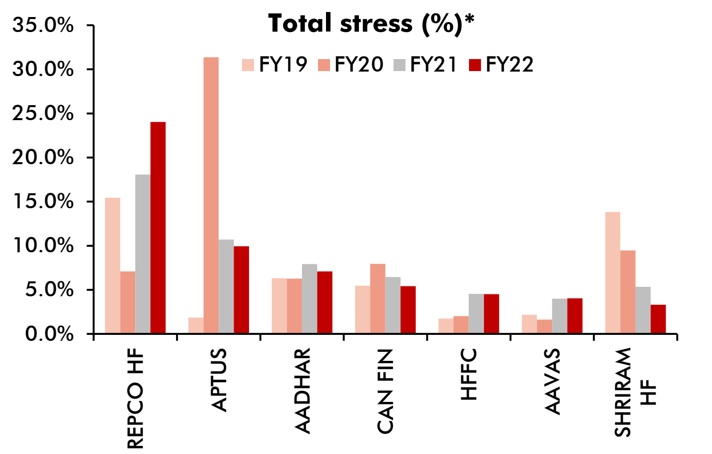
Source: Ambit Capital research, companies

Exhibit 108: Slippage ratio has been increasing for HFFC



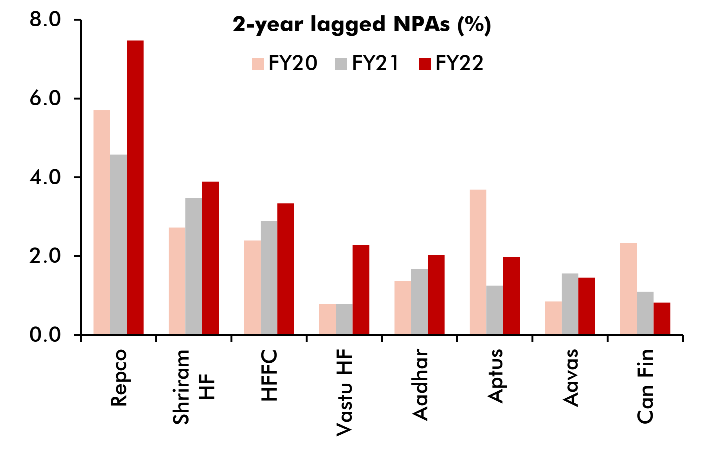
Source: Ambit Capital research, companies

Exhibit 109: Total stress levels have increased for Aavas/HFFC



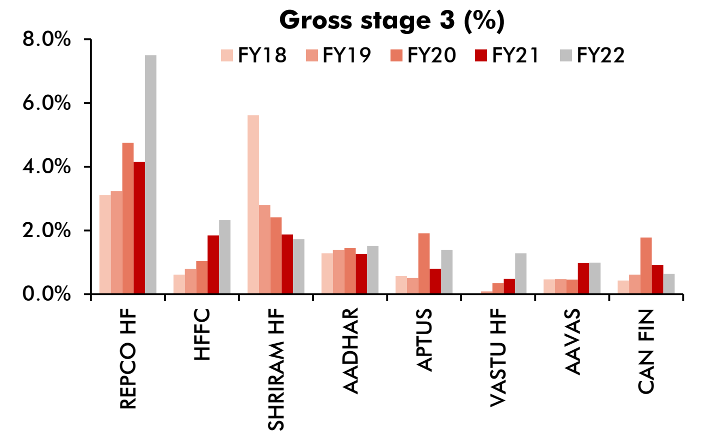
*Source: Ambit Capital research, companies. *Stage 2 + stage 3 + write-offs*

Exhibit 110: As defaults mostly occur 2 years post origination, 2-year lagged NPAs are a better proxy for stress



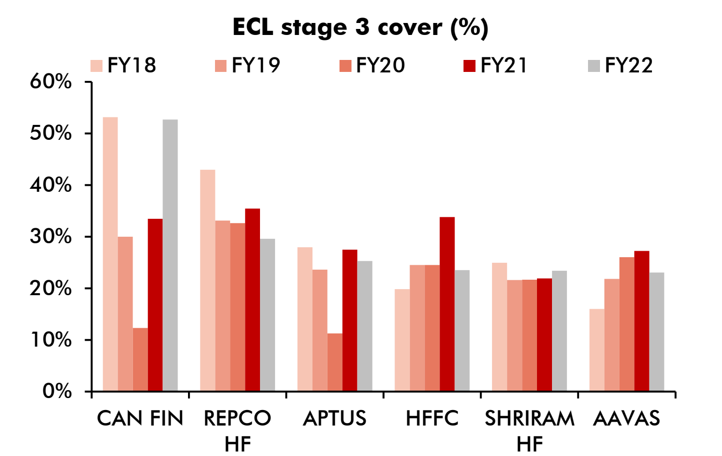
Source: Ambit Capital research, companies

Exhibit 111: 90-dpd sharply up for Repco while Aavas/HFFC have seen a gradual increase



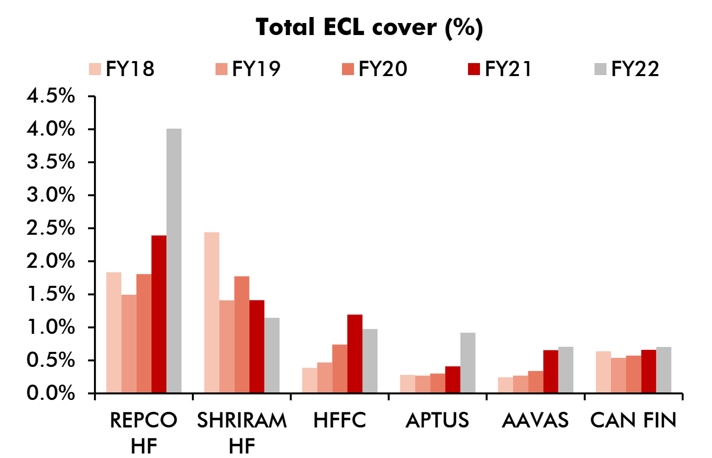
Source: Ambit Capital research, companies

Exhibit 112: Stage 3 ECL covers are comparable across AHFCs



Source: Ambit Capital research, companies

Exhibit 113: Aptus/Aavas have lower ECL covers

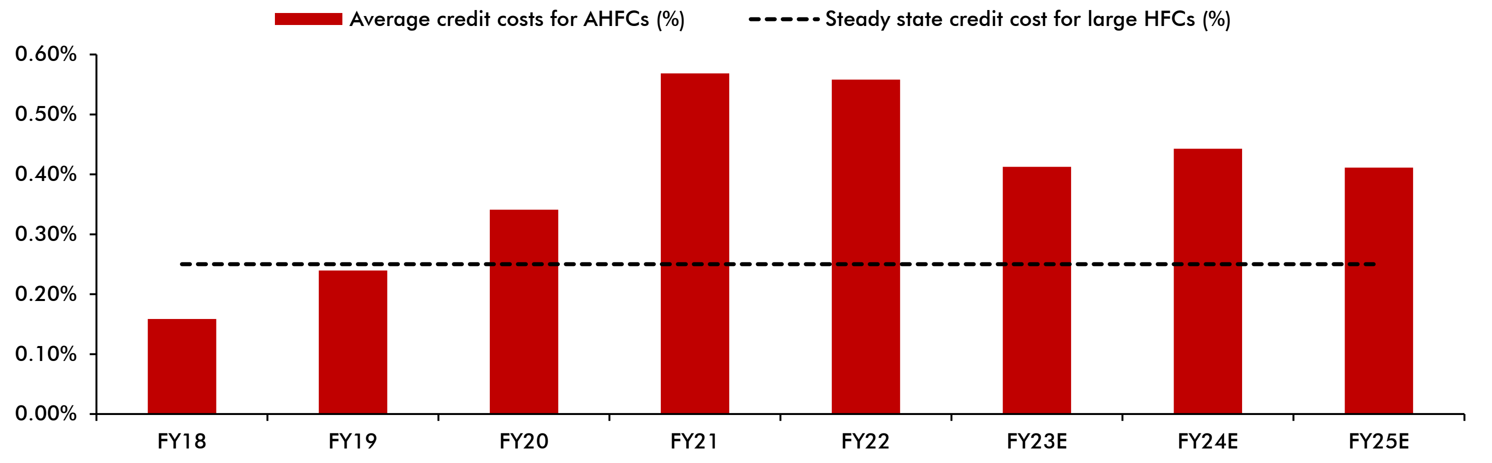


Source: Ambit Capital research, companies

AHFCs' business models are structured for higher credit costs

Considering the customer segment and consequently higher stress levels, we believe that AHFCs' business models are structured for higher credit costs (40-50bps) compared to large HFCs (20-25bps). Structural disadvantage on CoF would prevent AHFCs from targeting top quality customers. We expect Can Fin to see least amount of credit costs while HFFC/Aptus would be on the higher side.

Exhibit 114: Focusing on riskier category of customers will result in higher credit costs



Source: Ambit Capital research, companies. Note: Average taken for Aavas, Aptus, HFFC.

Lowest cost producer wins

Among small/mid-HFCs, Can Fin has the lowest cost of funds and a relatively more diversified liability mix. Canara Bank ownership (30%) has benefitted. Additionally, credit rating agencies draw comfort from Can Fin's long track record of being profitable and maintaining superior asset quality. Further, our calculations indicate that HFFC is able to obtain the lowest refinance rate on assignments. Higher share of fixed rate loans may present margin headwinds for Aavas/Aptus as cost of funds increases. Aptus has the least competitive cost of funds.

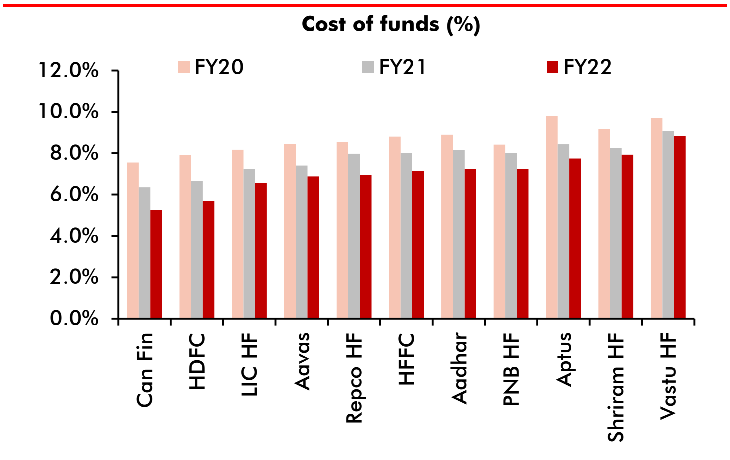
When product/service (home loan) is commodity, lowest borrowing cost wins

As highlighted before, home loan is a commodity product/service with multiple producers/suppliers. Naturally, large lenders (banks/HDFC/LICHF) have cornered >80% market share as they have lower cost of funds. However, HFCs with geographic/customer segment niche have grown despite having a higher cost of funds. In the HFC sector, Can Fin's lowest cost of funds has been aided by a higher share of CPs. Parent-backing (Canara Bank owns 30%) has also contributed towards credit ratings and ability to draw funds at lower cost. Aptus' cost of funds is least competitive, which is all the more negative from a long-term growth perspective.

Higher share of NCD shows market confidence

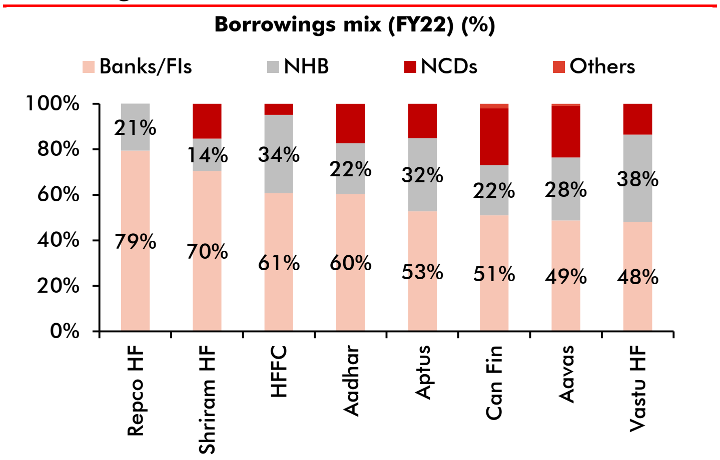
We also note that Aavas/Can Fin have relatively higher share of NCDs at 23%/25% (vs 5-17% for peers), indicating debt market's confidence in such names.

Exhibit 115: Can Fin is most competitive, Aptus/Vastu least



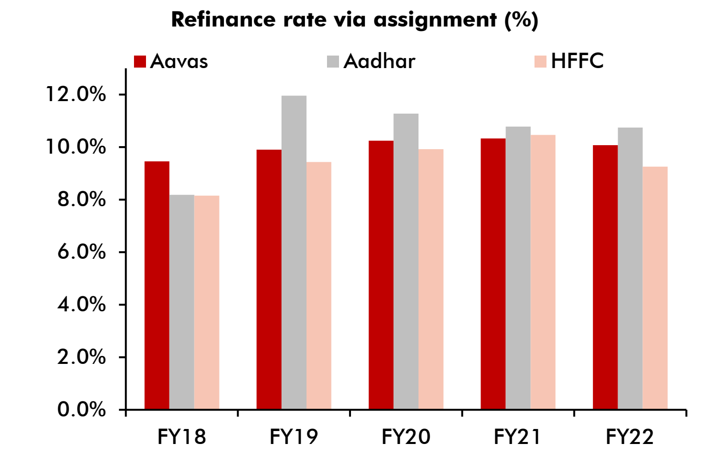
Source: Ambit Capital research, companies

Exhibit 116: Can Fin/Aavas have most diversified borrowings



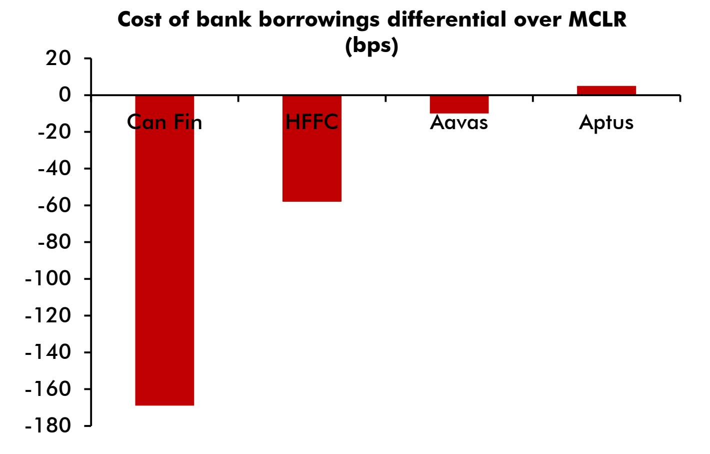
Source: Ambit Capital research, companies

Exhibit 117: Refinance rates on assignment are comparable



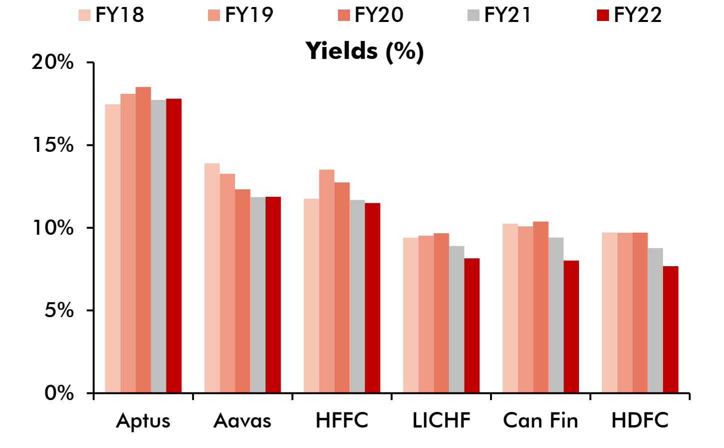
Source: Ambit Capital research, companies

Exhibit 118: Aptus' cost of bank funding at >MCLR



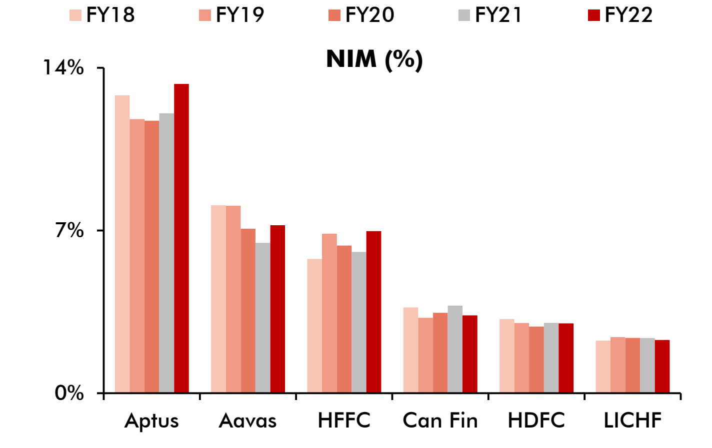
Source: Ambit Capital research, companies

Exhibit 119: Large lenders have most competitive yields…



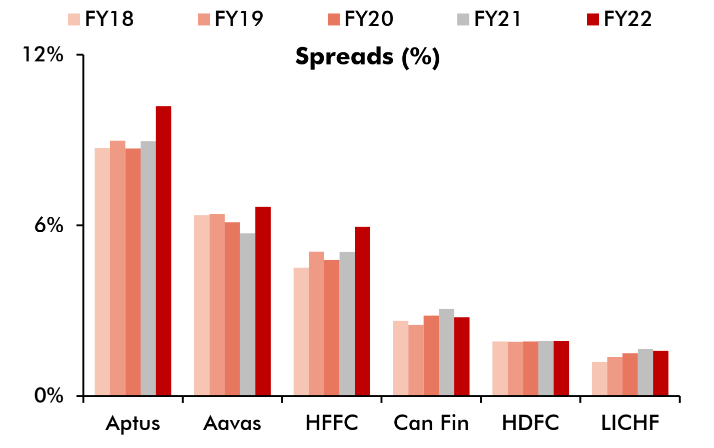
Source: Ambit Capital research, companies

Exhibit 120: …resulting in lower NIMs/spreads



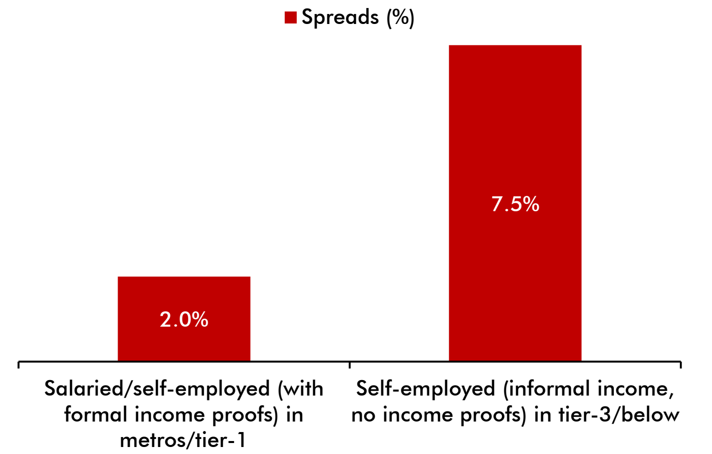
Source: Ambit Capital research, companies

Exhibit 121: With increasing competition, spreads tends to decline over time



Source: Ambit Capital research, companies

Exhibit 122: Higher spreads in informal income category reflects pricing for distribution and underwriting risk



Source: Ambit Capital research, companies

Board structure, governance, corporate events – unquantifiable yet critical

Aptus presents maximum number of concerns from a governance standpoint. This is more from a perspective of what can potentially go wrong or adherence to best practices. Most importantly, Aptus needs to reduce promoter/management influence on the board. Aptus' dividend declaration questions the idea of raising primary/growth capital just 15 months ago. HFFC/Aavas present no concerns, possibly implying best adherence to governance. Can Fin needs to arrest internal/disclosure processes.

Aptus needs most improvement

We note lapses/potential conflicts with respect to board governance, promoter influence/remuneration and capital allocation. On the other hand, we could not find any concerns at Aavas/HFFC.

Exhibit 123: We note maximum number of concerns with Aptus

Criteria	Aavas	Aptus	Can Fin	HFFC
Board structure	-	MD/chairman posts are no separated, thus creating potential concentration of power with a single person.	-	-
Audit committee	-	Committee is chaired by a shareholder, creating potential risk of influencing accounting practices.	-	-
Nomination & remuneration committee	-	Committee includes promoter/MD, creating potential risk of him influencing hiring/remuneration decisions.	-	-
Management team	-	CRO does not seem to be experienced in the function. CBO also manages risk, thus creating potential conflict of interest between sales and risk management.	-	-
Management remuneration	-	MD salary (also the promoter owing 25%) is 2.1% of PBT, highest among peers, despite the small balance sheet size.	-	-
Disclosure quality	-	-	(1) Rajasthan branch fraud was disclosed after 3-4 months of delay. (2) Sharp movement in stock price just before disclosure of CEO resignation. (3) Over time, number of regular disclosures have reduced (such as tier-1 ratio)	-
Corporate actions	-	Company raised primary capital of ₹5bn in Aug-21. Recently (Nov-22), company has declared dividend. This questions the decision to raise fresh capital 15 months ago during IPO.	-	-

Source: Ambit Capital research, companies

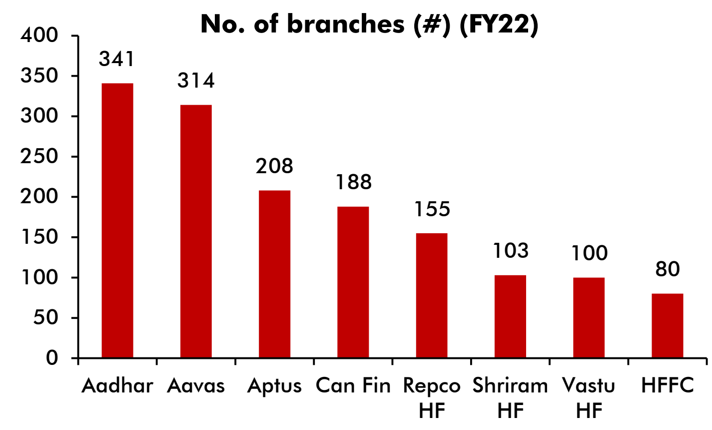
Aavas' execution has been top-notch

Based on our analysis of the overall business model strength, execution thus far and softer aspects such board structure/governance/disclosure quality, Aavas scores the highest. An important point to note is that while Aavas/Aptus/HFFC started operations only 1-2 years apart from each other, Aavas' AUM is >2x of Aptus/HFFC with better/comparable profitability and better asset quality.

Aavas has not shied away from making growth investments…

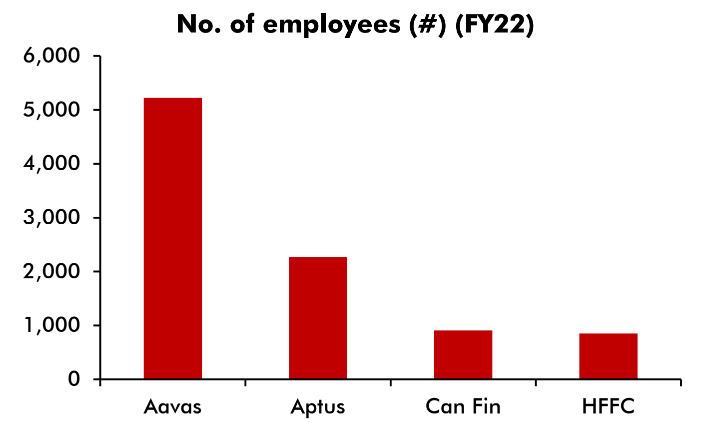
A key reason underlying Aavas' better-than-peers growth trajectory is its aggressive investments in branches and employees. Today, Aavas' branch network (320) is 1.5x/3.9x of Aptus/HFFC.

Exhibit 124: Aavas has the 2nd highest number of branches…



Source: Ambit Capital research, companies

Exhibit 125: …and highest number of employees

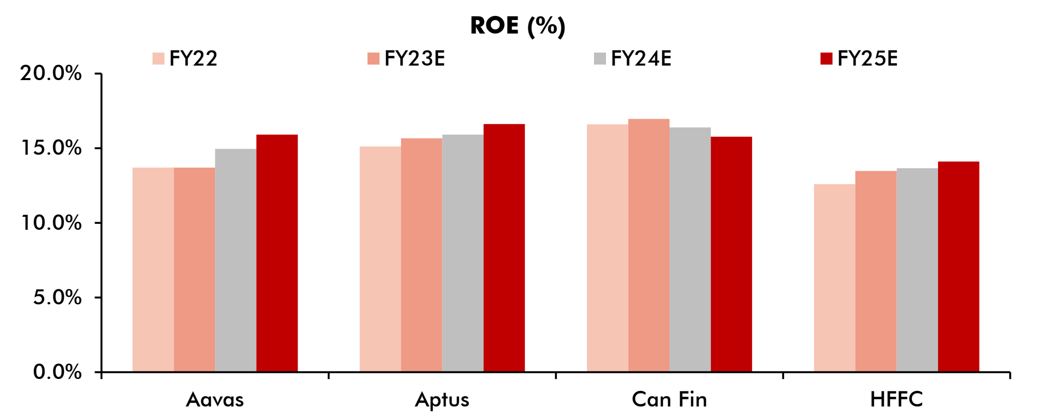


Source: Ambit Capital research, companies

…yet it is making better/comparable ROE

Naturally, growth investments came at a higher cost (opex: 3.5% vs 2.7/3.2% for Aptus/HFFC). However, the way we read the earnings print is that Aavas is on track to report 15% ROE in FY24E despite being the most aggressive in committing growth investments.

Exhibit 126: Aavas capable of delivering comparable ROE despite upfronting investments



Source: Ambit Capital research, companies

Exhibit 127: Aavas scores highest on business model strength

	Aavas	Aptus	Can Fin	HFFC
Growth	Relatively Strong	Relatively Strong	Relatively weak	Relatively Strong
Liability	Relatively Strong	Relatively weak	Strong	Average
Asset quality	Strong	Average	Relatively Strong	Average
Profitability	Relatively Strong	Average	Strong	Average
Board governance/disclosure quality	Strong	Relatively weak	Average	Strong
Overall score	Relatively Strong	Average	Average	Average

Source: Ambit Capital research, companies Note: - Strong; - Relatively Strong; - Average; - Relatively weak

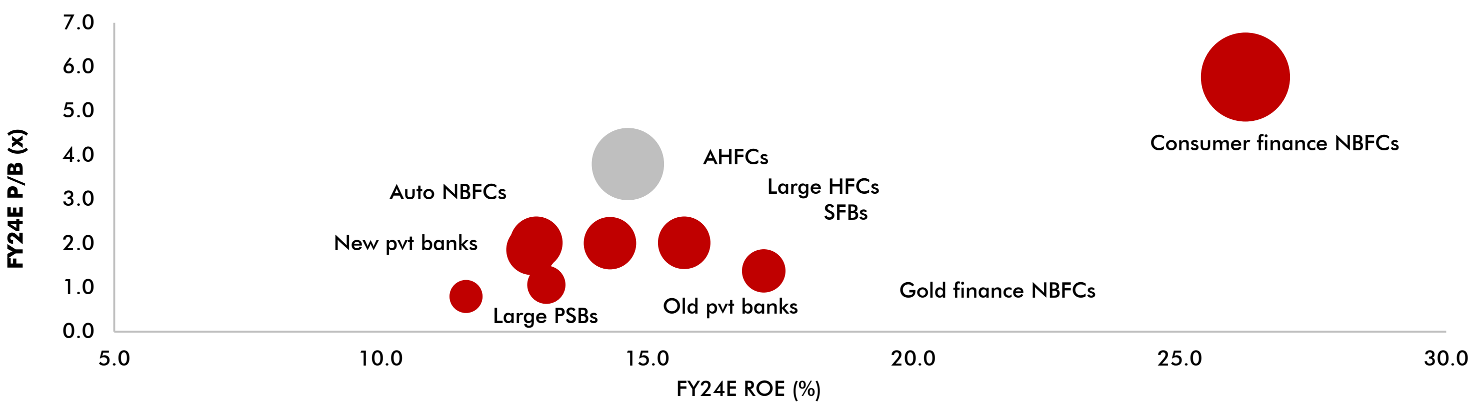
Stock valuations are priced to perfection

We estimate mortgage industry to grow at 13-14% CAGR for next 2 decades, led by aspirational demand. Affordable/smaller ticket segment is expected to grow at 200-300bps higher. In last few years, growth in tier-2/3 districts has been higher vs tier-1 districts. We believe that current AHFC valuations are already pricing for >20% AUM CAGR for next 20 years and likely overlooking growth challenges/risks. It's also important to note that historically, NBFCs/HFCs have delivered 15-19% CAGR over long-term; that too, in a lower regulatory environment. Among the names covered, we believe Aavas is best positioned to grow at 20% CAGR over FY22-42E due to its well-knit business processes, top management pedigree and investments in scale-building capacities. For Aptus/CANF/HFFC, our EPS estimates are up to 16% lower than consensus as we see margin/opex/credit cost risks to earnings.

Current valuations adequately capture/over-estimate long-term growth

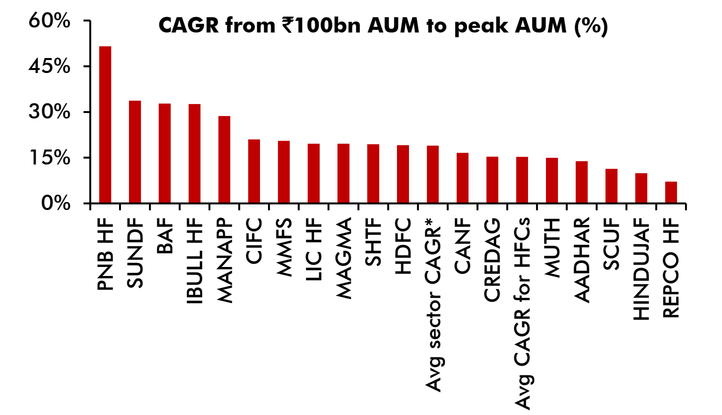
Current stock valuations (1.7-4x/11-30x FY24E BVPS/EPS) imply markets are expecting more than 15%/20% long-term AUM growth for Can Fin/AHFCs. Going by the industry's own track record, we believe long-term growth potential is lower. Our reasons are increasing competition and a stricter regulatory environment (post NBFC crisis).

Exhibit 128: Lofty valuations vs other lenders clearly reflect high growth expectations



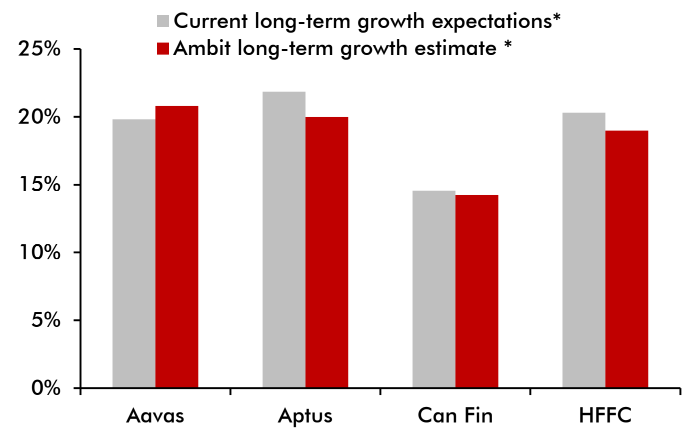
Source: Ambit Capital research, companies, Bloomberg

Exhibit 129: Historically, NBFCs have grown at 19% CAGR over AUM base of ₹100bn



*Source: Ambit Capital research, companies; *Sector = NBFCs + HFCs (excl. PNB HF, IBULL HF)*

Exhibit 130: Current valuations imply very high growth expectations

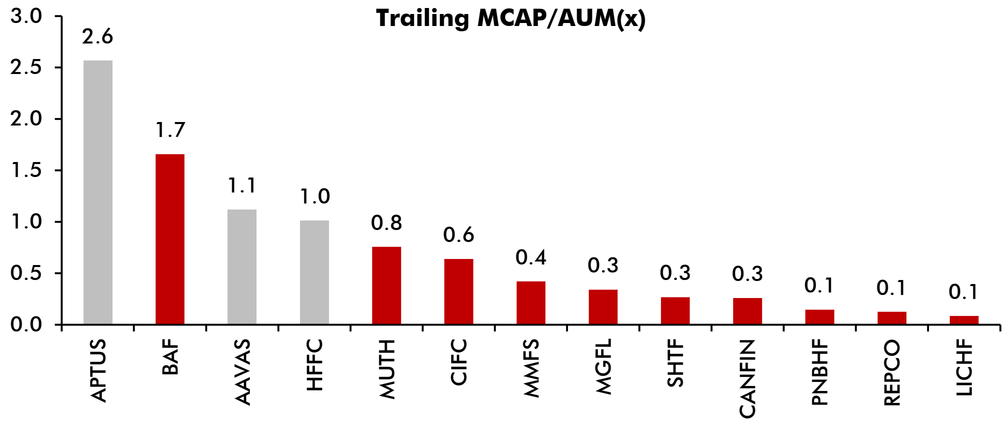


*Source: Ambit Capital research, companies. *CAGR from ₹100bn AUM.*

Tall expectations have led to valuation premium over broader sector

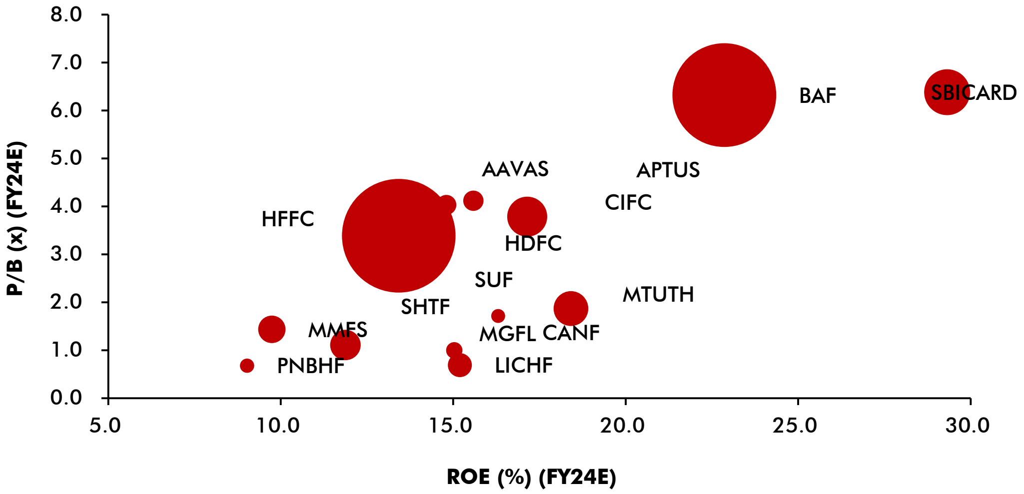
AHFCs trade at 1.2-3x MCAP/trailing AUM, implying significant premium being assigned to their growth capabilities. Aptus commands an even higher multiple than BAF despite limited track record. PSU-sponsored HFCs trade at the lowest valuations.

Exhibit 131: AHFCs trade at a significant premium to broader set of non-banks



Source: Ambit Capital research, Bloomberg, companies

Exhibit 132: AHFCs trade at a premium to large HFCs and most auto-NBFCs but at a discount to BAF/SBICARD

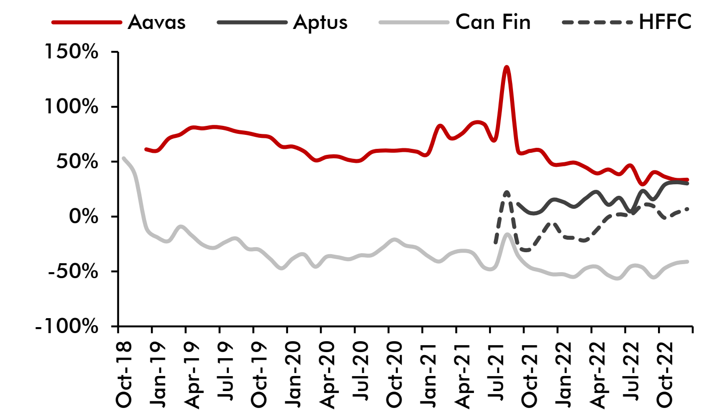


Source: Ambit Capital research, Bloomberg, companies

We expect valuation premium to narrow further

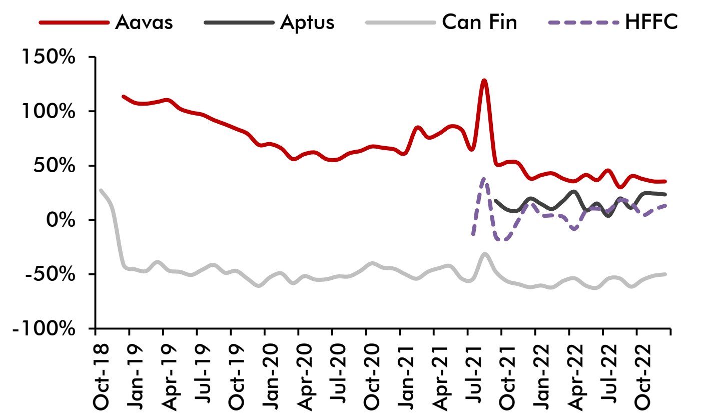
AHFCs trade at 7-35% premium to small/mid-size peers. Despite 25-41% correction in valuation multiples, the market's growth expectations remain tall.

Exhibit 133: 1-year fwd P/B (x) premium/(discount) to sector – AHFCs are trading at 7-34% premium



Source: Ambit Capital research, Bloomberg, companies

Exhibit 134: 1-year fwd P/E (x) premium/(discount) to sector – AHFCs are trading at 13-35% premiums

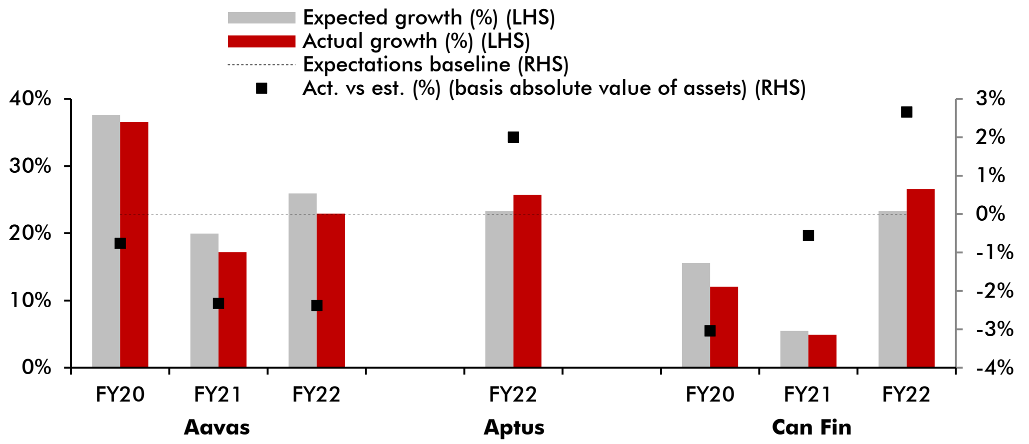


Source: Ambit Capital research, Bloomberg, companies

Aavas has been a classic example recently

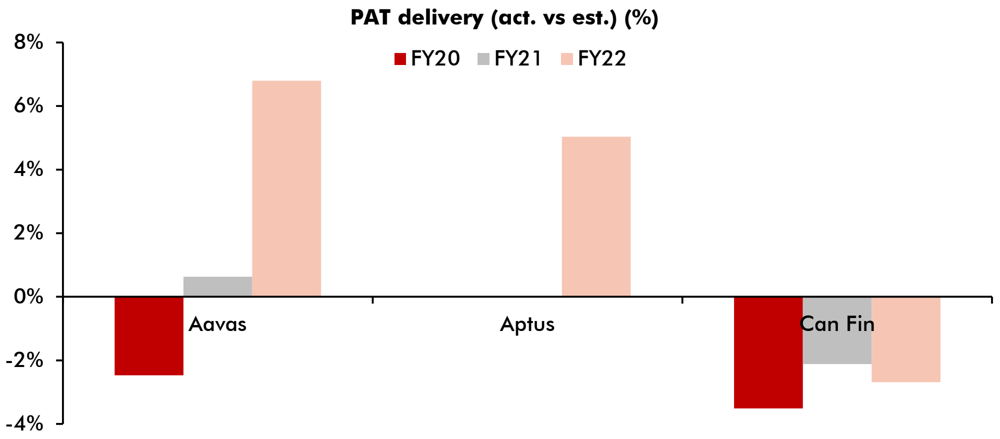
Up to ₹78bn in AUM (FY20), Aavas' annual AUM growth was tracking >30%. Since 1QFY21, the company's quarterly average AUM growth (YoY) was 22%. Over FY22-25E, we expect AUM CAGR of 23%. Based on our investor interactions 12-15 months ago, Aavas' high valuation multiples (1-year forward P/B peaked at 7.2x in Jan-22) vis-à-vis its structural growth trajectory was the most commonly highlighted bone of contention.

Exhibit 135: Aavas' growth delivery has fared weaker than peers



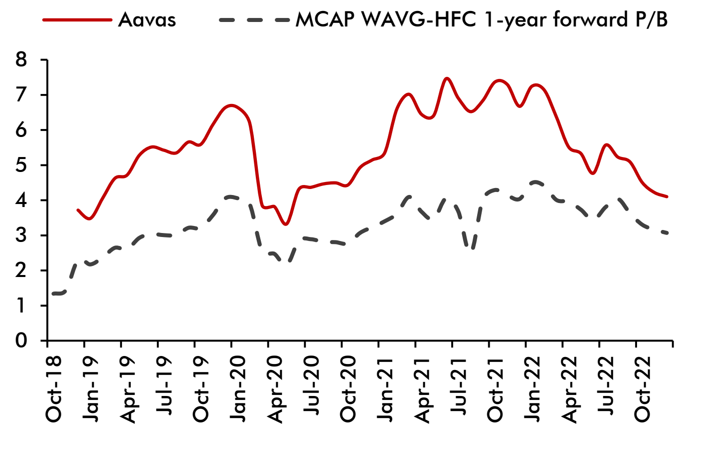
Source: Ambit Capital research, Bloomberg, companies

Exhibit 136: Aavas' earnings beat was no consolation for disappointing on growth expectations



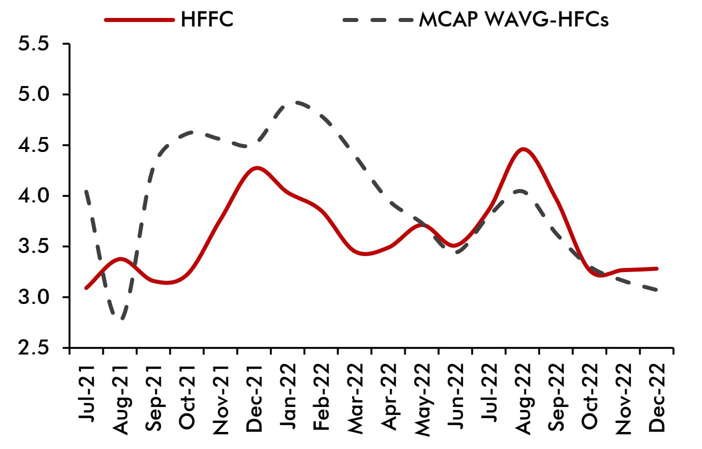
Source: Ambit Capital research, Bloomberg, companies

Exhibit 137: Aavas trades at 4.1x 1-yr fwd BVPS, 34% premium to mid/small-sized HFCs



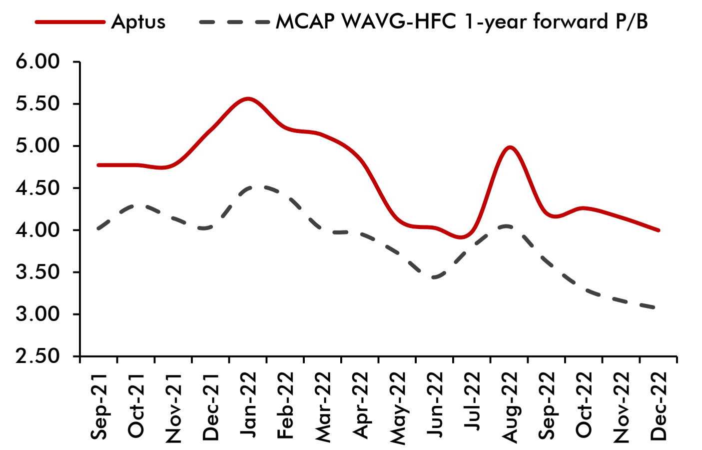
Source: Ambit Capital research, Bloomberg, companies

Exhibit 138: HFFC trades at 3.3x 1-yr fwd BVPS, 7% premium to mid/small-sized HFCs



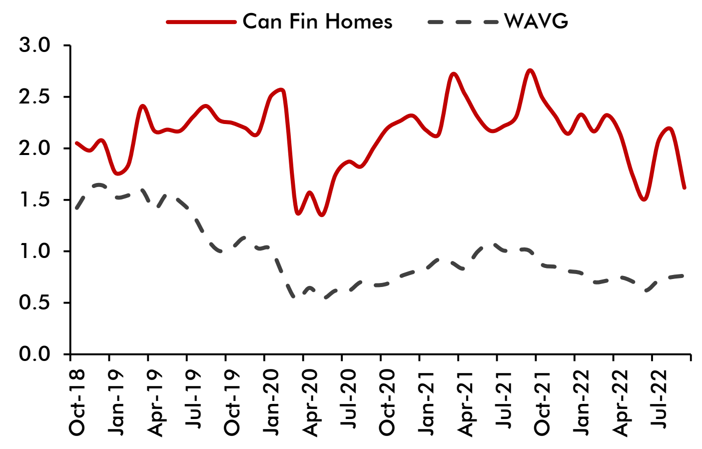
Source: Ambit Capital research, Bloomberg, companies

Exhibit 139: Aptus trades at 4x 1-yr fwd BVPS, 30% premium to mid/small-sized HFCs



Source: Ambit Capital research, Bloomberg, companies

Exhibit 140: Can Fin trades at 1.6x 1-yr fwd BVPS, 112% premium to PSU-sponsored HFCs



Source: Ambit Capital research, Bloomberg, companies

Overview of companies covered in this report:

Exhibit 141: Current AHFC valuations are factoring >20% long-term growth

	Aavas Financiers				Aptus Value Housing Finance				Can Fin Homes				Home First Finance			
TP and recommendation																
TP (₹)	2,148				245				450				601			
Recommendation	BUY				SELL				SELL				SELL			
Key financials (₹ bn)	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**
AUM	1,135	1,403	1,727	2,106	518	675	861	1,085	2,638	3,122	3,618	4,163	538	698	920	1,175
Disbursements	360	486	593	712	164	226	277	339	828	905	1,027	1,160	203	280	341	412
Net operating income	82.2	98.4	119.9	144.9	63.2	83.0	97.7	116.2	83.5	99.4	110.7	124.1	38.0	47.5	60.3	75.9
Operating profit	47.7	56.3	70.4	87.6	51.4	66.6	75.8	88.5	68.2	82.1	90.9	101.6	25.1	29.2	36.2	46.2
Net profit	35.7	41.5	52.3	65.0	37.0	48.7	54.9	64.4	47.1	58.7	63.8	70.9	18.6	21.4	26.0	33.3
Key ratios/growth rates (%)	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**
AUM growth	20	24	23	22	27	30	28	26	21	17	16	15	30	30	32	28
Disbursements growth	36	35	22	20	26	38	22	22	90	9	13	13	85	38	22	21
NIM (on AUM)	7.2	7.1	7.0	6.9	13.3	13.1	12.1	11.3	3.3	3.3	3.1	3.0	6.9	7.0	6.6	6.4
Opex/AUM	3.3	3.3	3.2	3.0	2.5	2.8	2.9	2.9	0.6	0.6	0.6	0.6	2.7	3.0	3.0	2.8
Credit cost	0.3	0.3	0.3	0.3	0.8	0.6	0.6	0.5	0.2	0.1	0.1	0.1	0.6	0.4	0.4	0.4
ROA	3.6	3.4	3.5	3.6	7.3	7.3	6.3	5.8	1.9	1.9	1.8	1.7	3.9	3.7	3.4	3.4
ROE	13.7	13.8	15.0	16.0	15.1	15.7	15.6	16.1	16.6	17.5	16.3	15.7	12.6	12.8	13.5	15.0
Valuation metrics	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**	**FY22**	**FY23E**	**FY24E**	**FY25E**
P/B (x)	4.9	4.3	3.7	3.2	5.1	4.5	4.0	3.5	2.3	2.0	1.7	1.5	4.1	3.6	3.1	2.7
P/E (x)	38.8	33.4	26.5	21.3	40.5	30.8	27.3	23.3	15.3	12.3	11.3	10.1	34.6	30.0	24.8	19.4
Branch distribution mix (%)																
Tier-1	3				2				27				32			
Tier-2	22				12				32				47			
Tier-3/below	75				86				41				22			
Customer mix (%)																
Salaried	40				28				74				72			
Self-employed	60				72				26				28			
Price-implied expectations	**FY22-42E**				**FY22-42E**				**FY22-42E**				**FY22-42E**			
Assets CAGR (%)	20				23				14				21			
PAT CAGR (%)	19				19				12				19			
Average ROA (%)	3.6				5.0				1.6				3.1			
Average ROE (%)	17.6				18.6				14.3				17.0			
Valuation assumptions	**FY22-42E**				**FY22-42E**				**FY22-42E**				**FY22-42E**			
Assets CAGR (%)	21				21				14				20			
PAT CAGR (%)	20				18				10				18			
Cost of equity (%)	14.0				14.0				14.0				14.0			

Source: Ambit Capital research, Bloomberg, companies

Aavas Financiers
BUY

INITIATING COVERAGE	AAVAS IN EQUITY	January 12, 2023

Go-getter!

Aavas' character and capabilities have shunned industry-defined limitations to growth. Distinguished focus on deep locations and self-employed/informal income aided 14% disbursal market share in <1mn ATS segment. This was supported by aggressive infra build-out and complete decentralization/team-building. Replicating such an operationally intensive model is difficult, hence lower competition/margin pressure. Next leg of investments in branches/tech/team aims to build ₹2tn in assets. Amidst high growth, low credit cost is comforting. Over FY22-25E, as Covid-born branches operate more efficiently, expect opex/assets to dip to 3.1%. Cumulative PLR hike of 125bps would limit margin compression to 36bps by FY25E, lower than peers. FV of ₹2148 implies 4.5x/32x FY24E BVPS/EPS, 25-75% premium to peers. Risks: Slower AUM growth, NIM contraction.

Competitive position: STRONG   Changes to this position: STABLE

Aavas is a cultural design

Aavas has a well-knit value-chain, completely in-house. Aggressive branch build-out, decentralization, segregated processes, supported by adequate manpower and local market intelligence ensured sales/asset quality are top-notch. Given operational intensity, Aavas' business model will be difficult to replicate. Hence, lower risk of competition-led margin pressure. With a vision of 20-25% CAGR for the next 10 years, Aavas continues to invest in branches/teams/technology.

Investing ahead of time

Aavas is undertaking investments in tech/leadership with a long-term view. Tech investments (in LMS, LOS) are expected to take care of scale ($15-20bn asset size) without technological constraints. Underwriting efficiency is also expected to improve by 67-100%, resulting in better productivity. Development programs, such as IIM-A tie-up, are aimed at developing tier-2/3 leadership teams. While upfronting investments, Aavas hasn't lost sight of profitability.

Earnings CAGR differential vs AUM to narrow

Aggressive investments in branches/employees and Covid disruption resulted in elevated opex ratios. Over FY22-25E, we expect EPS CAGR to mirror AUM CAGR of 23%. This will be driven by (1) Covid-born branches progressing towards their potential, resulting in better productivity (2) limited NIM contraction (34bps by FY25E) due to PLR hike of 125bps so far and highly competitive cost of funds.

It's worth the premium!

35% premium to small/mid-HFCs is steep but fair for a company exhibiting superior execution along with top-notch management pedigree and a hard-to-replicate business. Market's growth expectations of 20% CAGR (FY22-42E) are achievable. FV implies 4.5x FY24E BV, 25-75% premium to peers.

Key financials

Year to March	FY21	FY22	FY23E	FY24E	FY25E
Total Income (₹ mn)	6,409	8,223	9,839	12,009	14,610
Operating Profit (₹ mn)	3,905	4,775	5,631	7,063	8,876
Net Profit (₹ mn)	2,895	3,568	4,152	5,246	6,586
EPS (₹)	36.9	45.2	52.6	66.5	83.4
RoE (%)	12.9	13.7	13.8	15.0	16.2
P/E (x)	50.0	40.8	35.1	27.7	22.1
P/B (x)	6.0	5.2	4.5	3.9	3.3

Source: Company, Ambit Capital research

BFSI

Recommendation

Mcap (bn):	₹147/US$1.8
6M ADV (mn):	₹235/US$2.9
CMP:	₹1841
TP (12 mths):	₹2148
Upside (%):	17

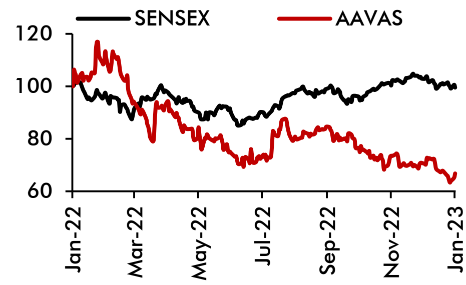
Flags

Accounting:	GREEN
Predictability:	GREEN
Earnings Momentum:	AMBER

Key catalysts

- Post 125bps PLR hike, NIMs are expected to see limited NIM decline of 9bps in FY24E.
- Efficient working of Covid-born branches to aid ~15bps reduction in opex/assets by FY24E.

Performance (%)



Source: Bloomberg, Ambit Capital Research

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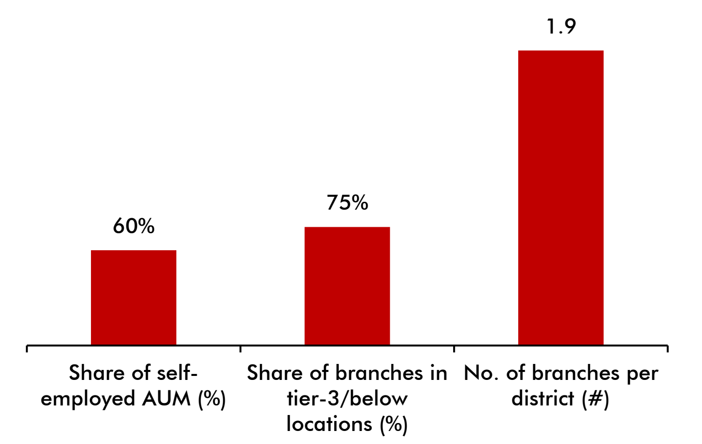
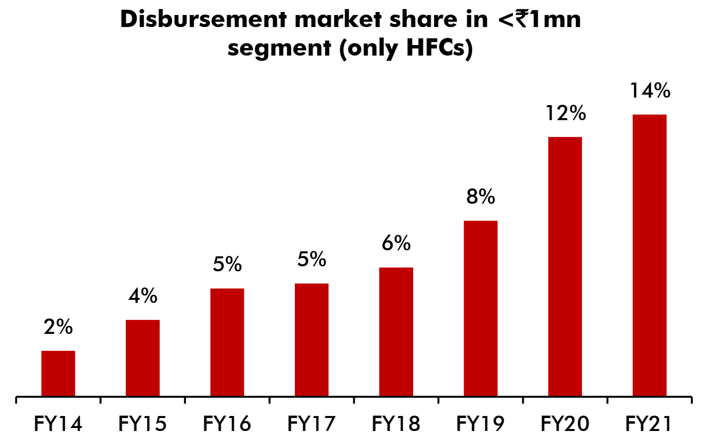
The Narrative in Charts

Exhibit 1: Aavas distinguishes by focusing on un/under-served geo/customer segments with deep branch presence



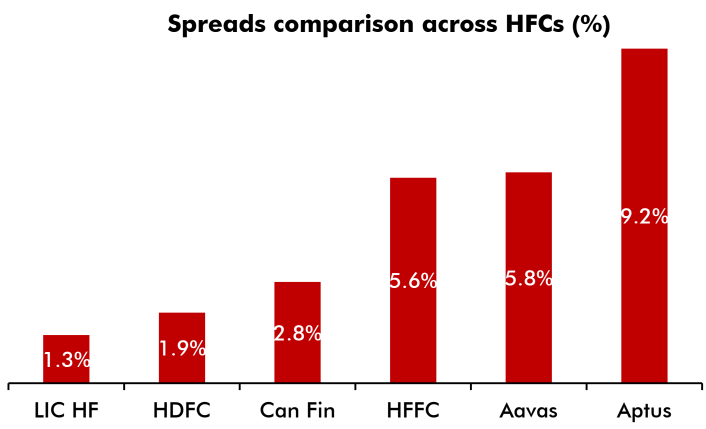
Source: Ambit Capital research, Company

Exhibit 2: Distinct focus has yielded fruits as disbursal market share increased



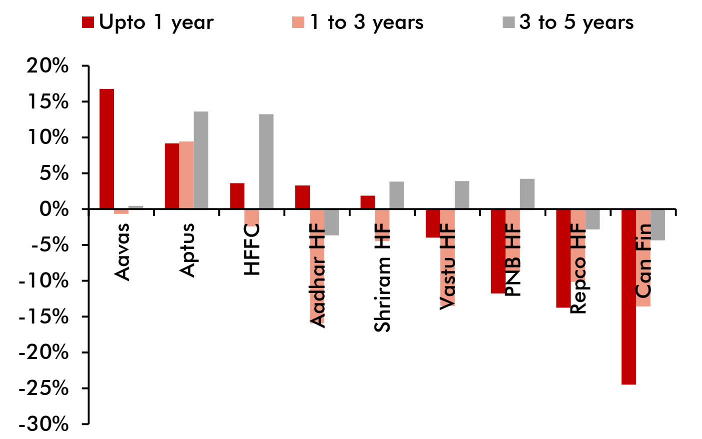
Source: Ambit Capital research, Company

Exhibit 3: Operating in less contested markets will ensure Aavas faces lower competitive pricing pressure



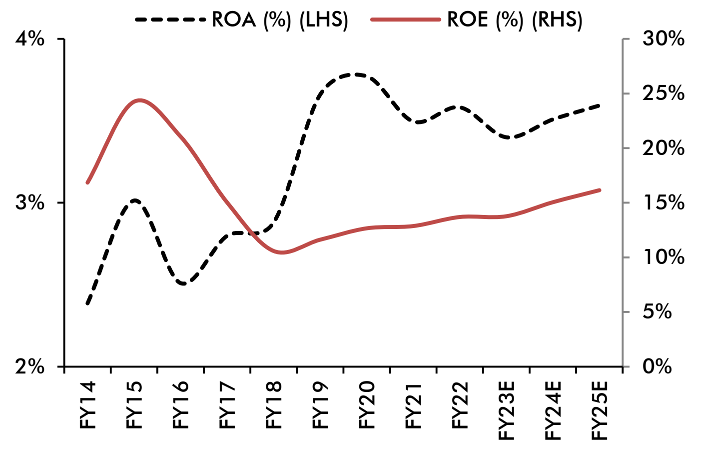
Source: Ambit Capital research, Company

Exhibit 4: Conservative ALM has ensured superior credibility among capital suppliers, hence low CoF



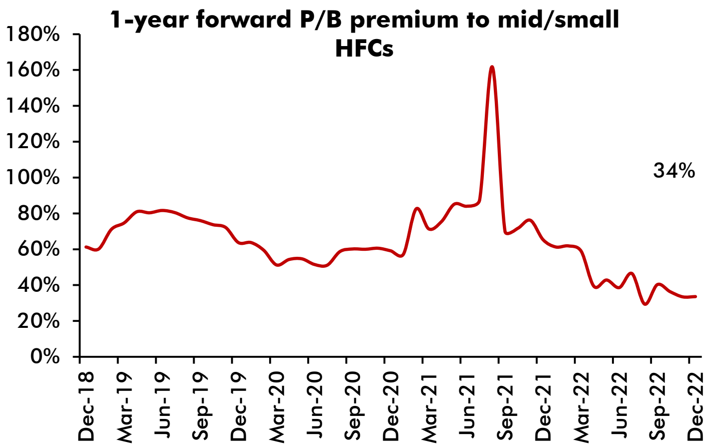
Source: Ambit Capital research, Company

Exhibit 5: Limited margin decline and improving opex to drive ROA/ROE



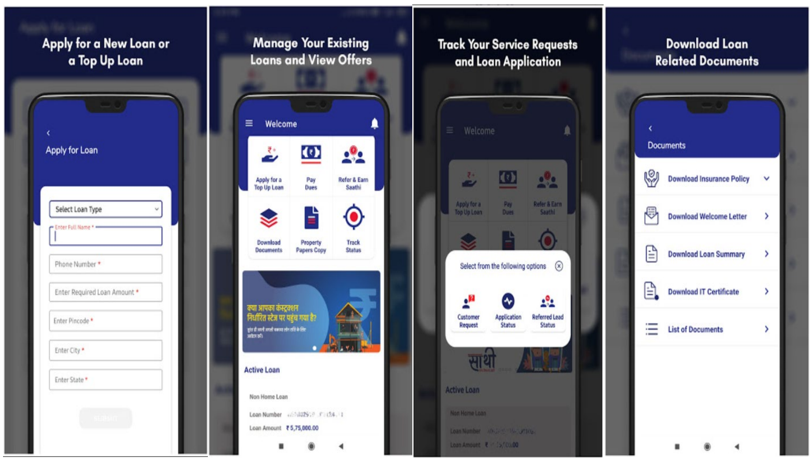
Source: Ambit Capital research, Company, Bloomberg

Exhibit 6: Premium valuation reflects scarcity of players having the ability to grow at 20% CAGR for next 20 years



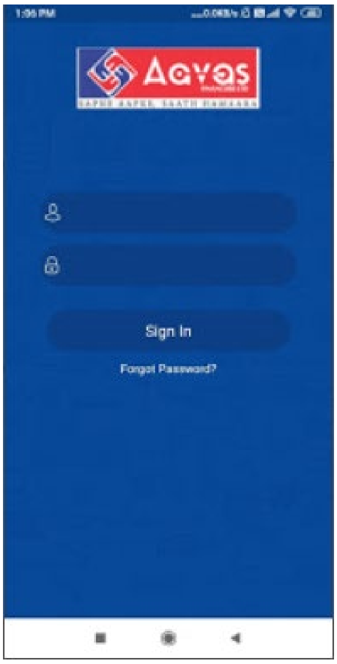
Source: Ambit Capital research, Company

Exhibit 7: Aavas loan app facilitates seamless customer experience



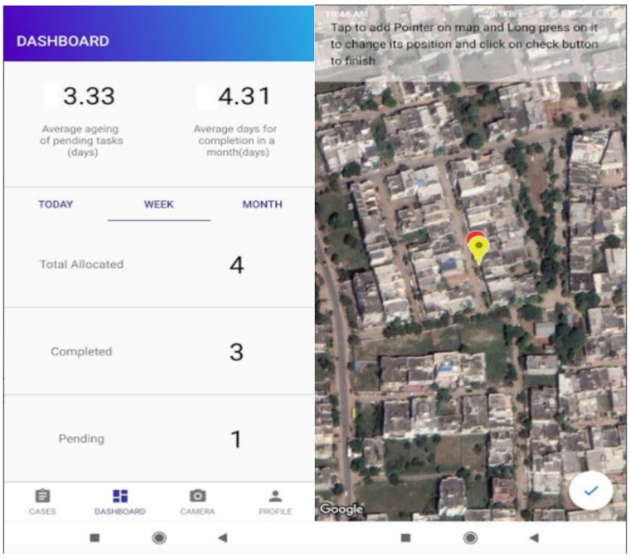
Source: Ambit Capital research, Company

Exhibit 8: Omnifin, used for dcumenting cutomer details, ensure faster TAT by reducing paperwork



Source: Ambit Capital research, Company

Exhibit 9: Aavas technical app helps in assessing technical evaluation

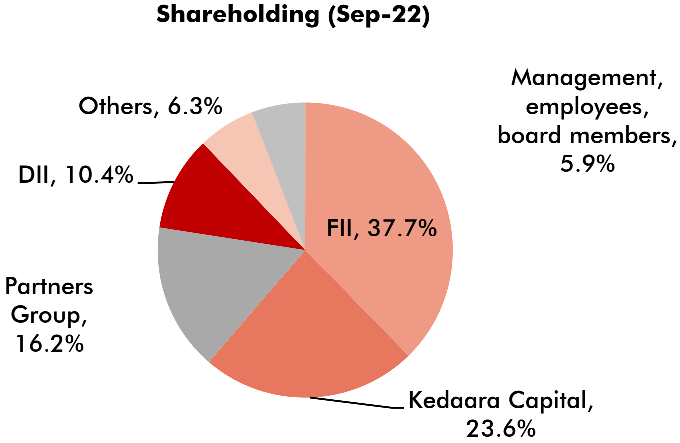


Source: Ambit Capital research, Company

Leading AHFC with focus on the un/under-served

Aavas was incorporated as an affordable HFC at Jaipur, Rajasthan in February 2011. In 2016, AU SFB sold 90% stake to Kedaara Capital to comply with regulatory requirements while pursuing the SFB licence. Aavas focuses on self-employed customers (60% of AUM in FY22) most of whom lack formal income proofs. ATS is <₹1mn. Extensive on-ground workforce, branch network and ability to gather local market intelligence, enables appropriate risk-pricing of customers (6.65% spreads vs 2% for large HFCs). The differentiating factor about Aavas' distribution is that it focuses on tier-3/below locations (75% of branches), where competition is less and growth runway is longer. BT risks would be negated by less-contested geographical focus to some extent. Lastly, high PE ownership my come across as discomforting due to possibility of ownership change.

Exhibit 10: PE-promoted with management's skin in the game



Source: Ambit Capital research, Company

Exhibit 11: SWOT analysis

Strengths	Weaknesses
▪ **Customer profile:** Aavas mainly lends to self-employed with informal/undocumented income, which are hard to assess for their creditworthiness and hence neglected by banks. ▪ **Geographical focus:** 75% of Aavas' branch network is located in tier-3/below locations, which are far-flung entailing high distribution costs, hence neglected by banks. ▪ **Focus on self-construction:** This product has less players as risks are higher and it is operationally more intensive than funding apartments.	▪ **Uncompetitive cost of funds:** Cost of funds is not the most competitive among the larger set of lenders, esp. vs banks. ▪ **Productivity is declining:** Aavas' productivity has been declining in last few years. Despite investing in new branches/employees, growth in new business sourced has not kept pace. ▪ **High PE ownership may restrict leverage, impacting growth/ROE:** High PE ownership has always remained a concern due to possibility of sudden ownership change driven by PE's own fund mandates. Plus, credit rating agencies find PE ownership less comforting.

Opportunities	Threats
▪ **Industry to see 13-14% CAGR over next 2 decades:** Mortgage industry is expected to grow at 13-14% p.a. over the next 2 decades. This presents huge opportunity esp. given that Aavas is catering to a distinct customer/geographical segment which is under-supplied. ▪ **Recently foray into south India:** Recent foray into south India presents large addressable opportunity for Aavas.	▪ **High pre-payments:** Uncompetitive cost of funds can result in high pre-payments/BTs, leading to impact on AUM growth. ▪ **High attrition:** Recently, the attrition in the industry has been high. Given that Aavas relies heavily on its employee strength for business generation/collection, continued high attrition can threaten business performance.

Source: Company, Ambit Capital research

Designed to focus on deeper presence and relationships

Aavas runs a tight ship with most functions (origination/credit/collections) in-house. Such a structure is opex-heavy but results in better understanding of the customers and deeper relationships. Also, given the subjectivity involved in underwriting of the target customer profile, manpower requirement is high. Investments in collections infra have resulted in better asset quality vs most peers. Given Aavas' strategy to have deeper presence, it has ~2 branches in each district. This has also led to Aavas having an extensive presence.

Exhibit 12: Aavas follows a tightly knit process from origination to disbursement

Functions	In-house/ outsourced	Comments
Sales	In-house	The company sources all its customers directly. Maintaining direct contact with customers has led to majority of customers coming by way of referrals.
		Branch personnel is responsible for sourcing loans.
		Leads are recorded on a mobile application.
		Upon sourcing a customer and obtaining a loan application along with relevant information, the RM enter the case details into the system and hands over the file to the credit officer.
Initial screening	In-house	The branch personnel is responsible for carrying out initial/preliminary checks on credit worthiness of a prospective customer, providing support on documentation and disbursements.
		A credit bureau report is generated where the credit score is reviewed along with a track record of loan repayments.
		The loan application is checked for various parameters such as completeness of the application form, relevant KYC details, initial money deposit cheque, income proofs.
Underwriting	In-house	Majority of the properties financed are single-unit, self-occupied.
		Credit assessment is aided by 60 templates of customer profiles developed over the years (these are updated regularly).
		There is a separate risk measurement for every geography the company operates in.
		The customer credit worthiness is arrived at based on cash flow assessment of the customer's business (this includes physical counting of customer footfalls, invoice vouching).
		Credit underwriting vertical is completely different from the sales team.
		For certain loans, the company obtains guarantees from a guarantor. For salaried customers, the company obtains a guarantee from the employer.
		Credit/underwriting managers visit the customers to understand their business/revenue streams/expenses and based on income validations, determine loan eligibiliy, followed by preparation of cash flow analysis.
		Credit team sends the documents to the risk-containment unit to verify their authenticity.
Legal/technical/valuation	In-house	Credit/sales teams work with lawyers and valuers in-house + external vendors) to verify the authenticity of the documents.
Collections	In-house	The end-to-end process is controlled in-house. Field executives are responsible for collections. Each field executive is assigned a specified number of files.
		Maintaining direct contact with the customers helps to minimize default risks and understanding the customer situation better.
		In addition to collections team, sales team members are also responsible for collections and asset quality.
		High focus on early warning signals in 1+ dpd accounts. Collections team are localised. There are separate collection teams focusing on cases which are overdue for a certain period and those where SARFAESI is required.
		Customers are reminded of upcoming payment dues through text messges, automated calls.
		In case overdue persists, a senior collections officer visits the customer.
		Collections team comprises of people who have extensive experience with SARFAESI, DRT and other legal recovery procedures.

Source: Company, Ambit Capital research

Management team with credible background and skin in the game

Aavas is led by Sushil Agarwal who is a founding member and holds 3.5% stake in the company. Having started his career with banks, he has extensive experience in the lending industry. Before Aavas, he was National Credit Manager (business banking group-SME) at ICICI Bank and was heading a large team. Given Sushil Agarwal's banking stint, he enjoys high credibility and repute amongst bankers. Other management team members have worked with established banks/NBFCs, and therefore come with good quality experience.

Exhibit 13: Most management team has worked in credible financial institutions; holds equity

Name	Designation	Background/work-ex	Remuneration (₹mn)	% of PBT	% of equity held
Sushil Kumar Agarwal	MD & CEO	21+ years in retail financial services. Worked at Kotak Bank, ICICI Bank, AU SFB.	31	0.7%	3.5%
Ghanshyam Rawat	Chief Financial Officer	Worked at Indorama Synthetics, Accenture, First Blue Home Finance, Deutsche Postbank Home Finance.	22	0.5%	1.1%
Ashutosh Atre	Chief Risk Officer	Worked at Equitas, ICICI Bank, Cholamandalam.	10	0.2%	0.1%
Siddharth Srivastava	Chief Business Officer	Experienced in secured/unsecured lending. Worked at ICICI Bank, Tata Infomedia, ITC.	-		-
Jijy Oommen	Chief Technology Officer	Worked at Kinara Capital, Wonderla Holidays, Manappuram Finance, Bajaj Capital	8	0.2%	-
Ripudaman Bandral	Chief Credit Officer	Worked at Indiabulls, ICICI Bank, HDFC Ltd.	8	0.2%	-
Rajeev Sinha	Executive VP, Operations	Worked at Indiabulls, CoinTribe.	7	0.2%	0.0%
Surendra Sihag	Executive VP, Collections	Worked at Bajaj Finance, Cholamandalam.	11	0.2%	0.1%
Sharad Pathak	Company Secretary & Compliance Officer	Working at Aavas since May 2012.	-		-
Rajaram Balasubramaniam	Chief Strategy Officer & Head of Analytics	Worked at Citibank, Standard Chartered Bank.	-		-

Source: Company, Ambit Capital research

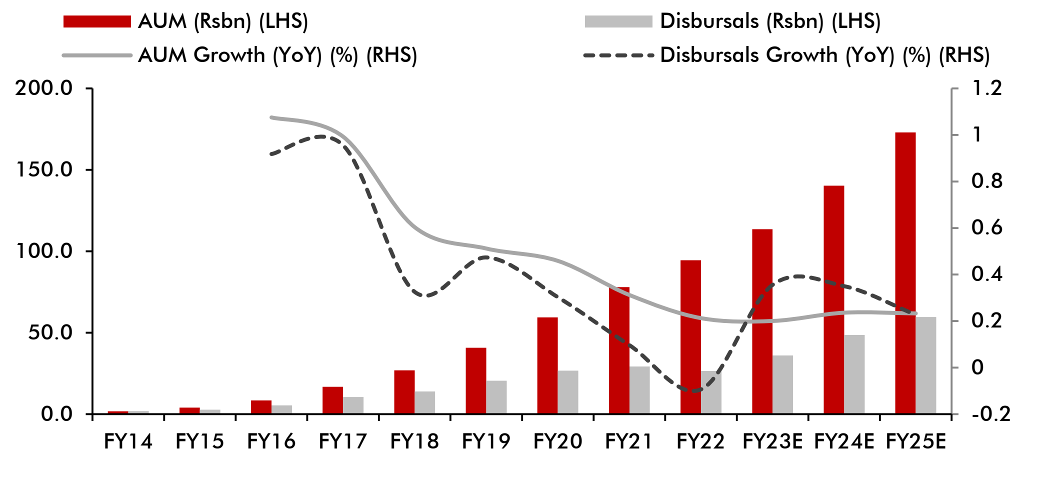
Less contested markets have aided growth

Aavas' AUM/disbursements have grown at 45%/31% CAGR since FY15, leading to disbursal market share in <₹1mn ATS segment increasing to 14% (FY21). Distinguished focus on a less contested space (self-employed customers, tier-3/below locations) has yielded 20%+ growth rates and pricing premium (spreads at 3.3x of large HFCs'). But such a strategy has also entailed high opex (3.5%). Investments in manpower/branch infra have aided pristine asset quality. Large spreads and low credit costs have aided ROA/ROE expansion over the years, though they are still <15%. Over FY15-22, PPOP per share/EPS clocked 30%/34% CAGR, lagging AUM CAGR of 45% due to elevated opex. Superior execution vs peers and 20% long-term AUM CAGR expectations are reasons for stock commanding 35% valuation premium over peers.

Distinct focus has yielded market share gains in <₹1mn segment

Aavas' AUM/disbursements increased at 45%/31% CAGR since FY15. Market share in total industry increased to ~0.4% as of Mar-22, still minuscule. In the sub-₹1mn segment, the company increased market share in last few years, owing to aggressive branch expansion and presence in 13 states.

Exhibit 14: Distinct geo/customer focus and underwriting capabilities, key sources of advantage, have resulted in market share gains

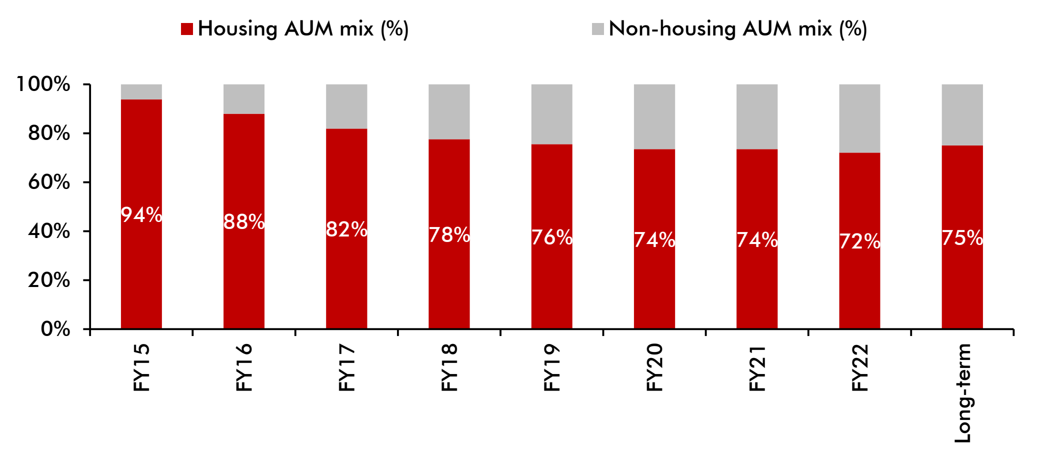


Source: Company, Ambit Capital research

Started from Rajasthan. Mostly focused on housing loans in tier-3 locations

Product wise, housing/non-housing AUM mix is 72%/28%. Long-term housing/non-housing mix is expected to settle around 75%/25%. Main focus is on self-construction (85% of units financed) which is a relatively less serviced product segment.

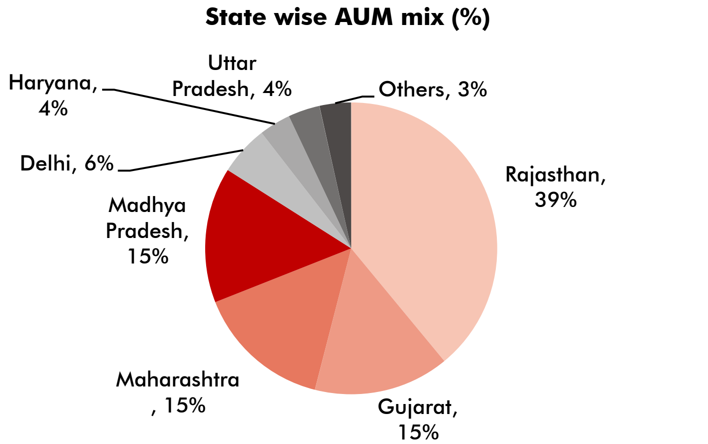
Exhibit 15: Major focus is on housing loans



Source: Company, Ambit Capital research

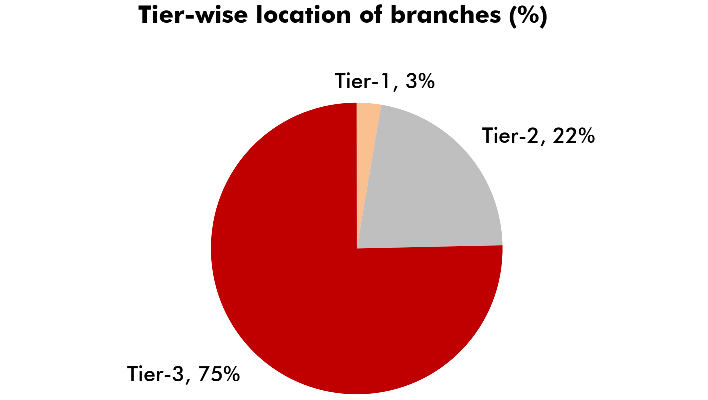
Geographically, Rajasthan holds the largest AUM share (39% in FY22 vs 48% in FY17) given it's the home state. As part of its initial expansion strategy, Aavas ventured into Maharashtra and Gujarat outside of home. As indicated by branch location split, focus is majorly on serving the deeper regions with 75% branches located in tier-3/below locations.

Exhibit 16: Rajasthan (home state) is the biggest market for Aavas



Source: Ambit Capital research, Company

Exhibit 17: Focus is on deeper regions

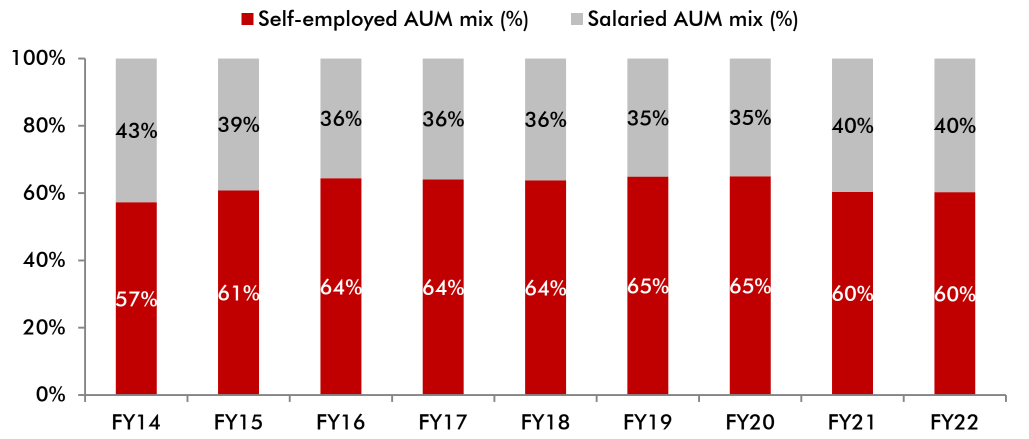


Source: Ambit Capital research, Company

Focus customer segment is self-employed/undocumented income, usually neglected by large financiers

Customer segment mainly consists of self-employed (60% of AUM in FY22). Most of these customers lack formal income proofs and, hence, underwriting them the traditional way becomes difficult. Aavas, through its extensive workforce and specialized underwriting tools, is able to determine whether a customer is eligible for loans or not.

Exhibit 18: Aavas focuses on the un/under-served self-employed category

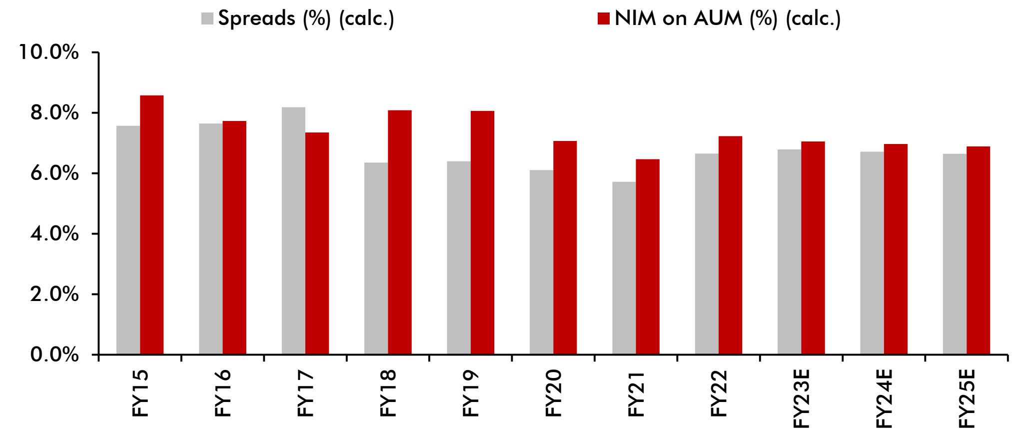


Source: Company, Ambit Capital research

Large spreads are a function of distribution reach and specialized underwriting

Operating in tier-3/below locations and underwriting perceivably risky customers (undocumented income) enable Aavas to charge higher spreads. Aavas' spreads are 3.3x of large HFCs.

Exhibit 19: Aavas' spreads are >3x of large HFCs, aided by focusing on less contested markets

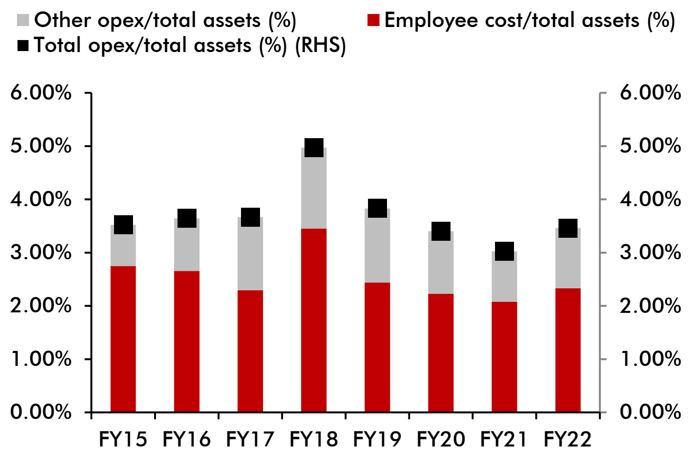


Source: Company, Ambit Capital research

High opex ratios are a function of being customer-centric

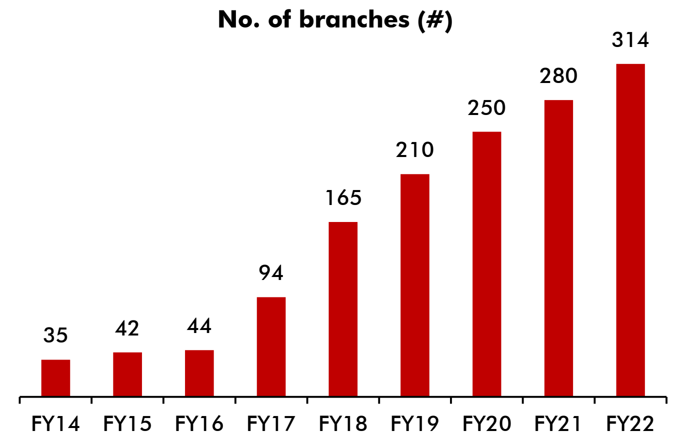
Aavas' key philosophy is to build deep customer relationships. For this reason, the company has kept most functions in-house. Unlike large HFCs, originations is mostly done in-house. Following a decentralized model for underwriting and collections has entailed high investments in manpower and branch infra. This has resulted in opex ratios being higher.

Exhibit 20: Hands-on approach keep opex ratios elevated



Source: Ambit Capital research, Company

Exhibit 21: Aavas opens 35 branches on average annually

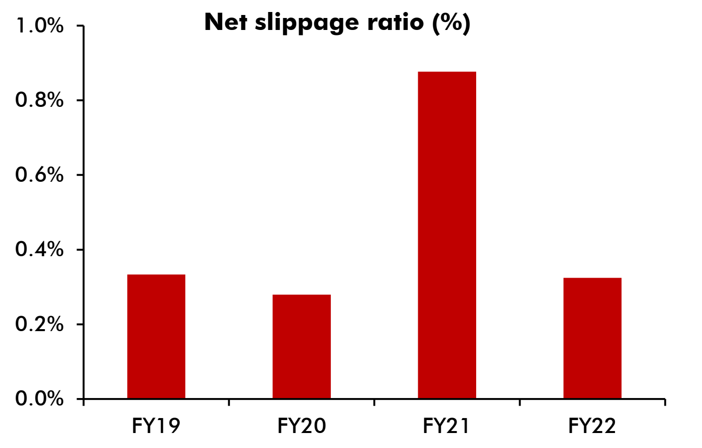


Source: Ambit Capital research, Company

Investments in underwriting/collections have kept asset quality in check

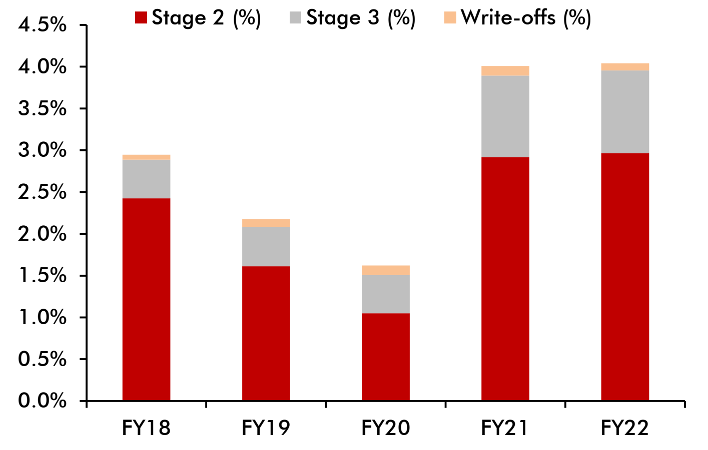
Aavas' asset quality experience has been better than most peers. This can be attributed to its superior underwriting skills. Having built AUM of >₹122bn since starting in FY12, we believe the company has achieved certain level of seasoning.

Exhibit 22: Net slippages have been lower than most peers, owing to superior underwriting…



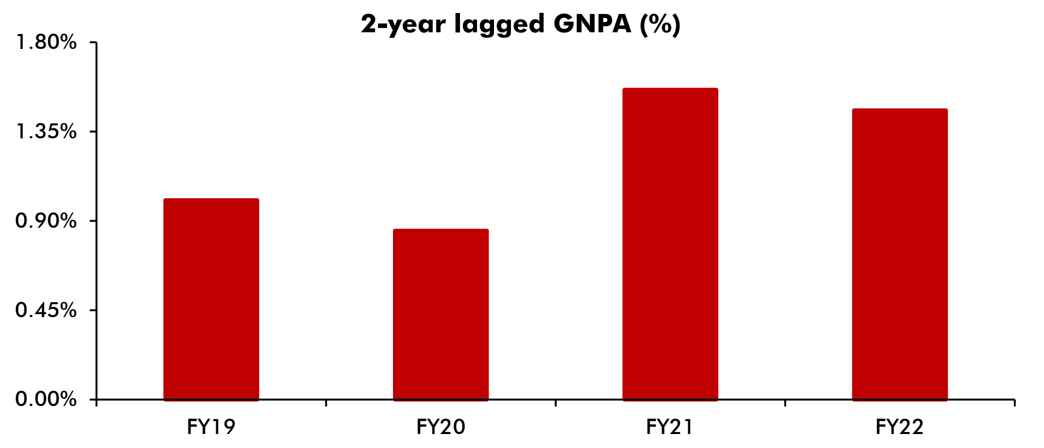
Source: Ambit Capital research, Company

Exhibit 23: …resulting in overall lower stock of stress vs peers



Source: Ambit Capital research, Company

Exhibit 24: Lagged NPAs have averaged 1.2%



Source: Ambit Capital research, Company

High margins, low credit costs have aided ROA/ROE expansion

Aavas registered ~14% ROE in FY22 on the back of high spreads and low credit costs, even as opex ratio was elevated at 3.5%. Over FY15-22, PPOP per share/EPS clocked 30%/34% CAGR, lagging AUM CAGR of 45%. On a structural basis, the company is guiding for 2.5% ROA, which is 100-110bps lower than the current run-rate.

Exhibit 25: Limited NIM impact and efficiency improvement to drive earnings growth

Du-pont analysis (%)	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
NII (NIM)	8.7%	8.4%	7.6%	7.8%	8.5%	8.4%	7.4%	6.7%	7.5%	7.3%	7.3%	7.2%
Other income	0.0%	0.0%	0.2%	0.5%	0.7%	1.0%	0.9%	1.0%	0.7%	0.7%	0.7%	0.7%
Net operating income	8.8%	8.5%	7.8%	8.3%	9.2%	9.4%	8.2%	7.7%	8.3%	8.1%	8.0%	8.0%
Opex	5.3%	3.5%	3.6%	3.7%	5.0%	3.8%	3.4%	3.0%	3.5%	3.4%	3.3%	3.1%
Operating profit	3.4%	4.9%	4.2%	4.6%	4.2%	5.5%	4.8%	4.7%	4.8%	4.6%	4.7%	4.8%
Credit cost	0.3%	0.4%	0.4%	0.3%	0.1%	0.2%	0.2%	0.4%	0.2%	0.3%	0.2%	0.3%
PBT	3.1%	4.6%	3.8%	4.3%	4.2%	5.4%	4.6%	4.3%	4.6%	4.3%	4.5%	4.6%
Tax	23.4%	34.1%	34.4%	34.7%	30.7%	31.7%	17.5%	18.1%	21.6%	21.6%	21.6%	21.6%
PAT (ROA)	2.4%	3.0%	2.5%	2.8%	2.9%	3.7%	3.8%	3.5%	3.6%	3.4%	3.5%	3.6%
Leverage (x)	7.1	8.0	8.4	5.4	3.7	3.2	3.4	3.7	3.8	4.0	4.3	4.5
ROE	16.8%	24.3%	21.1%	15.0%	10.6%	11.6%	12.7%	12.9%	13.7%	13.8%	15.0%	16.2%

Source: Ambit Capital research, Company

Aavas' execution prowess will continue

We expect Aavas' strong execution to continue going forward. This would be reflected in Aavas' PPOP/share and EPS compounding at a higher rate over FY22-25E vs peers. Higher earnings growth for Aavas would be led by:

- **Lower impact on spreads/margins amid increasing rates:** We expect Aavas' NIM to decline by 34bps by FY25E which is lower than 72bps/196bps decline for HFFC/Aptus.
- **Improvement in opex ratio:** We expect Aavas' opex/asset ratio to decline by 33bps to 3.1% by FY25E while peers are expected to see either stagnant or increasing opex ratio as they undertake branch expansion/new state forays.

Having upfronted its investments in branches/employees/tech, we expect Aavas' PPOP/share CAGR (FY22-25E) at 22%, higher than 21% CAGR over FY19-22. This would drive ROE to ~15/16% in FY24E/25E.

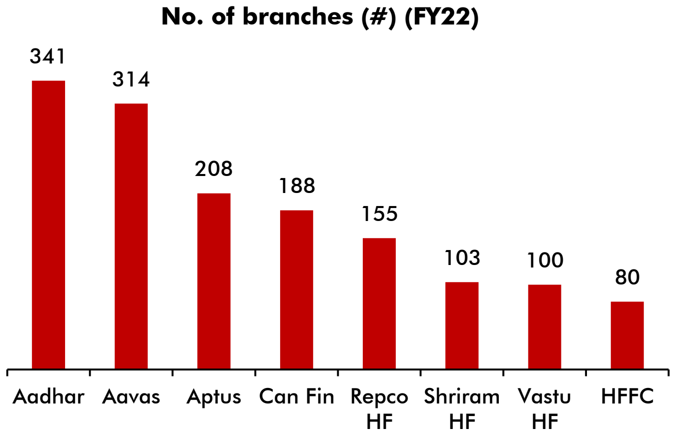
Having upfronted investments, efficiency should set sail

Aavas' aggressive growth investments led to opex/AUM (FY22) being higher than peers. However, post upfronting investments, Aavas' opex/AUM is expected to dip to 3.1% by FY25E (long-term: 2.5%). 1/3rd of the current branches (opened between FY20-22) were not able to operate efficiently due to Covid. As these branches move towards their potential (typical timeline: 3 years), branch efficiency would improve. Tech investments (₹1.5bn) over the coming years is expected to improve underwriting efficiency by 67-100%, possibly unlocking sourcing productivity and therefore, higher/efficient growth. Opex CAGR over FY22-25E is expected to be 18% vs 35% CAGR over FY17-22 vs NII 21% CAGR over FY22-25E, leading to efficiency improvement.

Most aggressive in making growth investments

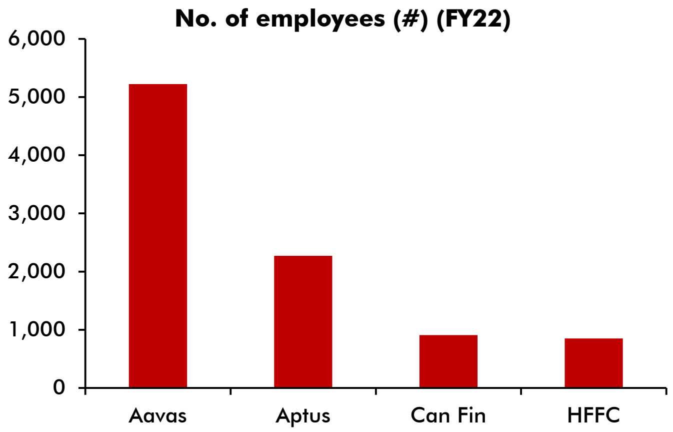
Being cognizant of the need to generate volumes in order to grow with a small ticket size, Aavas has been one of the most aggressive in expanding its branch network. Further, with a focus on enhancing customer relationship value, the company has kept nearly the entire origination-to-collection value chain in-house. Such a strategy has entailed high manpower investments. As a result, Aavas' employee base too expanded at a higher rate vs peers. The company is also spending ₹1.5bn on tech to enhance its operational efficiency and long-term scalability needs.

Exhibit 26: Aavas has the second-highest number of branches...



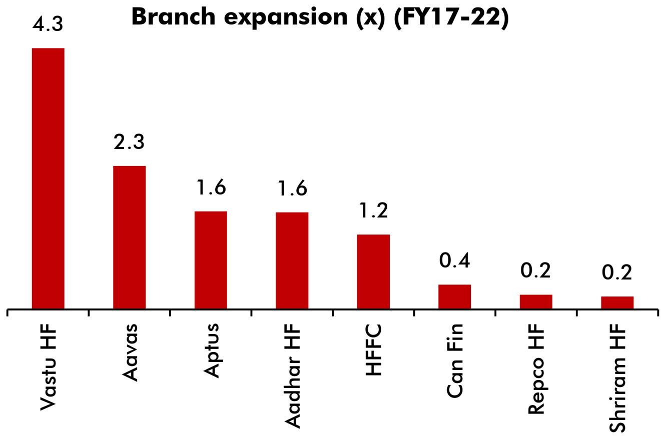
Source: Ambit Capital research, companies

Exhibit 27: ...and highest number of employees



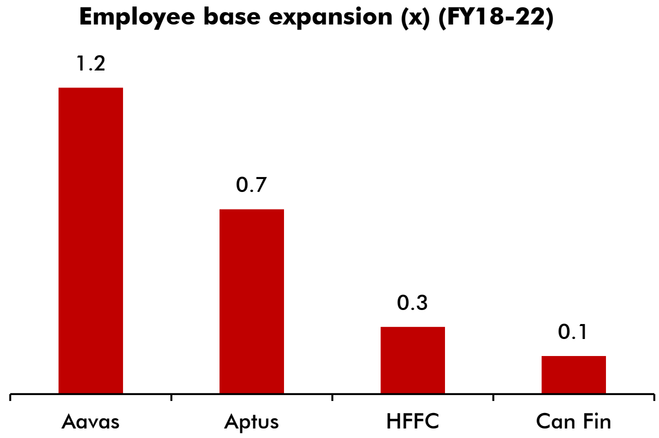
Source: Ambit Capital research, companies

Exhibit 28: Aavas has been aggressive in creating distribution infra through branch expansion...



Source: Ambit Capital research, Company

Exhibit 29: ...as well as in manpower investments, as almost entire value chain is in-house

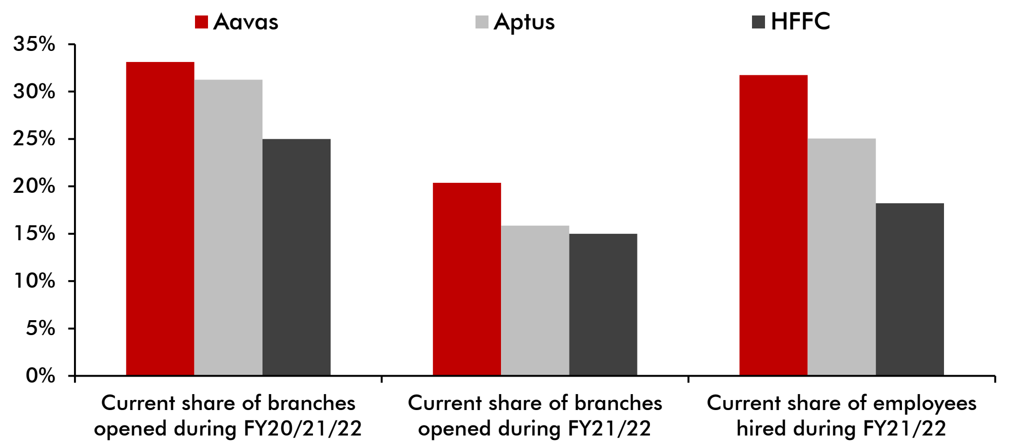


Source: Ambit Capital research, Company

32-33% of growth infra created in last 3 years was operating below potential

32% of current employees and 33% of current branches were hired/created over last 3 years (FY20-22). This timeline overlapped with Covid (FY21/22). Given that a typical branch takes 3 years to reach full potential, we believe that 32-33% of growth infra (branches/employees) created during FY20-22 was operating below potential due to Covid disruptions. Going forward, as the business operates under normal conditions (asset sweating), we expect efficiency gains from existing branches. Further, we note that Aavas' investments in branches/employees have been higher than peers.

Exhibit 30: Despite the larger AUM size and Covid disruption, Aavas' investments continued undeterred



Source: Ambit Capital research, Company

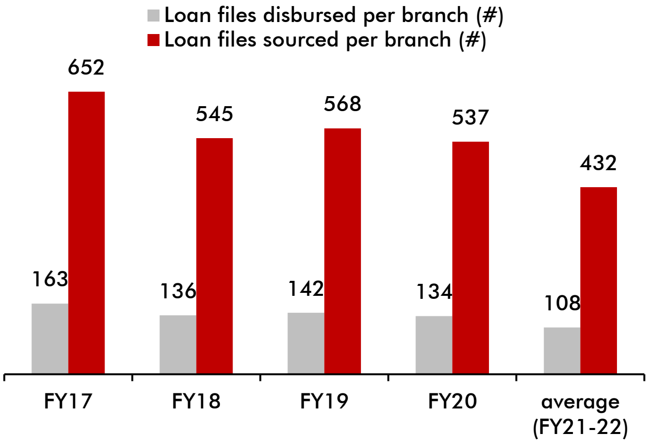
Tech investments to lead to higher underwriting efficiency

Besides undertaking aggressive investments in branches/employees for growth capacity creation, Aavas has outlined ₹1.5bn tech spend (revamping of LOS/LMS). The company has migrated LMS to a banking level software and will be implanting an ERP software which is best of the best.

How will tech investments help?

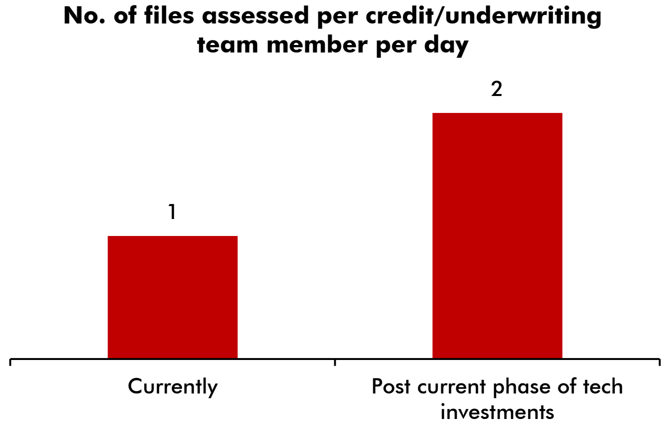
- Aid scalability (up to ₹2tn in assets) without technological constraints.
- Underwriting efficiency is expected to improve by 67-100%. This could result in higher sourcing efficiency and therefore, higher growth.
- Empower the company to manage the entire customer engagement and relationship around an advanced tech framework.
- Investing in data lakes/analytics will help incorporate 2,000 APIs at a time.

Exhibit 31: Aavas' productivity has been declining due to aggressive branch build-out…



Source: Ambit Capital research, Company, Bloomberg. Note: No. of loans files have been estimated based on disbursements value and ATS as disclosed by the company.

Exhibit 32: …but post current phase of investments, underwriting efficiency is expected to improve 67-100%

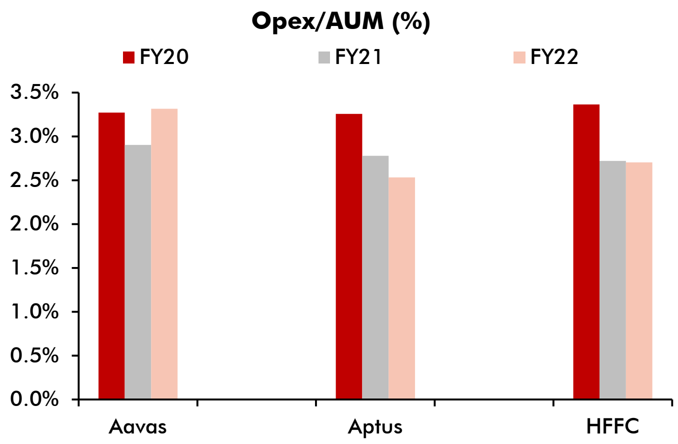


Source: Ambit Capital research, Company

Opex ratios set to improve, while peers would see stagnation/deterioration

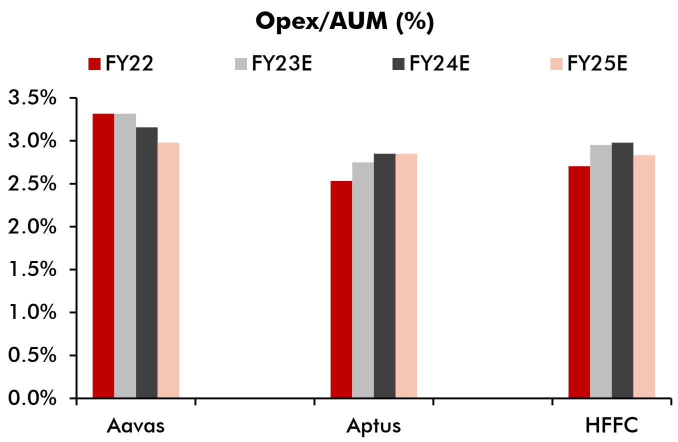
Increasing opex ratios is not necessarily bad as branch/employee investments are necessary for growth. However, Aavas is at a juncture where opex ratios have peaked and are expected to improve, led by operational efficiency improvement. At the same time, peers are likely to witness higher opex ratios as they embark on branch expansion/new state forays.

Exhibit 33: Aavas' opex hasn't improved due to aggressive investments…



Source: Ambit Capital research, Company, Bloomberg

Exhibit 34: …but near-term trends would be opposite as Aavas experiences efficiency gains



Source: Ambit Capital research, Company

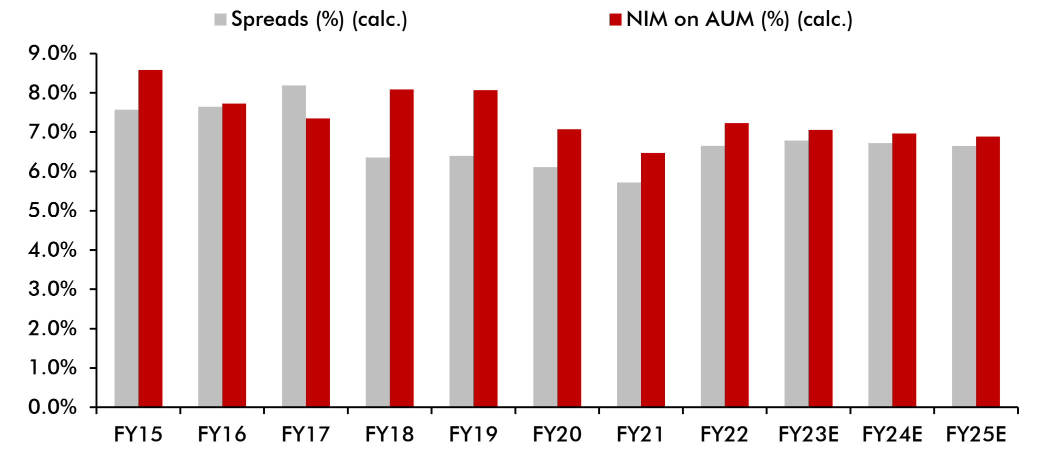
Margin decline to be limited

Among peers, we believe Aavas is best-placed from a margin trajectory standpoint. We expect Aavas' NIM to contract by 33bps by FY25E, lower than 72bps/196bps NIM decline expected for HFFC/Aptus. Aavas' limited NIM compression would be driven by cumulative PLR hike of 125bps taken so far. The management expects spreads to remain stable hereon. Further, Aavas' competitive cost of funds is expected to be supportive. Over time, Aavas has been able to negotiate better bank pricing. Debt market confidence in Aavas is higher vs peers given the blended cost of funds differential vs benchmark bond yield. Aavas prudent ALM approach provides comfort on balance sheet management.

PLR hike of 125bps would negate increasing CoF to some extent

YTDFY23, Aavas has taken a cumulative PLR hike of 125bps (75bps in 1HFY23 + 50bps w.e.f 5th Oct 2022). This is expected to help in partially negating the margin compression due to increasing cost of funds. The company is confident of maintaining spreads given that PLR hikes have been taken after considering all cost increases. We expect Aavas' NIM to decline by 34bps by FY25E which is lower than 72bps/196bps decline for HFFC/Aptus. As of now, the company does not expect any impact of rising interest rates on customer's ability to service loan obligations.

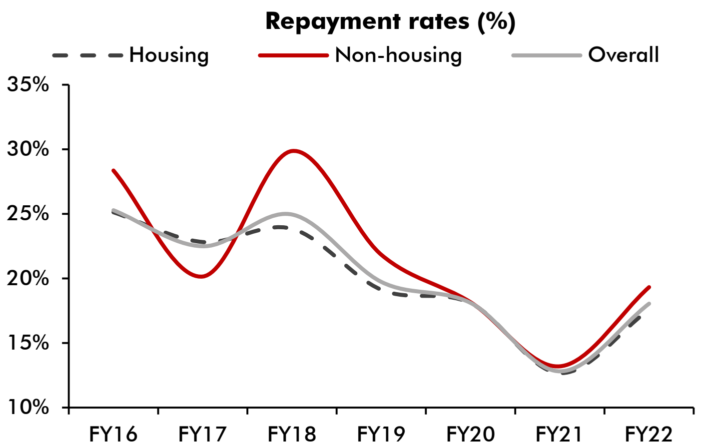
Exhibit 35: Aavas is expected to face limited margin compression, aided by 125bps PLR hike so far



Source: Ambit Capital research, Company

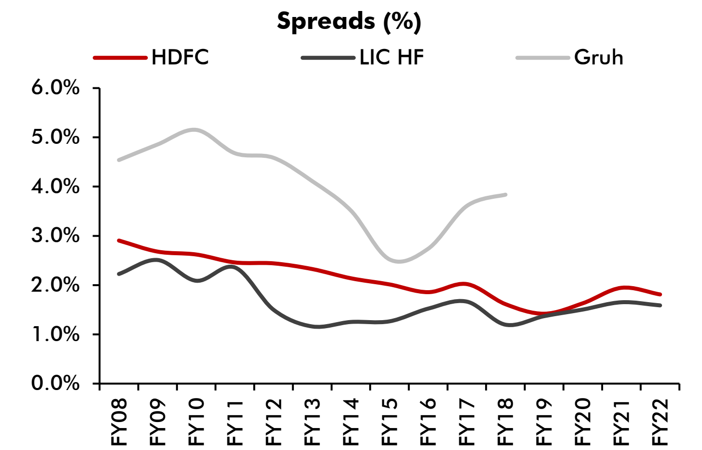
However, long-term spread/margin compression is inevitable as increasing scale, competition and prepayment risks force Aavas/companies to make growth/NIM trade-off.

Exhibit 36: Aavas is not immune to BT pressure



Source: Ambit Capital research, Company

Exhibit 37: Eventually, competition drives spreads lower

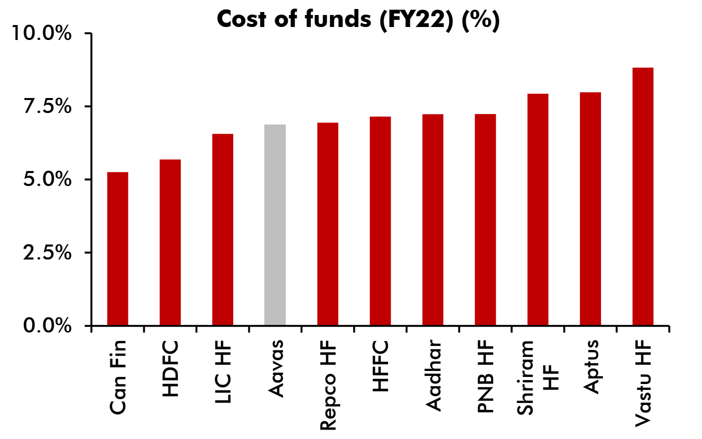


Source: Ambit Capital research, Company

Aavas has one of the most competitive cost of fund levels

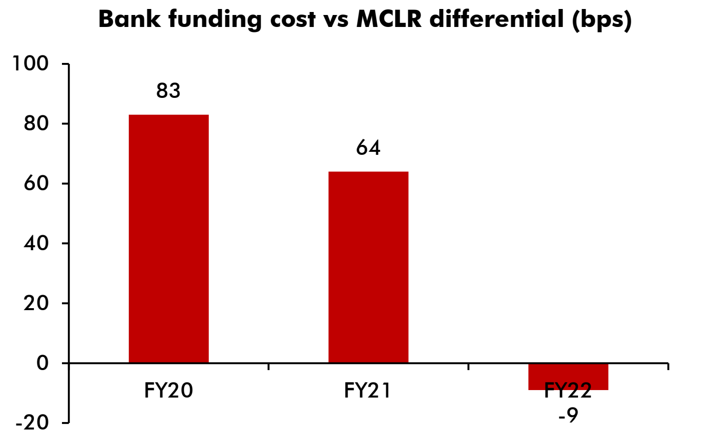
Aavas' cost of funds is lower than peers given its superior execution track record. Aavas started operations around the same time as Aptus/HFFC, yet it has AUM size which is >2x of peers. The company has scaled up while maintaining top-notch asset quality. Given its track record and superior risk management, the company enjoys a good reputation among banks/debt markets.

Exhibit 38: Aavas' cost of funds is one of the most competitive



Source: Ambit Capital research, Company

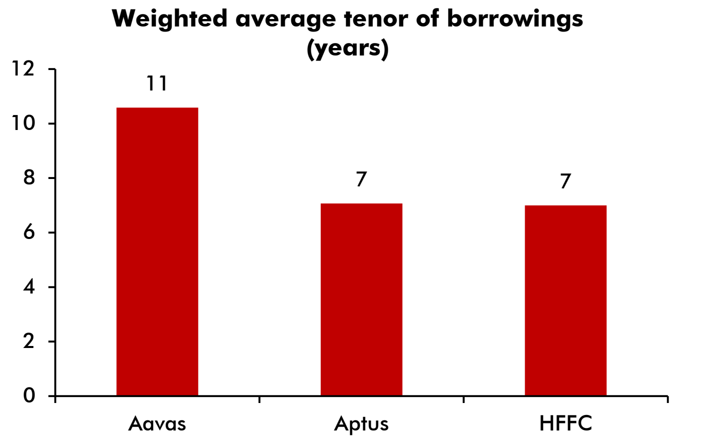
Exhibit 39: Aavas has been able to better negotiate bank funding rates



Source: Ambit Capital research, Company. Differential = Aavas' bank funding cost minus corresponding 1-year MCLR

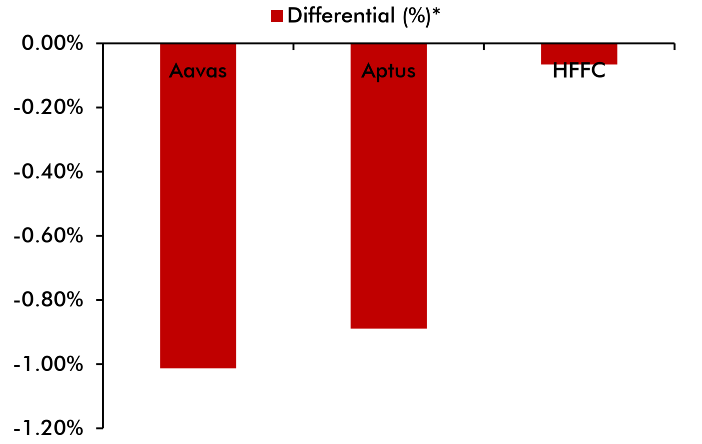
It is worth highlighting that Aavas' reported cost of funds (6.88% in FY22) is based on weighted average borrowings tenor of 11 years. For Aptus/HFFC, weighted average tenor of borrowings 7 years, shorter than Aavas. If we were to compare cost of funds across the companies for a similar tenor, Aavas' cost of funds differential vs Aptus/HFFC would be even wider.

Exhibit 40: Aavas' borrows longer term than peers and hence the higher quality ALM



Source: Ambit Capital research, Company

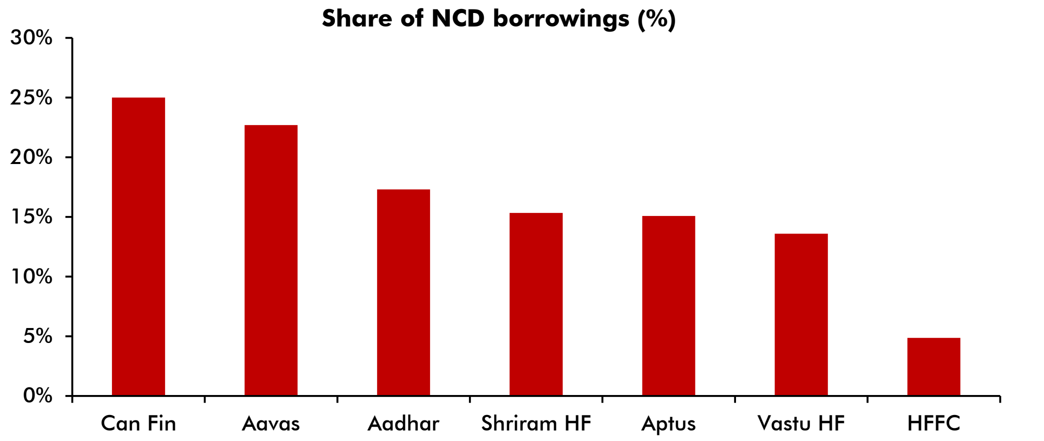
Exhibit 41: Differential vs benchmark bond yield indicates debt market confidence in Aavas



Source: Ambit Capital research, Company, Bloomberg. Differential = Reported cost of funds – average benchmark bond yield. For Aavas/HFFC, we have considered AA-rated yields; for Aptus, A-rated yield.

Among peers, Aavas has one of the highest share of debt market borrowings, likely indicating market's greater trust in its franchise.

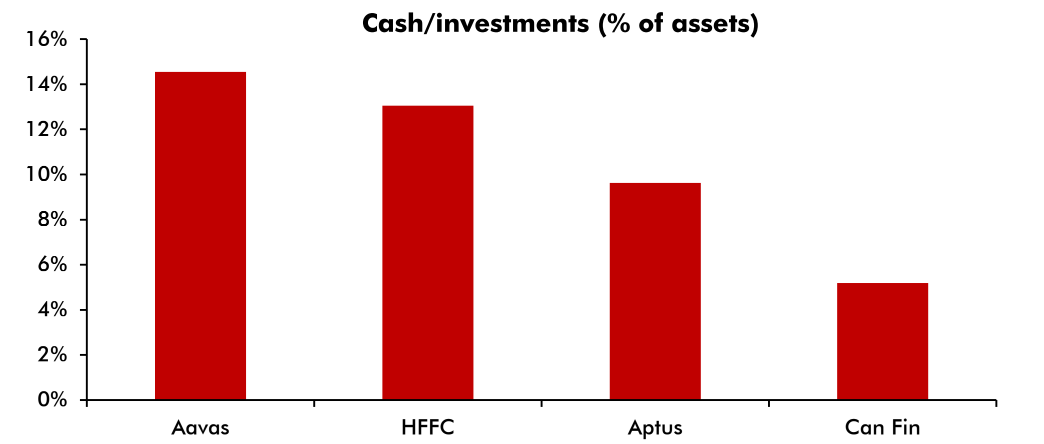
Exhibit 42: Aavas has higher share of NCD borrowings



Source: Ambit Capital research, Company

Aavas runs positive ALM across buckets while most peers run a negative short-term ALM mismatch, highlighting prudent approach to balance sheet management. Further, the company's on-balance-sheet liquidity is higher vs Aptus/Can Fin/HFFC.

Exhibit 43: Aavas maintains higher liquidity



Source: Ambit Capital research, Company

Worth the premium!

Aavas is a cultural design which is hard to replicate, making it less prone to competitive pressures. FV of ₹2148 is based on excess earnings (COE: 14%). 35% premium to small/mid-HFCs reflects scarcity of players having the ability to grow at 20% CAGR for the next 20 years. Against mortgage industry CAGR of 13-14% over FY22-42E, AHFCs are expected to grow 200-300bps higher. Aavas is best-positioned to capture such opportunity given its niche focus on less contested segments (tier-3/below, self-employed/informal income). Despite running a highly conservative ALM, Aavas' cost of funds is lower than most, reflecting superior reputation among capital suppliers. Low credit costs indicate superior underwriting. While the company undertakes investments with ₹2tn balance sheet vision, we see 15% ROE visibility by FY24E. Over FY22-25E, we expect EPS CAGR to mirror AUM CAGR of 23% due to efficiency improvement and limited NIM compression.

Exhibit 44: Earnings growth to lag AUM growth due to spread compression and elevated opex

	FY20	FY21	FY22	FY23E	FY24E	FY25E	Comments
Assumptions							
YoY AUM growth	31.2%	21.3%	20.1%	23.6%	23.3%	22.6%	Expect AUM growth (YoY) to gradually taper down due to increasing competition and growing base. We are factoring in disbursements growth (YoY) of 18-20% and repayment rate of 19%.
Yield on AUM (calc.)	12.3%	11.9%	11.9%	12.2%	12.3%	12.5%	In the current upward rate environment, yields are likely to increase as the company has taken PLR hikes.
Cost of funds (calc.)	8.0%	7.9%	6.7%	7.3%	7.6%	7.8%	Cost of funds is expected to increase given the upward rate environment.
NIM (calc.)	7.1%	6.5%	7.2%	7.1%	7.0%	6.9%	As a result of current rate scenario and competition, expect margins to trend down.
Opex to income (%)	41.5%	39.1%	41.9%	42.8%	41.2%	39.2%	Expect opex ratios to decline on back of improving underwriting/sourcing efficiency.
Opex to asset ratio (%)	3.4%	3.0%	3.5%	3.4%	3.3%	3.1%	
Credit cost (%)	0.3%	0.5%	0.3%	0.3%	0.3%	0.3%	Catering to self-employed segment will entail higher credit costs.
Output (₹bn)							
AUM	78	95	114	140	173	212	
NII	4.9	5.6	7.5	9.0	10.9	13.3	
Operating profit	3.2	3.9	4.8	5.6	7.1	8.9	
Net profit	2.5	2.9	3.6	4.2	5.2	6.6	
EPS (₹)	31.8	36.9	45.2	52.6	66.5	83.4	
BVPS (₹)	268	306	356	408	475	558	
ROA (%)	3.8%	3.5%	3.6%	3.4%	3.5%	3.6%	
ROE (%)	12.7%	12.9%	13.7%	13.8%	15.0%	16.2%	

Source: Ambit Capital research, Company

Exhibit 45: Expect earnings to be in line with the consensus

₹mn	Consensus estimates			Ambit estimates			Difference (%) (Ambit vs cons.)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Net operating income	10,000	12,122	14,963	9,839	12,009	14,610	-2%	-1%	-2%
PAT	4,212	5,210	6,548	4,152	5,246	6,586	-1%	1%	1%
EPS (₹)	53	66	83	53	66	83	-2%	0%	0%
BVPS (₹)	410	475	551	408	475	558	0%	0%	1%
ROA (%)	3.5%	3.5%	3.5%	3.4%	3.5%	3.6%	-11bps	0bps	11bps
ROE (%)	13.9%	14.8%	15.0%	13.8%	15.0%	16.2%	-16bps	25bps	114bps

Source: Ambit Capital research, Company

Our TP of ₹2148 is arrived at based on assumptions discussed above and assumed cost of equity (Ke) of 14%. Aavas' earnings growth has lagged peers' (FY19-22 CAGR: 21-26% vs 38-43% for peers). However, we are at a juncture where Aavas' opex ratios are set to improve, implying PPOP/EPS growth would be higher (FY22-25E CAGR: 23%).

Exhibit 46: Sensitivity of valuations to long-term growth and ROE assumptions

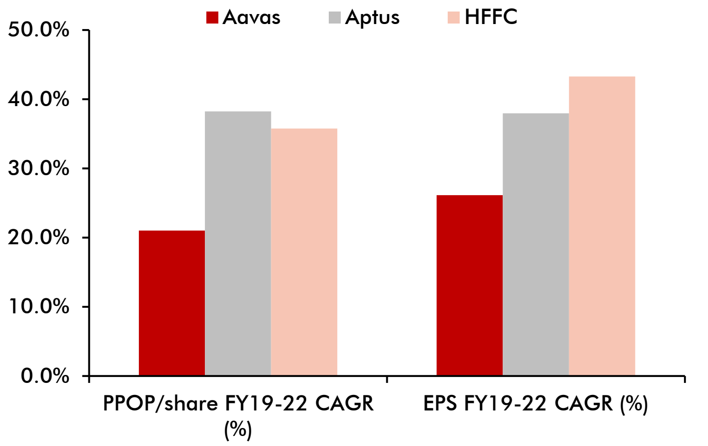
FY26-42E	Bear case	Base case	Bull case	Comments
Average assets growth	18.5%	21.0%	21.2%	In bear case, we are assuming competitive intensity (new business as well as BT) to be higher as arbitrage between banks and HFCs diminishes. In bull case, we are assuming that Aavas will be able to defend against competition and add new scale-accretive products.
Average ROA	3.4%	3.7%	3.8%	Bear case average NIM/credit cost: 6.5%/0.3%. Bull case average NIM/credit cost: 6.9%/0.2%.
Average ROE	16.8%	18.4%	18.8%	
Target price (₹)	**1,262**	**2,148**	**2,411**	
Implied P/E - FY24E	19.0	32.3	36.3	
Implied P/B - FY24E	2.7	4.5	5.1	

Source: Ambit Capital research, company

Earnings growth trend vs peers set to reverse

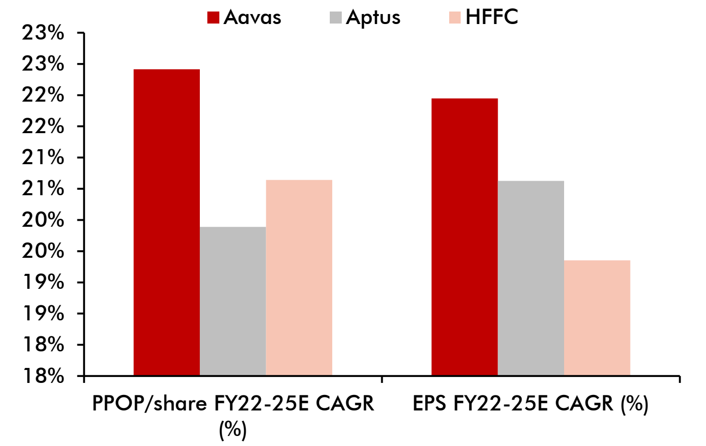
Over FY19-22, PPOP/share and EPS growth for Aavas have lagged Aptus/HHFC. However, given the expected opex trajectory over FY22-25E, we expect Aavas' earnings growth to be higher vs peers.

Exhibit 47: Aavas' earnings growth has lagged peers' due to opex intensity…



Source: Ambit Capital research, Company, Bloomberg

Exhibit 48: …but the trend is expected to reverse as opex efficiency improves

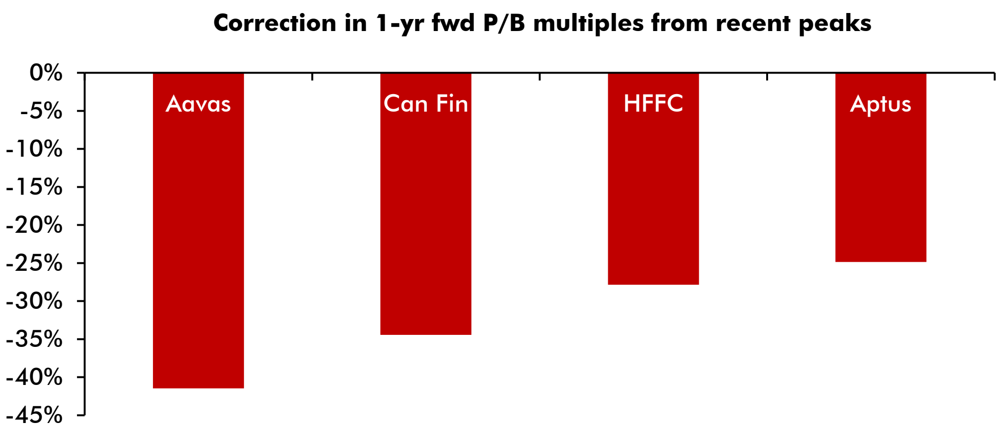


Source: Ambit Capital research, Company

Stock valuations are now more reasonable as growth expectations have reset

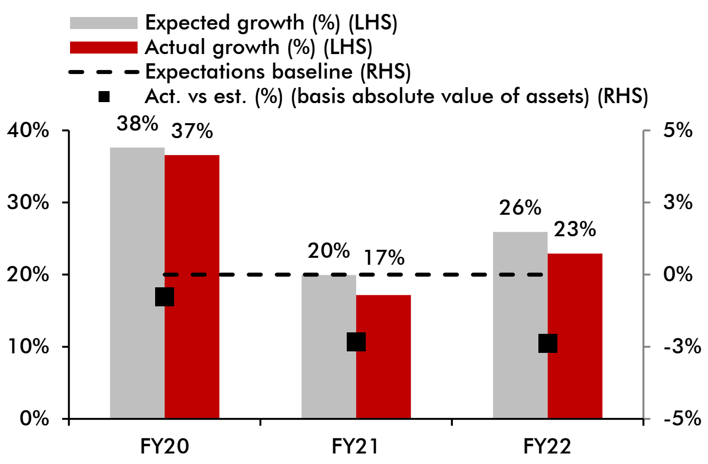
Aavas' stock valuations corrected >40% since its most recent peak (Feb-22). This was led by downward revision of long-term growth expectations, possibly from 25-30% to 20% now. Going by industry's long-term historical track record (19% CAGR) and Aavas' business model/management pedigree, current growth expectations seem reasonable.

Exhibit 49: Aavas' valuation correction of 41% was steepest



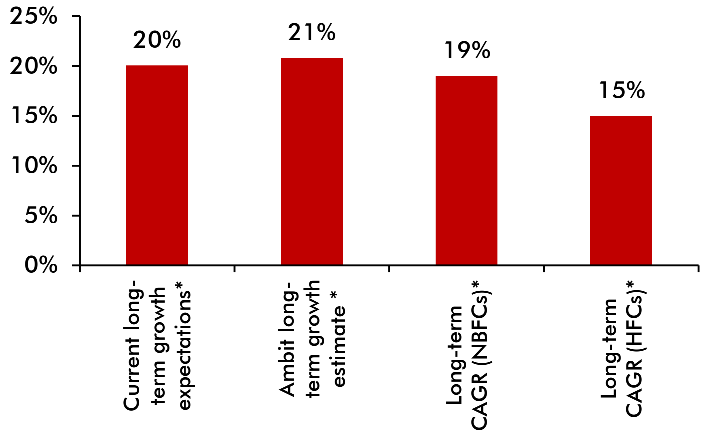
Source: Ambit Capital research, Bloomberg, companies

Exhibit 50: Growth expectations were tall…



Source: Ambit Capital research, Company, Bloomberg

Exhibit 51: …but have now moderated to 20%

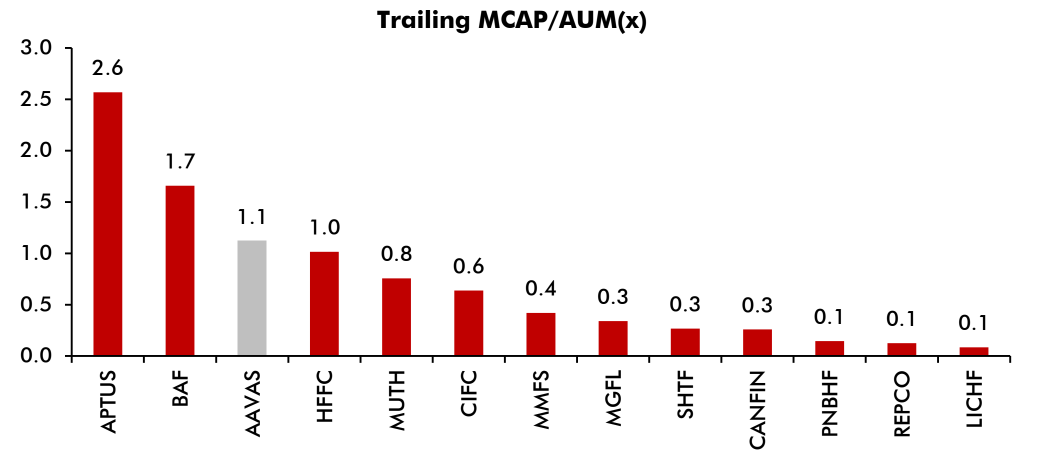


Source: Ambit Capital research, Company

Distinguished strategy, execution, management pedigree command premium

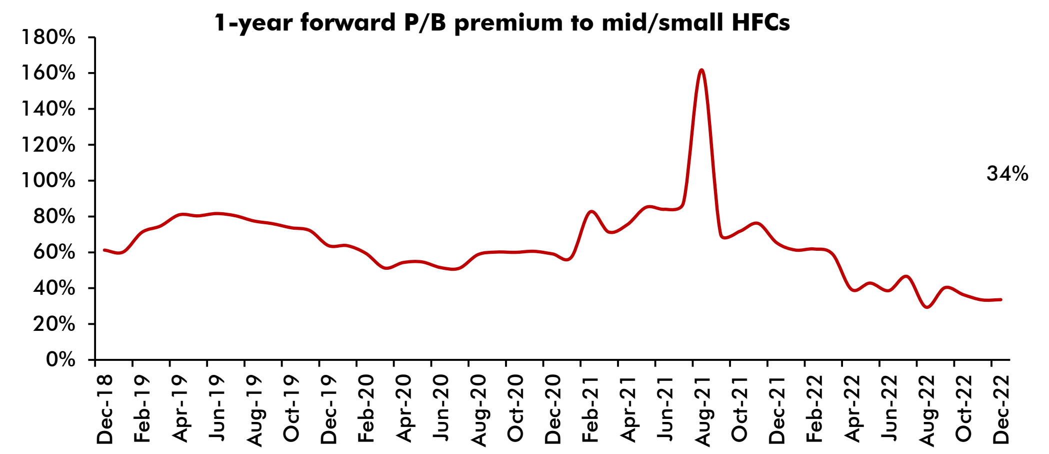
Aavas valuation premium over most other NBFCs/HFCs can be attributed to its distinguished customer/geographic strategy, superior execution, best-in-class systems/processes, top-notch management pedigree and 20% CAGR expectations going ahead.

Exhibit 52: Aavas trades at a significant premium to most other NBFCs/HFCs



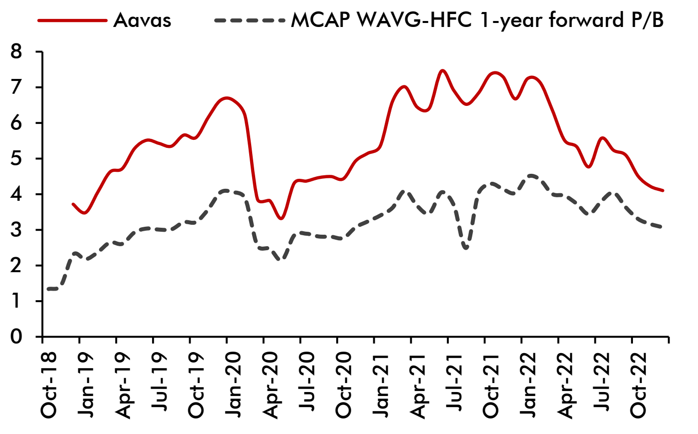
Source: Ambit Capital research, Company, Bloomberg

Exhibit 53: Despite the correction, Aavas' premium is still significant



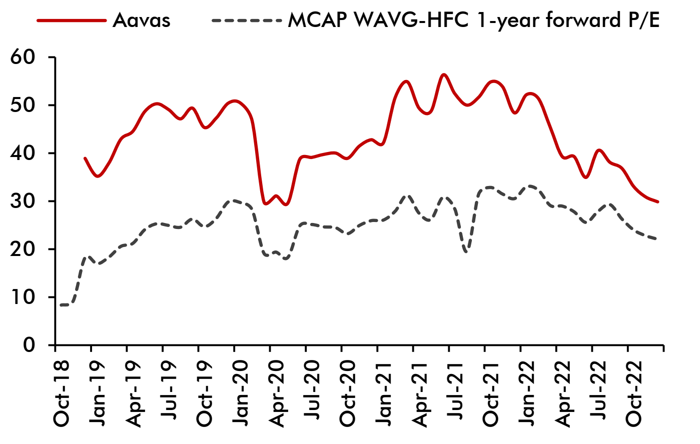
Source: Ambit Capital research, Company

Exhibit 54: Aavas trades at 34% premium to mid/small HFCs on 1-year fwd P/B



Source: Ambit Capital research, Company, Bloomberg

Exhibit 55: Aavas trades at 35% premium to mid/small HFCs on 1-year fwd P/B



Source: Ambit Capital research, Company

Risks & catalysts

Key risks

Higher competition can impact AUM growth: We are currently building in 23% AUM CAGR. Higher competition can impact AUM growth trajectory in terms of new customer acquisition and/or BT pressure. In the latest low rate cycle, Aavas faced BT pressure, which impacted growth.

NIM contraction: Currently, we are building in 34bps decline in NIM by FY25E. However, if higher competition forces Aavas to price its offerings lower or if cost of funds increases at a higher pace, the decline in NIM would be larger.

Productivity declines, impacting opex efficiency: Currently, we are assuming that Aavas' opex/assets will decline by 33bps to 3.1% by FY25E. This would be led by efficiency improvement measures being undertaken by the company. If the company is unable to improve sourcing efficiency, opex ratios may not decline.

Key man risk: Sushil Agarwal, founding CEO, drives much of the vision for Aavas. Therefore, his departure from the company would pose negative implications for the company.

Catalysts

Limited decline in NIM: Having taken a 125bps PLR hike so far, NIMs are expected to see negligible NIM decline of 9bps in FY24E.

Improving opex efficiency: Opex/assets is expected to reduce by ~15bps in FY24E, leading to 25% PPOP growth vs 23% AUM growth in FY24E. Earnings growth differential vs AUM growth is expected to narrow.

Exhibit 56: Explanation of our flags on the cover page

Segment	Score	Comments
Accounting	GREEN	We do not find anything unusual in the company's accounting policies and believe reported numbers are a true reflection of performance. Disclosures are better than peers.
Predictability	GREEN	AAVAS has reported stable earnings growth and has also met consensus earnings.
Earnings Momentum	AMBER	In the past six months, consensus has downgraded its FY23/24E EPS estimates by 1%/3%.

Source: Ambit Capital research, company

Financials

Income Statement

Particulars (₹mn)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net interest income	**4,857**	**5,579**	**7,516**	**8,950**	**10,912**	**13,262**
Non-interest Income	565	830	708	888	1,097	1,348
Total Income	**5,421**	**6,409**	**8,223**	**9,839**	**12,009**	**14,610**
Total opex	**2,247**	**2,504**	**3,449**	**4,207**	**4,946**	**5,734**
Employee Expenses	1,471	1,721	2,322	2,860	3,358	3,893
Other Expenses	777	783	1,126	1,348	1,588	1,841
Pre provision profit	**3,174**	**3,905**	**4,775**	**5,631**	**7,063**	**8,876**
Provisions	153	371	226	335	371	475
Profit before tax	**3,020**	**3,533**	**4,549**	**5,296**	**6,692**	**8,400**
Tax	529	638	981	1,144	1,445	1,814
PAT - Standalone	**2,491**	**2,895**	**3,568**	**4,152**	**5,246**	**6,586**

Source: Ambit Capital research, company

Balance Sheet

Particulars (₹mn)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net worth	20,979	24,014	28,086	32,239	37,485	44,071
Borrowings	53,520	63,454	79,725	99,258	123,079	152,003
Total liabilities	**76,263**	**89,353**	**109,840**	**134,435**	**164,621**	**201,924**
Loans (on-book)	61,808	75,230	90,522	111,367	137,277	168,202
Cash & investments	11,966	11,255	15,977	18,859	22,154	27,361
Other assets	2,490	2,869	3,340	4,209	5,190	6,362
Total assets	**76,263**	**89,353**	**109,840**	**134,435**	**164,621**	**201,924**
AUM	**77,961**	**94,543**	**113,502**	**140,304**	**172,999**	**212,057**

Source: Ambit Capital research, company

Key Ratios

Particulars (%)	FY20	FY21	FY22	FY23E	FY24E	FY25E
AUM growth (%)	31.2	21.3	20.1	23.6	23.3	22.6
Disbursements growth (%)	9.7	-9.3	35.6	35.0	22.7	21.2
EPS growth (%)	41.2	15.9	22.6	16.4	26.4	25.5
Net interest margin (NIM) (%)	7.1	6.5	7.2	7.1	7.0	6.9
Cost to income (%)	41.5	39.1	41.9	42.8	41.2	39.2
Opex (% of AAUM)	3.3	2.9	3.3	3.3	3.2	3.0
Gross NPAs (%)	0.5	1.0	1.0	1.0	1.0	1.0
Credit costs (% of AAUM)	0.3	0.5	0.3	0.3	0.3	0.3
Provision Coverage (%)	26.0	27.2	23.1	25.0	28.0	32.0
Tier-1 (%)	53.9	53.3	50.7	47.5	45.1	43.2
Leverage (x)	3.4	3.7	3.8	4.0	4.3	4.5

Source: Ambit Capital research, company

Valuation

Particulars	FY20	FY21	FY22	FY23E	FY24E	FY25E
BVPS (₹)	268	306	356	408	475	558
EPS (₹)	31.8	36.9	45.2	52.6	66.5	83.4
ROA (%)	3.8	3.5	3.6	3.4	3.5	3.6
ROE (%)	12.7	12.9	13.7	13.8	15.0	16.2
P/E	58.0	50.0	40.8	35.1	27.7	22.1
P/BV	6.9	6.0	5.2	4.5	3.9	3.3

Source: Ambit Capital research, company

Annexure: Board comprises majorly of PE nominees

Board has substantial representation from PE-nominated directors. Nearly all directors have relevant industry experience

Exhibit 57: Majority of the board is comprised of PE nominee directors

Name	Designation	Background/work-ex	Industry experience	Other directorships
Sandeep Tandon	Chairman & Independent director	Bachelor's degree in science (electrical engineering) from the University of Southern California. Additionally, he has completed the Harvard Business School YPO President Program.		10
Sushil Kumar Agarwal	MD & CEO	21+ years in retail financial services. Worked at Kotak Bank, ICICI Bank, AU SFB.	Yes	-
Kalpana Iyer	Independent director	Bachelor's in commerce, qualified CA. Previously associated with Citibank. Currently, MD of Svakarma Finance.	Yes	2
Soumya Rajan	Independent director	MD/CEO of Waterfield Advisors. Previously worked at StanChart (private banking).	Yes	7
Ramchandra Kasargod Kamath	Non-executive nominee director	Nominee director appointed by Lake District and Kedaara. Previously worked in PSU banks.	Yes	2
Vivek Vig	Non-executive nominee director	Nominee director appointed by Partners Group. Preivously worked with banks/NBFCs.	Yes	-
Nishant Sharma	Non-executive nominee director	Non-executive promoter nomiee director appointed by Lake District. CIO of Kedaara Capital.	Yes	-
Manas Tandon	Non-executive nominee director	Non-executive promoter nomiee director appointed by Partners Group. Head of Partners Group's Mumbai office.	Yes	1
Kartikeya Dhruv Kaji	Non-executive nominee director	Non-executive promoter nomiee director appointed by Lake District. Director at Kedaara Capital.	Yes	4

Source: Ambit Capital research, Company

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Aptus Value Housing Finance

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INITIATING COVERAGE | **APTUS IN EQUITY** | **January 12, 2023**

Expectations are too high!

Focus on tier-3/below locations and self-employed/informal income segment is key competitive advantage but not enough for long-term sustainable model. High bounce rates and early bucket stress are natural outcomes of business construct and subsequent collection efforts are noted, but scale-up hereon will entail higher credit costs. Initial impressions of non-south foray aren't impressive. Fixed rate book in a rising rate environment and elevated opex due to new state forays are double whammy for earnings growth. We note several governance lapses, most notably concentration of power with promoter and presence on NRC. Current valuations imply market expectations of 22% AUM CAGR for next 20 years with no significant margin compression – seems a tall task. FV of ₹245 implies 3.3x FY24E BVPS, a 25% discount to Aavas. Key risks: NIM expansion, better asset quality/lower credit costs and higher efficiency.

Competitive position: MODERATE   Changes to this position: STABLE

Niche play/low-base aiding growth rates

Aptus' AUM/disbursements CAGR of 46%/39% CAGR since FY15 were aided by focusing on less-competitive segments. In-house operations aided low repayment rates, contributing to AUM growth. Pricing power (high margins) and low credit costs due to low portfolio seasoning aided average ROA of 6.3% (FY17-22).

Scaling up will come with higher costs

Deep investments in in-house sales/collections are key differentiating factors. However, scaling up with the same processes/business structure will entail higher costs. New state forays will require initial set-up costs. Historical credit costs averaging 24bps are too low for the kind of risk being underwritten. Last few quarters, higher stage 2 ECL cover translated into higher credit costs of 70bps. We expect NIMs to decline by 196bps by FY25E due to high share of fixed rate loans and ever-increasing competition.

Governance standards less than ideal

We observe multiple concerns regarding board governance and MD's remuneration. Dividend declaration puts under question the primary capital raise (via IPO) in Aug-21.

Ask rates on growth overlook risks to scaling up

Aptus currently commands 30% premium to small/mid-peers. We believe this valuation premium is unjustified as the company does not have a very long track record of growing profitably. We see competition, increasing credit costs, weak non-south execution are key challenges/risks to scaling up.

Key financials

Year to March	FY21	FY22	FY23E	FY24E	FY25E
Total Income (₹ mn)	4,517	6,316	8,296	9,772	11,622
Operating Profit (₹ mn)	3,509	5,145	6,656	7,582	8,848
Net Profit (₹ mn)	2,669	3,701	4,872	5,494	6,435
EPS (₹)	5.5	7.4	9.8	11.1	13.0
RoE (%)	14.5	15.1	15.7	15.6	16.1
P/E (x)	53.9	40.1	30.5	27.0	23.1
P/B (x)	7.3	5.1	4.5	4.0	3.5

Source: Ambit Capital research, company

BFSI

Recommendation

Mcap (bn):	₹149/US$1.8
6M ADV (mn):	₹149/US$1.9
CMP:	₹299
TP (12 mths):	₹245
Downside (%):	18

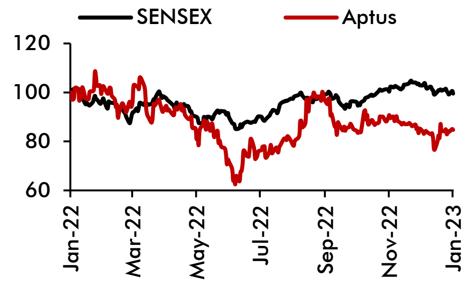
Flags

Accounting:	GREEN
Predictability:	GREEN
Earnings Momentum:	GREEN

Key catalysts

- Expect NIMs to decline by 100bps in FY24E due to increasing CoF and high share of fixed rate loans.
- Opex ratio to increase to 2.5% in FY24E on back of continued expansion.

Performance (%)



Source: Bloomberg, Ambit Capital Research

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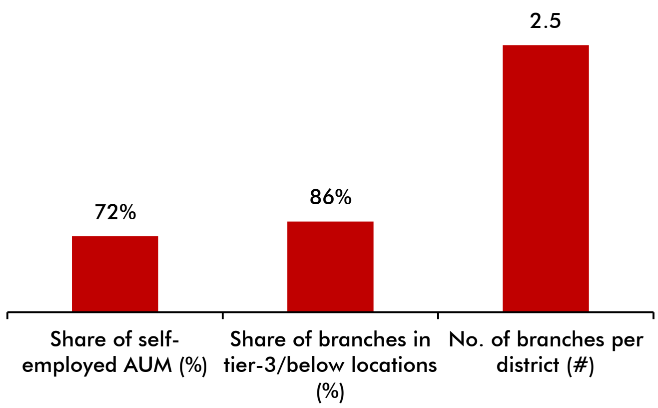
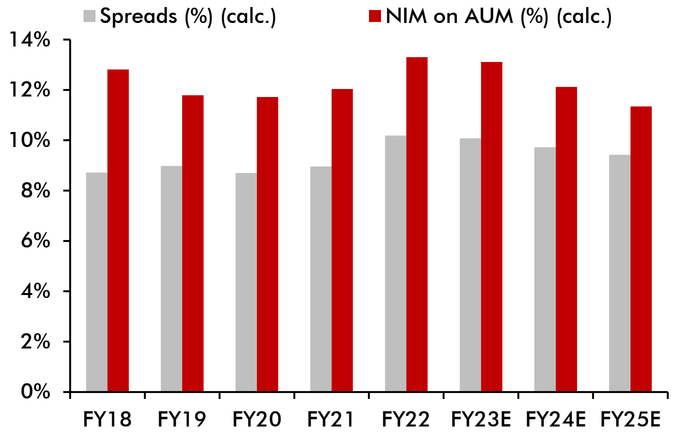
The Narrative in Charts

Exhibit 1: Aptus' key advantage are its ability to cater to the un/under-served market segments



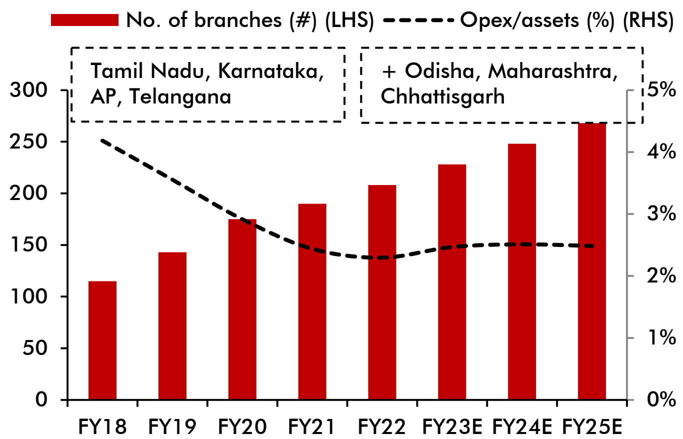
Source: Ambit Capital research, company

Exhibit 2: As a result, it has been able to charge higher spreads (>5x of large HFCs)



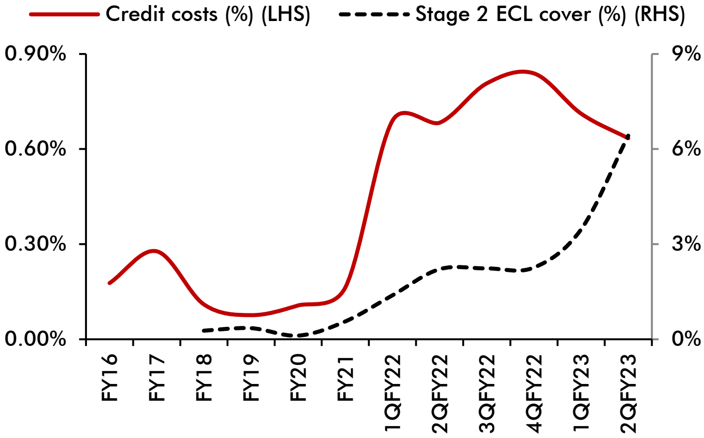
Source: Ambit Capital research, company

Exhibit 3: Opex ratios, which have been key driver of profitability, are set to rise due to new expansion



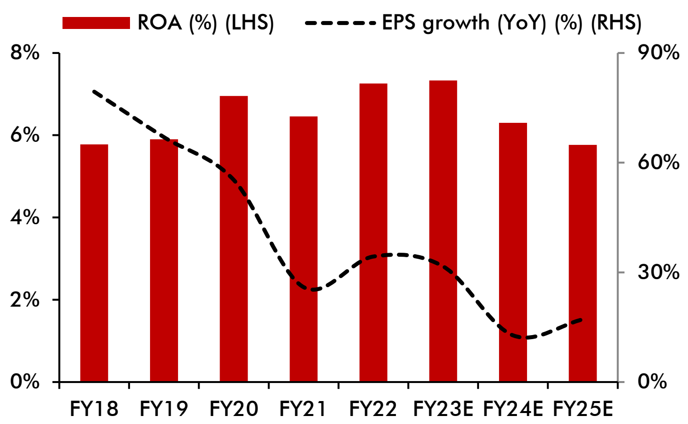
Source: Ambit Capital research, company

Exhibit 4: Credit cost to settle at elevated level as stage 2 cover increases



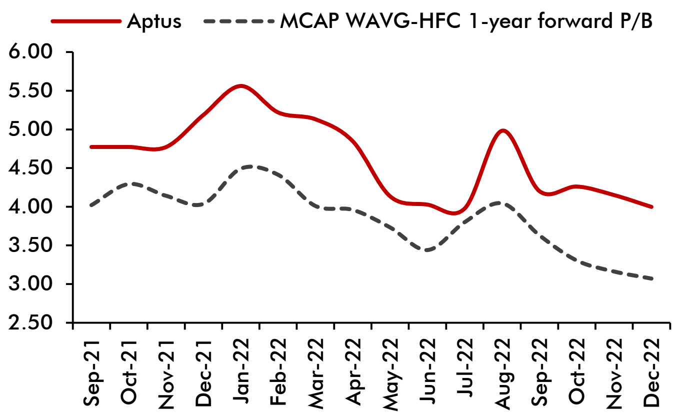
Source: Ambit Capital research, company

Exhibit 5: With increasing opex/credit costs, declining NIMs, EPS growth will decelerate



Source: Ambit Capital research, company, Bloomberg

Exhibit 6: 1-year fwd P/B premium to sector should moderate

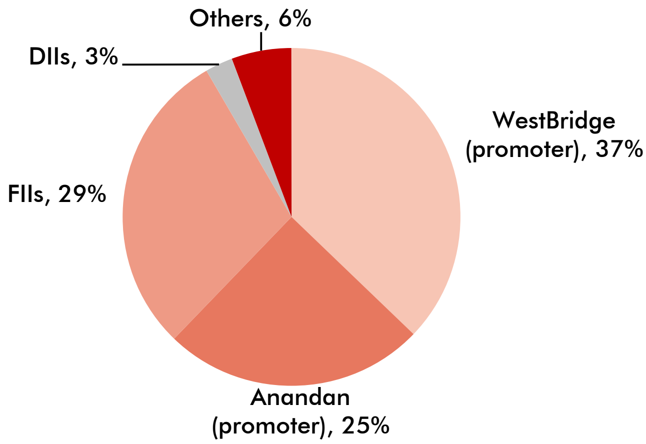


Source: Ambit Capital research, companies

South-based, focusing on self-employed in deep geographies

Aptus was incorporated in 2009 in Chennai, Tamil Nadu. It focuses on small ticket size home and non-home loans (ATS: ₹0.7mn). Customer-wise, it focuses on self-employed (72% of AUM), most of whom lack formal income proofs. The differentiating factor about Aptus' distribution is that it operates in tier-3/below locations (86% of branches), where competition is less. Among small-ticket HFCs, Aptus cost of funds is uncompetitive. Although the company has not faced too much prepayment pressure in the last cycle, low repayment rates may not sustain if the company expands into urban regions. Our analysis also indicates that productivity for the company has been low compared to Aavas. High PE ownership is discomforting due to possibility of ownership change. Lastly, the company is currently drawing entire business from south India, which indicates geographic concentration.

Exhibit 7: Co-owned by investor-promoter and founder-promoter



Source: Ambit Capital research, company

Exhibit 8: SWOT analysis

Strengths	Weaknesses
▪ **Customer profile:** Aptus mainly lends to self-employed with informal/undocumented income. ▪ **Geographical focus:** 86% of Aptus' branch network is located in tier-3/below locations. ▪ **Focus on self-construction:** This product has fewer players as risks are higher and it is operationally more intensive than funding apartments. ▪ **Multi-product focus:** Affordable housing is 56% of AUM; LAP/business loans form the rest. LAP/business loans are higher yielding products, which enhance overall margins.	▪ **Uncompetitive cost of funds:** Aptus' cost of funds is least competitive among the larger set of lenders, esp. vs banks. ▪ **Productivity is low:** While productivity levels maybe improving, on absolute basis, they are lower than Aavas/HFFC. ▪ **High PE ownership:** High PE ownership has always remained a concern due to possibility of sudden ownership change driven by PE's own fund mandates. ▪ **Governance standards not ideal:** MD/chairman post is held by the same person. Promoter being the chairman, exposes board to promoter's influence. Company raised ₹5bn of primary capital via IPO in Aug-21 and has declared dividend in Nov-22. ▪ **Geographical concentration:** 100% of AUM is currently out of south India. Any region specific disruption can impact Aptus negatively.
Opportunities	**Threats**
▪ **Industry to see 13-14% CAGR over next 2 decades:** Mortgage industry is expected to grow at 13-14% p.a. over the next 2 decades. ▪ **Expanding to other regions:** Currently, Aptus draws entire business from the south. The company has an opportunity to expand into other regions (north/west/central). ▪ **Expanding sourcing channels:** Currently, Aptus sourcing entirely in-house. The company can add DSAs as an external sourcing channel, which will add to growth.	▪ **High pre-payments:** Uncompetitive cost of funds can result in high pre-payments/BTs, leading to impact on AUM growth. ▪ **High attrition:** Although Aptus has not seen as high attrition as others, it remains an industry risk. ▪ **Succession planning:** M. Anandan, managing director, is driving the business currently. He is >70 years old and will possibly work for only handful number of years. Therefore, there is risk of succession planning.

Source: Ambit Capital research, company

Granular ATS entails investments across value chain

Aptus follows a completely in-house strategy, from origination to collections. This strategy is similar to the one followed by Aavas. Though such structures are opex-heavy (2.7% opex/AUM), they ensure better understanding of the customers. In case of self-employed customers with informal income proofs, such a structure helps in attaining better credit evaluation (involves high degree of subjective assessment). Even though Aptus' stage 2 ratio is higher than peers, stage 3 is lower than several comparable HFCs. This could be attributed to high investments in collection infra. Aptus follows a branch heavy strategy as it has 2-3 branches per district.

Exhibit 9: Like Aavas, Aptus too has a completely in-house approach to business

Functions	In-house/outsourced	Comments
Sales	In-house	Sourcing is 100% in-house by branch staff.
		Direct sourcing model helps in maintaining strong and long-term relationship with the customer and it also helps in new customer acquisition via customer referrals.
Initial screening	In-house	Customers are visited by sales officer, branch manager and branch credit officer as part of credit assessment process.
		Credit officers spend considerable time to understand
Underwriting	In-house	Underwriting/approval/disbursement processes are centralised.
		Credit officers at branches are responsible for assessing customers' business/income (formal/informal)/expenses by direct field visits, verification of documents, conducting reference checks (locality, suppliers/vendors, customers). They determine the customer's ability to repay.
		Assessed income is verified with surrogates such as recently created assets, including cars, residential lifestyle.
		Credit officers also use credit bureau scores to determine the credit history of customers.
		Company has developed 60 type of customer profiles for credit assessment. These profiles are updated regularly for regional and local market developments, resulting in better credit/customer assessment.
		There is a clear segregation of duties between sales originators and credit/underwriting officers.
Legal/technical/valuation	In-house	The in-house legal/technical team undertakes field visit to identify the location of the proposed collateral and to trace the flow of the title documents of the proposed collateral and their authenticity
		The title deeds are cross-verified with government records.
		For legal/technical functions, the in-house team is based at hubs which cater to several locations.
Collections	In-house	All borrowers are registered for auto debit facility.
		Customers are reminded of their payments through text messages and automated phone calls.
		Between 0-29 dpd, the company sends customers letters and calls them to remind of the payment.
		Between 30-89 dpd, the company undertakes field visit to customers' pace of work/residence.
		For >90dpd, SARFAESI is initiated.
Monitoring	In-house	After disbursal, the company monitors the loan performance closely for 15-24 months to check for early warning signals of potential defaults.
		Site visits are conducted 3 months after disbursals and periodically thereafter.
		Stress testing is conducted portfolio-wise, pincode-wise, sourcing wise to check for probability of default.

Source: Ambit Capital research, company

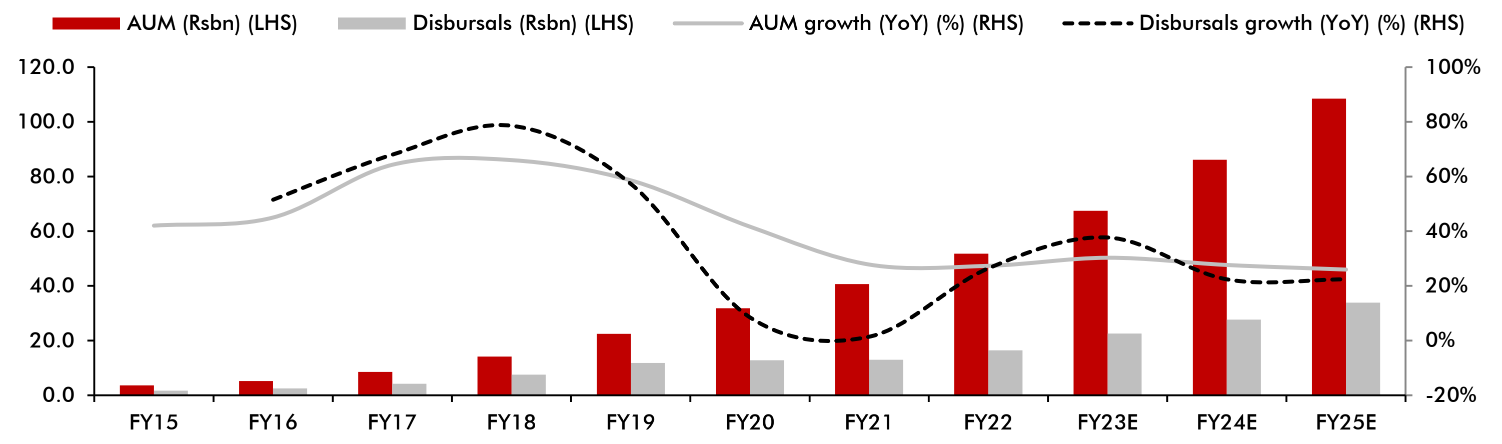
Stellar growth due to less competition

Aptus' distinct focus on tier-3/below locations and self-employed/informal income customers aided higher-than-industry growth, leading to 4.6% disbursal market share in the <₹1mn ATS segment. Catering to the un-serviced/under-serviced segments enabled Aptus to charge spreads which are >5x of large HFCs. However, such a business construct also entailed higher costs, reflected in 2.7% opex/assets. Large spreads and low credit costs (due to low seasoning) aided ROE expansion to >15% in FY22. Over FY16-22, PPOP per share/EPS increased at 51%/54% CAGR vs AUM CAGR of 47%, led by improving opex.

Distinct focus, low base have aided high growth rates

Aptus' consolidated AUM/disbursements increased at 47%/37% CAGR since FY16. Though, in the <₹1mn ticket size segment, disbursement market share has been increasing (FY22: 4.6%) owing to extensive network of 208 branches.

Exhibit 10: Distinct geo/customer focus, low base have led to sustained high growth rates

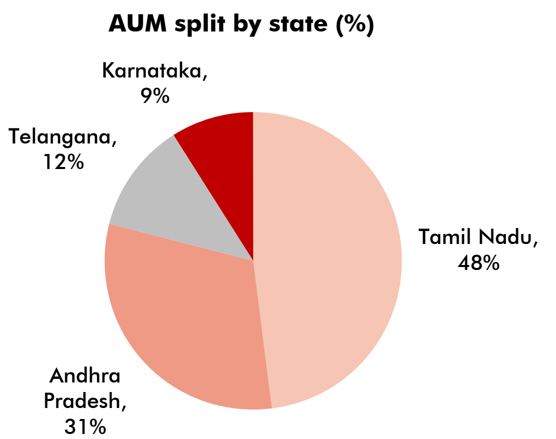


Source: Ambit Capital research, company

Mostly south-focused. Operating in deep locations

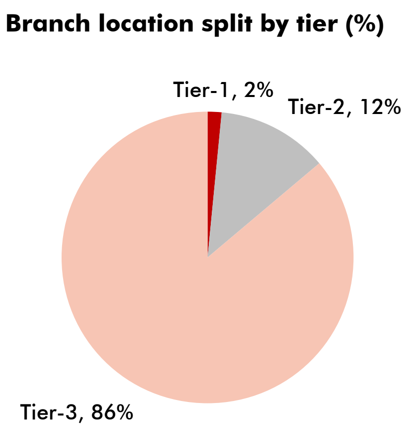
The company draws its entire AUM from 4 southern states (Tamil Nadu, Karnataka, Andhra Pradesh, Telangana). Though, recently it opened a branch in Odisha and Maharashtra/Chhattisgarh also figure on the state-list for new expansion. Location wise, the focus is mostly on tier-3/below locations (86% of branches), like Aavas. The competition in such locations is less compared to tier-1 locations.

Exhibit 11: 100% business comes from 4 southern states



Source: Ambit Capital research, company

Exhibit 12: Aptus operates in deeper geographies

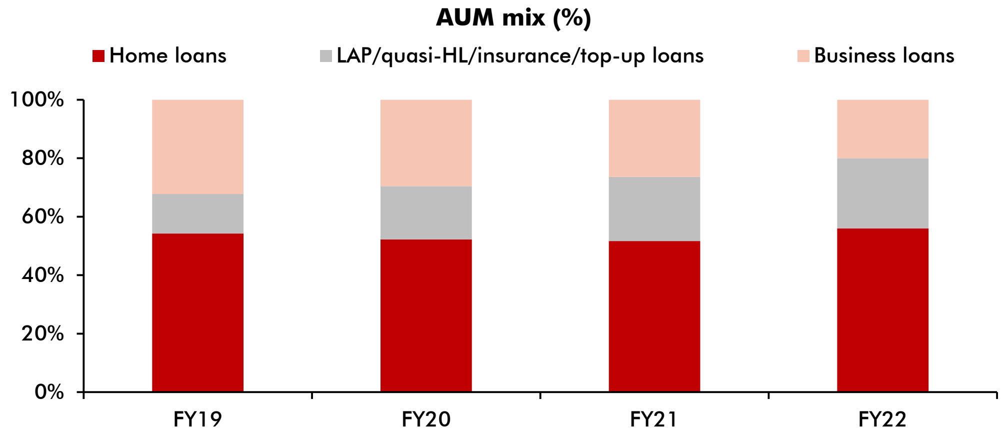


Source: Ambit Capital research, company

Aptus has a more diversified portfolio mix

Compared to other HFCs, Aptus' portfolio mix is more diversified. Main focus is on self-construction, which is a relatively less serviced segment.

Exhibit 13: Aptus' AUM is more diversified than peers

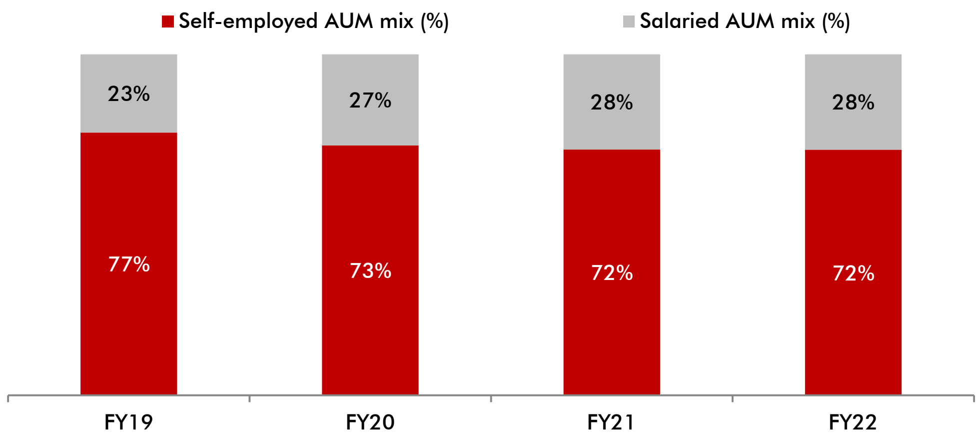


Source: Ambit Capital research, company

Focus is on self-employed/undocumented income

The company focuses on self-employed customers (72% of AUM). Aptus' focus on such customer segment is also the highest among peers. Most of these customers lack formal income proofs and hence, underwriting them the traditional way becomes difficult. Aptus, through its extensive workforce and specialized underwriting tools, is able to determine whether a customer is eligible for loans or not.

Exhibit 14: Aptus specializes in underwriting the self-employed with informal income

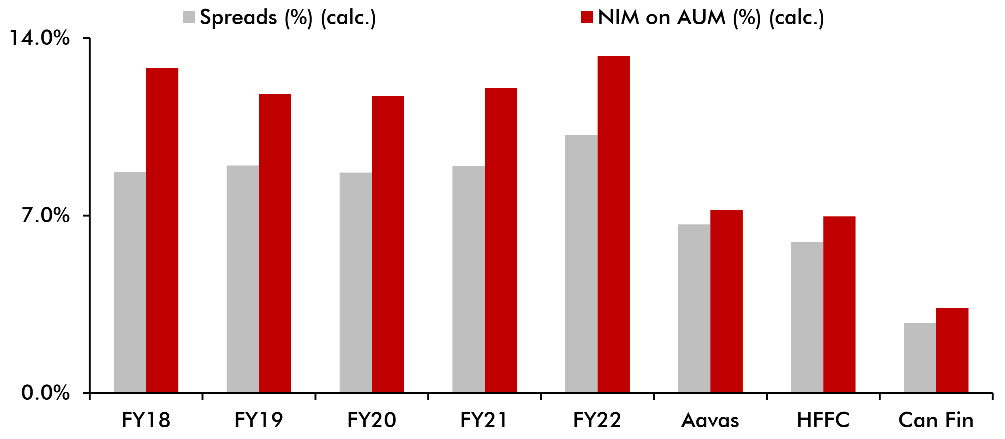


Source: Ambit Capital research, company

Operating in less competitive markets have aided spreads

Aptus' spreads (10.2%) are the highest among HFCs and are >5x of large HFCs. The reason why Aptus is able to extract premium pricing is that it focuses on a un/under-serviced market (self-employed customer, tier-3/below locations).

Exhibit 15: Aptus' spreads are highest among HFCs given its focus on less competitive segments

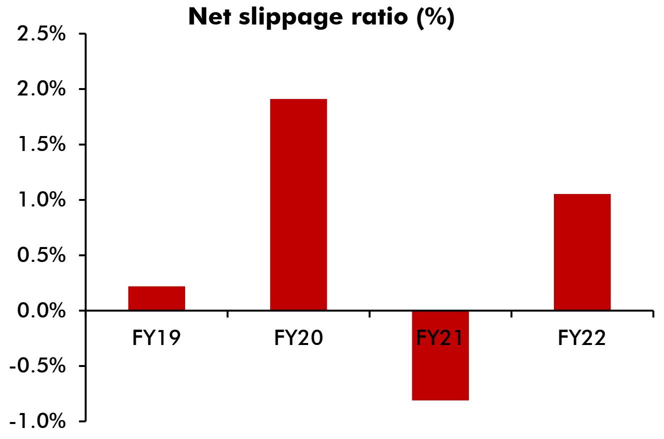


Source: Ambit Capital research, company; Note: Aavas/HFFC/Can Fin spreads/NIMs are for FY22

Investments in collections aid sharp reduction from stage 2 to stage 3

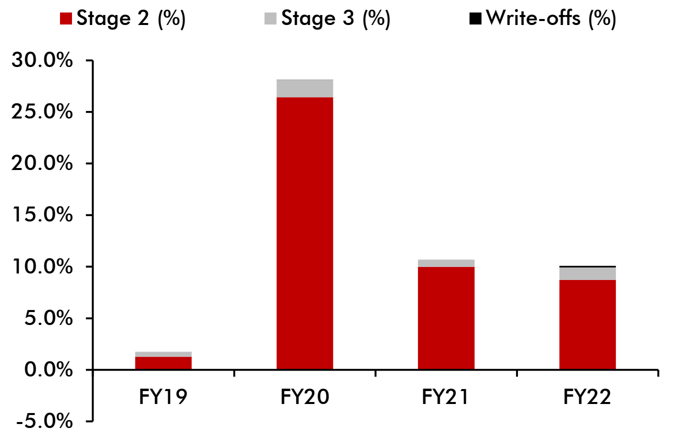
Aptus has one the highest differentials between stage 2 and stage 3 ratios compared to peers, second only to Repco HF. However, its stage 3 ratio is lower than many others, owing to substantial collection/recovery efforts executed in the 30-90 dpd bucket. As a result, despite its stage 2 ratio is high, the net slippage ratio is lower (0.7% vs 1.2-1.3% for HFFC/Repco HF). Overall asset quality has been moderate compared to peers.

Exhibit 16: Investments in collections have arrested slippages…



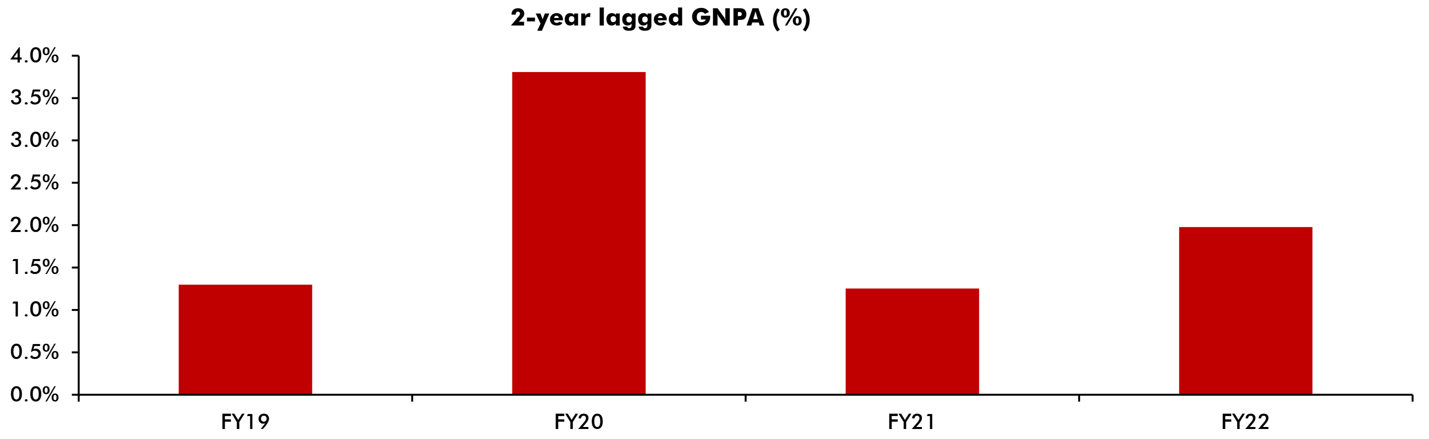
Source: Ambit Capital research, company

Exhibit 17: …as indicated by substantial differential between stage 2 and stage 3 loans



Source: Ambit Capital research, company

Exhibit 18: On lagged basis, Aptus' asset quality has been moderate



Source: Ambit Capital research, company

15%+ ROE aided by large spreads and improving efficiency

In FY22, Aptus reported 15.1% ROE aided by 13%+ NIM and lower opex/assets. Over the last few years, the company has been able to bring down its opex ratios owing to asset build up. We note that Aptus has lower repayment rates vs Aavas/HFFC, which had supported AUM growth and thus, opex improvement. Over FY16-22, PPOP per share/EPS have increased at 51%/54% CAGR compared to AUM CAGR of 47%, mainly due to declining opex.

Exhibit 19: Near-term earning pressure would be led by declining margins and elevated opex/credit costs

Du-pont analysis (%)	FY17	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
NII (NIM)	12.7%	12.6%	11.4%	10.5%	10.6%	12.1%	11.8%	10.7%	9.9%
Other income	0.8%	0.5%	0.3%	0.7%	0.4%	0.3%	0.7%	0.5%	0.5%
Net operating income	13.4%	13.0%	11.7%	11.2%	10.9%	12.4%	12.5%	11.2%	10.4%
Opex	4.8%	4.2%	3.6%	2.9%	2.4%	2.3%	2.5%	2.5%	2.5%
Operating profit	8.6%	8.9%	8.2%	8.2%	8.5%	10.1%	10.0%	8.7%	7.9%
Credit cost	0.3%	0.1%	0.1%	0.1%	0.1%	0.7%	0.5%	0.5%	0.4%
PBT	8.3%	8.8%	8.1%	8.2%	8.3%	9.4%	9.5%	8.2%	7.5%
Tax	33.8%	34.1%	27.0%	14.7%	22.6%	22.9%	23.0%	23.0%	23.0%
PAT (ROA)	5.5%	5.8%	5.9%	7.0%	6.5%	7.3%	7.3%	6.3%	5.8%
Leverage (x)	1.8	2.1	3.0	2.5	2.2	2.1	2.1	2.5	2.8
ROE	10.2%	12.1%	17.4%	17.5%	14.5%	15.1%	15.7%	15.6%	16.1%

Source: Ambit Capital research, company

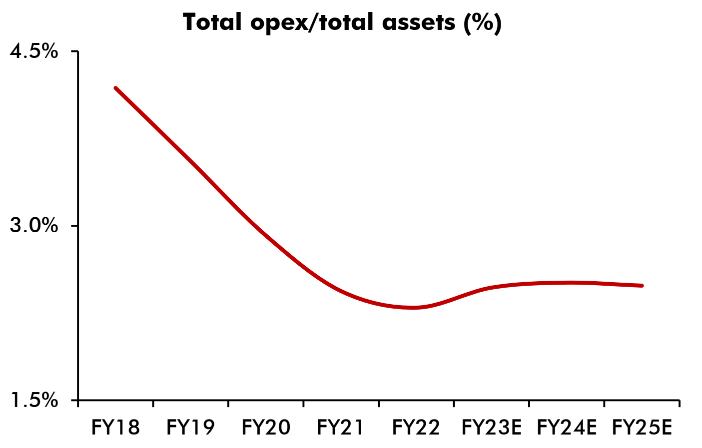
Scaling up will come at a cost

In view of the current business structure which entails heavy reinvestments in branches/manpower, we expect opex/assets to remain elevated. Besides this, new branch openings, geographical diversification (Odisha/Maharashtra/Chhattisgarh) will result in higher initial set-up costs, leading to higher opex as these are completely new regions. We also believe that south is seeing increasing competitive intensity. As Aptus' increases scale, asset retention costs could increase. Further, we expect credit costs to increase vs historical trend as Aptus moves closer to peers' levels of provisioning on stage 2 assets. As the share of such assets is higher for Aptus, it will lead to higher overall credit costs.

Aptus' customer-centric business model entails high opex

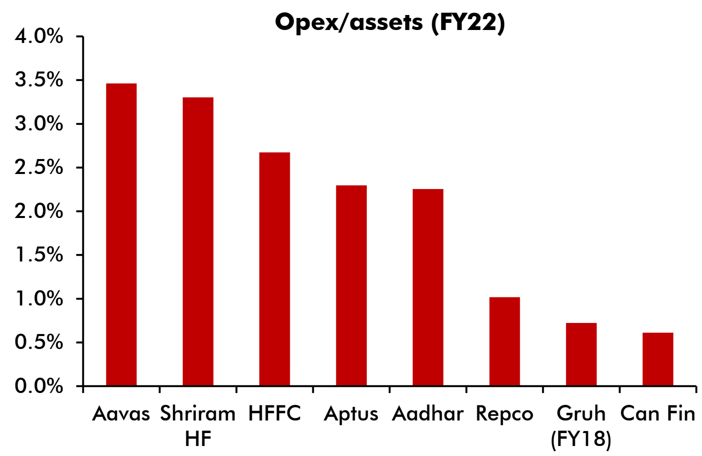
Given the granularity of the business model (ATS: ~₹0.7mn) and in-house functions across the value chain, investments in branches and manpower is high. This is well demonstrated by its branches-per-district ratio, which is 2.5 (2-3 branches in every district), implying a branch-heavy business strategy. As a result, opex ratios are elevated (opex/assets: 2.4%) and will remain so.

Exhibit 20: Opex ratios to remain elevated



Source: Ambit Capital research, company

Exhibit 21: Aptus' opex is higher than most peers

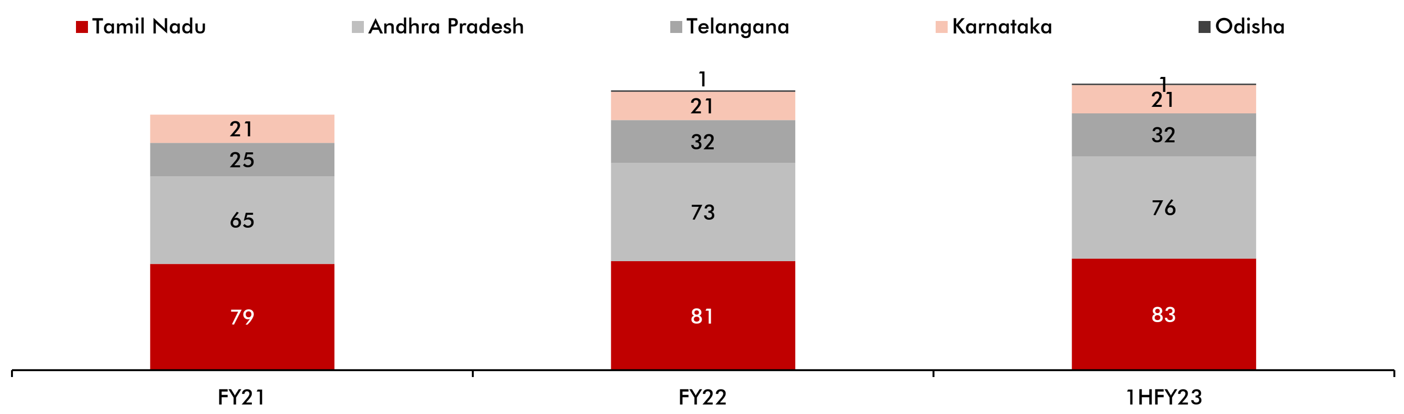


Source: Ambit Capital research, company

New branches, geographic diversification will entail higher investments

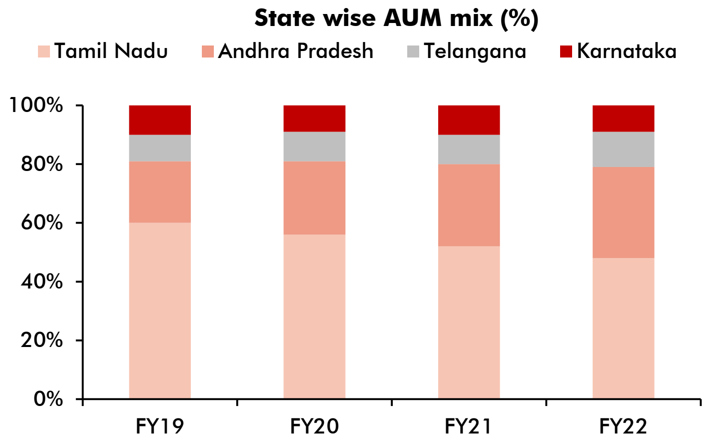
As the company continues to expand its branch network (guiding for 20 new branches annually), opex intensity is expected to remain high. Further, geographical diversification too will initially come at a cost. Currently, Aptus draws entire business from south India. Recently it has forayed into Odisha. Chhattisgarh/Maharashtra are next. We believe that entering new geographies will keep opex ratios elevated due to higher initial set-up costs/investments.

Exhibit 22: Odisha/Maharashtra/Chhattisgarh are next on expansion list



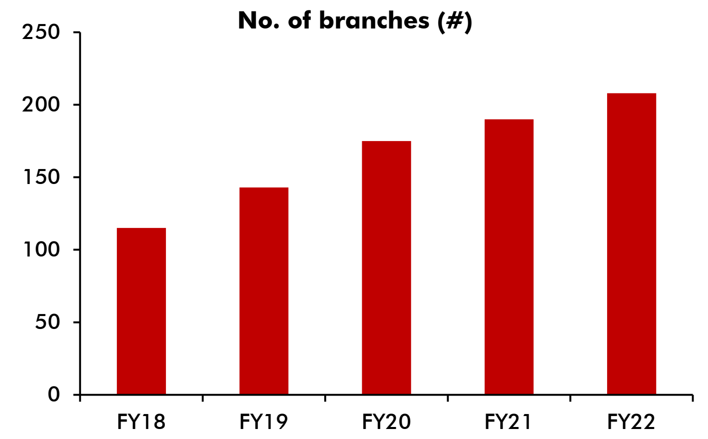
Source: Ambit Capital research, company

Exhibit 23: Entire business currently comes from south



Source: Ambit Capital research, company

Exhibit 24: Aptus aims to open 20 branches annually

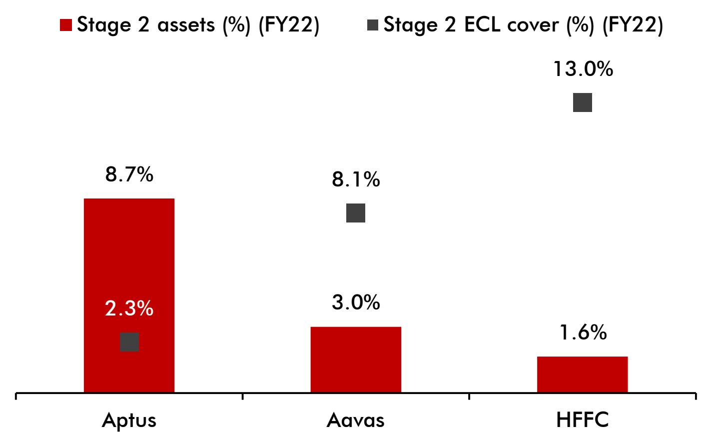


Source: Ambit Capital research, company

Higher stage 2 cover to result in higher credit costs

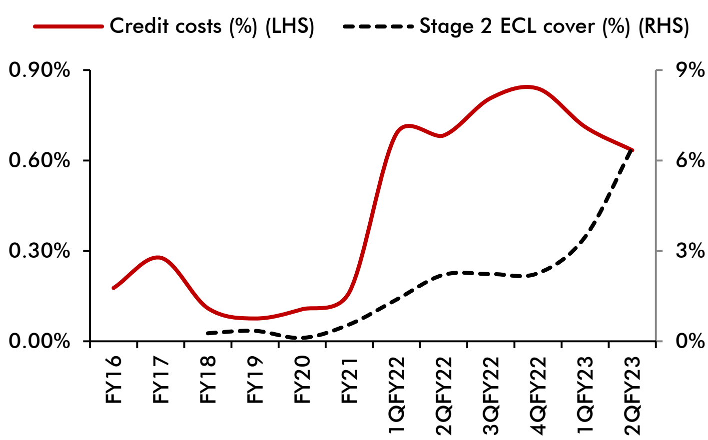
We note that Aptus' credit costs averaged 24bps over FY16-22. Historically, Aptus maintained low stage 2 coverage. Even as of FY22, its stage 2 ECL coverage was 2.3%, lower than Aavas/HFFC. However, quarterly trends clearly indicate that the company has been shoring up coverage on stage 2 assets and now stands at ~6.5%. Even the annualized average credit cost over 4QFY21-2QFY23 averaged 71bps. Therefore, we believe the scaling up with be accompanied by higher credit costs than seen historically. We expect average credit cost of ~60bps.

Exhibit 25: Low stage 2 ECL suppressed historical credit costs



Source: Ambit Capital research, company

Exhibit 26: But matching peers means overall credit costs will settle higher



Source: Ambit Capital research, company

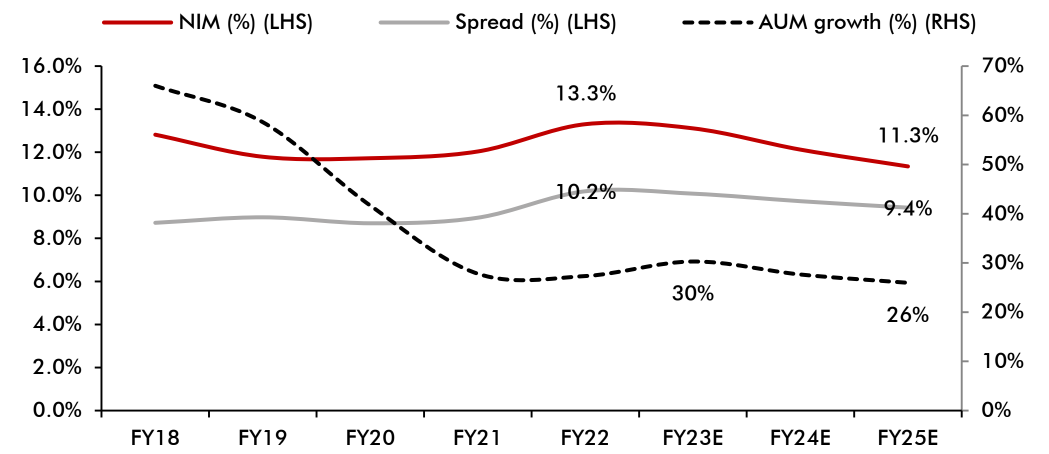
NIMs to contract

We expect spreads/NIMs to decline by 76bps/196bps over FY22-25E led by increasing cost of funds as 78% of the AUM is fixed rate. We also observe that among peers, Aptus' cost of funds is least competitive. Differential in Aptus' cost of NCDs and bank funding over benchmark rates is widest. We expect NII CAGR of 22% to lag AUM CAGR of 28% over FY22-25E due to NIM compression. However, management believes recent rating upgrade will mitigate margin impact. Our long-term thesis on AHFC facing margin compression as they gain scale, as exemplified by large HFCs, holds true for Aptus as well.

High growth/high margins cannot go hand-in-hand

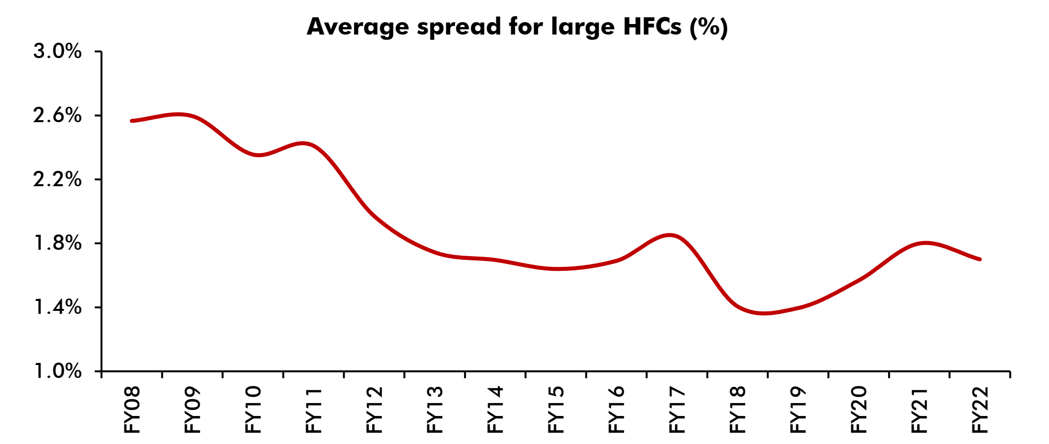
In a competitive market such as mortgages, growth and margins cannot go hand-in-hand. Currently, Aptus' low base and focus on a niche segment (self-employed in tier-3/below locations) enable high growth/high margin. However, as the balance sheet scales up, competition increases, the company is likely to face AUM growth/NIM trade-off. With opex likely to remain at current levels (2.7% opex/AUM guidance), declining spreads/NIMs is a negative for earnings growth.

Exhibit 27: Expect spreads/NIMs to decline



Source: Ambit Capital research, company

Exhibit 28: A longer-term perspective on how average spreads have declined for large scale HFCs due to competition



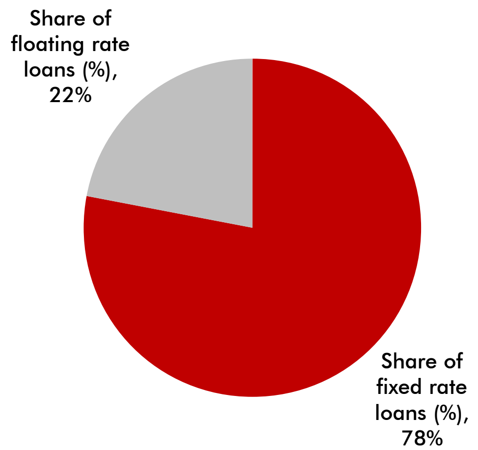
Source: Ambit Capital research, company

High share of fixed-rate loans, uncompetitive CoF will hit near-term NIM

Aptus currently has 78% of AUM under the fixed-rate regime. With cost of funds increasing in the current environment, we expect spreads/NIMs to compress by 76bps/196bps to 9.4%/11.3%. For Aptus, we expect NII/PAT CAGR of 22%/20%, lagging AUM CAGR of 28%, over FY22-25E. Given the recent credit rating upgrades, the management believes it would be able to mitigate spread/margin compression.

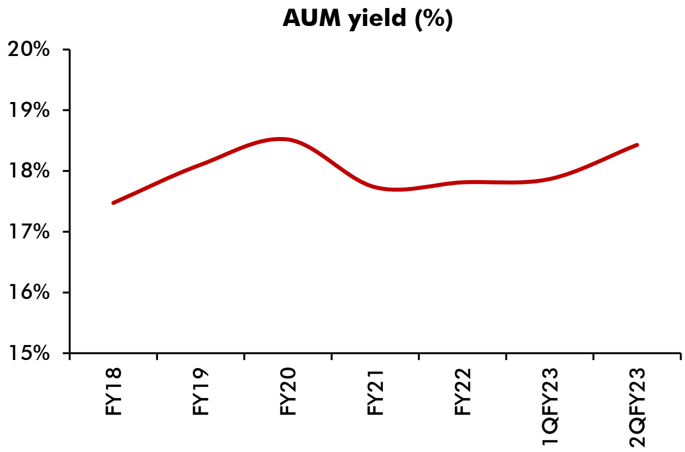
We also observe that among peers, Aptus' cost of funds is least competitive. Differential in Aptus' cost of NCDs and bank funding over prevailing/benchmark rates is widest, possibly implying banks' and the debt market's lower confidence in the franchise.

Exhibit 29: High share of fixed rate loans will restrict rate transmission



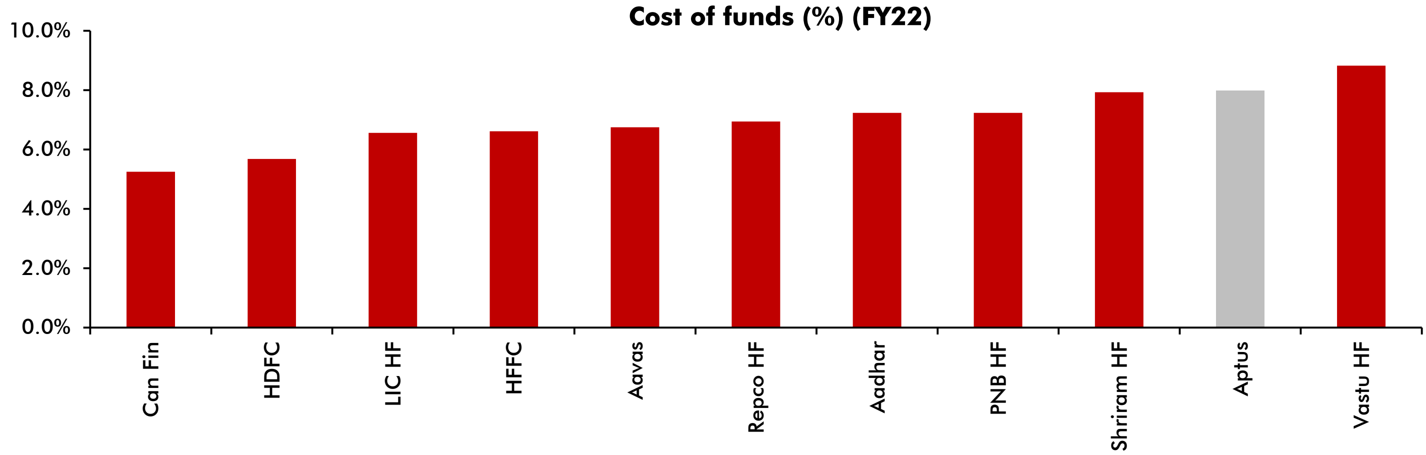
Source: Ambit Capital research, company

Exhibit 30: Given the high share of fixed rate loans, yields have been sticky at around 18%



Source: Ambit Capital research, companies

Exhibit 31: Aptus' cost of funds is least competitive



Source: Ambit Capital research, company

Does not score well on softer aspects

We find practices around management compensation, capital allocation, board structure and composition of various committees less than ideal or not up to industry standards. Stakeholder Empowerment Services (SES) notes that (1) MD salary is 3.2x/5.3x of Aavas/HFFC and highest as % of PBT among peers and (2) MD/chairman being one person potentially concentrates power in one set of hands. Further, we think that (1) Board committees are exposed to potential risk of undue influence at multiple points and (2) risk function needs to be strengthened.

CEO compensation is high

SES notes that CEO Mr. M. Anandan (MD) draws a salary which is 3.2-5.3x of Aavas/HFFC despite a smaller balance sheet.

Exhibit 32: Aptus MD's remuneration as % of PBT is highest

Company	Aptus	HFFC	Aavas	PNB HF	Can Fin	HDFC
MD/CEO name	M Anandan	Manoj Viswanathan	Sushil Agarwal	Hardayal Prasad	Girish Kousgi	Keki Mistry
MD/CEO remuneration (₹ mn)	100	19	31	29	12	190
% of PBT	2.1%	1.0%	0.7%	0.3%	0.3%	0.1%
Total assets (FY22) (₹ bn)	57	51	110	657	279	6,409

Source: Ambit Capital research, company

MD and Chairman posts are not separated

MD and promoter Mr. Anandan is also chairman of the board. As per SES, in the interest of good governance, the two positions must be separated as otherwise there is risk of concentration of power with a single person.

Committee composition is not ideal

Composition of the various statutory committees is not as per best/ideal industry practices.

Exhibit 33: Board committees composition exposed to multiple influences

Metric	Ideal practice	Aptus	Risk/limitation
Composition of NRC committee	Should be independent of KMP influence	Promoter/MD, M Anandan, sits on the committee.	Presence of KMP/MD/promoter may influence his/her own remuneration, which may not be commensurate with actual business performance.
Composition of audit committee	Should be independent of KMP/shareholder influence	Audit committee is chaired by a shareholder.	Vested interests create potential risk of earnings manipulation.

Source: Ambit Capital research, company

Quality of management

John Vijayan, Chief Risk Officer, has experience in operations, finance, customer servicing and internal audit but no experience in risk management. In fact, Subramaniam G seems to be heading business as well as risk functions. Ideally, business and risk functions should be separate.

Exhibit 34: Risk function overlapping with business is not ideal. CRO's work-ex seems to lack risk management experience

KMP name	Designation	Background/work-ex
Subramaniam G	Chief of Business and Risk	Several years of experience in lending (financial products), risk management, operations and collections
John Vijayan	Chief Risk Officer	Experience in Financial Services in the areas of Operations, Finance, Customer Servicing and Internal Audit.

Source: Ambit Capital research, company

Confusing strategy around capital allocation

The company raised ₹5bn in primary capital via IPO in Aug-21. After just over a year, the company declared an interim dividend of ₹2/share in Nov-22. The amount of dividend payout would be 20% of primary capital raised in IPO. At this dividend rate, the company would be paying out the entire primary capital raised last year in the next 5 years. Dividend declaration puts a question mark on rationale behind capital raise during the IPO.

Valuation-implied ask rates on growth are too high!

Our FV of ₹245 is based on excess earnings model (COE: 14%) and implies 3.3x/22x FY24E BVPS/EPS. We expect the HFC industry to grow at 13-14% for the next 2 decades and AHFCs will grow at 200-300bps higher. At the current valuation, we believe the market is expecting Aptus to grow at 22% CAGR for the next 20 years, likely underestimating the BT risks at scale as Aptus' repayment rates have been lower. Aptus' focus on its chosen segments, tier-3/below location and self-employed customers, are coming at higher cost of credit. Scaling up with similar business performance, especially outside south, would be difficult. Over FY22-25E, we expect AUM/NII/EPS CAGR of 28%/22%/20%. In view of the challenges ahead, current valuations, at 4x/27x FY24E BVPS/EPS, are likely to moderate.

Exhibit 35: Expect AUM growth to remain strong but margins compression will impact PAT growth

	FY20	FY21	FY22	FY23E	FY24E	FY25E	Comments
Assumptions							
YoY AUM growth	41.7%	27.8%	27.3%	30.3%	27.6%	26.0%	AUM growth to remain higher than peers. Expect disbursements CAGR at 27% and relatively lower repayment rate (13%).
Yield on AUM (calc.)	18.5%	17.7%	17.8%	17.9%	17.8%	17.6%	Unlikely to expand much as 78% of the AUM is fixed rate.
Cost of funds (calc.)	10.2%	9.1%	8.0%	8.2%	8.4%	8.6%	Cost of funds to see upward pressure amid increasing systemic rates.
NIM (calc.)	11.7%	12.0%	13.3%	13.1%	12.1%	11.3%	NIMs to compress on back of increasing cost of funds and leverage.
Cost to income (%)	26.1%	22.3%	18.5%	19.8%	22.4%	23.9%	Opex ratios to remain elevated on back of new branch openings and new state forays.
Opex to asset ratio (%)	2.9%	2.4%	2.3%	2.5%	2.5%	2.5%	
Credit cost (%)	0.1%	0.2%	0.8%	0.6%	0.6%	0.5%	Credit costs to remain higher than peers on back of target customer segment (self-employed).
Output (₹ bn)							
AUM	32	41	52	67	86	109	
NII	3.2	4.4	6.2	7.8	9.3	11.0	
Operating profit	2.5	3.5	5.1	6.7	7.6	8.8	
Net profit	2.1	2.7	3.7	4.9	5.5	6.4	
EPS (₹)	4.4	5.5	7.4	9.8	11.1	13.0	
BVPS (₹)	36	41	59	67	75	86	
ROA (%)	7.0%	6.5%	7.3%	7.3%	6.3%	5.8%	
ROE (%)	17.5%	14.5%	15.1%	15.7%	15.6%	16.1%	

Source: Ambit Capital research, company

Exhibit 36: Ambit vs consensus – our earnings are upto 10% below consensus

₹mn	Consensus estimates			Ambit estimates			Difference (%) (Ambit vs cons.)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Net operating income	8,179	10,017	12,380	8,296	9,772	11,622	1%	-2%	-6%
PAT	4,844	5,877	7,159	4,872	5,494	6,435	1%	-7%	-10%
EPS (₹)	10	12	14	10	11	13	1%	-6%	-10%
BVPS (₹)	68	79	95	67	75	86	-2%	-5%	-9%
ROA (%)	7.4%	7.0%	6.4%	7.3%	6.3%	5.8%	-8bps	-67bps	-64bps
ROE (%)	15.2%	15.8%	16.4%	15.7%	15.6%	16.1%	46bps	-21bps	-32bps

Source: Ambit Capital research, company, Bloomberg

Our TP of ₹245 is arrived at based on assumptions discussed above and assumed cost of equity (Ke) of 14%. Current valuations are stretched in the context of the expected near-term earnings trajectory (FY22-25E EPS CAGR: 20% vs AUM CAGR: 28%) as well as long-term AUM/earnings growth potential. Further, Aptus has a limited track record of growth (execution capability, portfolio isn't seasoned).

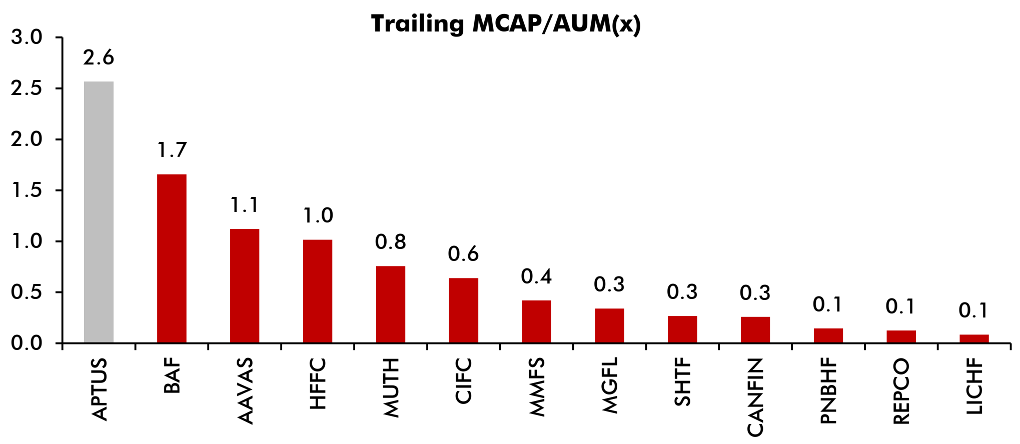
Exhibit 37: Sensitivity of valuations to long-term growth and ROE assumptions

FY26-42E	Bear case	Base case	Bull case	Comments
Average assets growth	18.4%	21.0%	22.4%	In bear case, we are assuming competitive intensity (new business as well as BT) to be higher as arbitrage between banks and HFCs diminishes. In bull case, we are assuming that Aptus will be able to defend against competition and add new scale-accretive products.
Average ROA	4.7%	5.0%	5.2%	Bear case average NIM/credit cost: 8.1%/0.5%. Bull case average NIM/credit cost: 8.8%/0.3%.
Average ROE	16.5%	18.0%	19.0%	
Target price (₹)	**156**	**245**	**321**	
Implied P/E - FY24E	14.1	22.2	29.0	
Implied P/B - FY24E	2.1	3.3	4.3	

Source: Ambit Capital research, company

In a way, markets seem to believe that Aptus deserves more premium than the industry's best which have longer/proven track records.

Exhibit 38: Aptus seems even more expensive than BAF

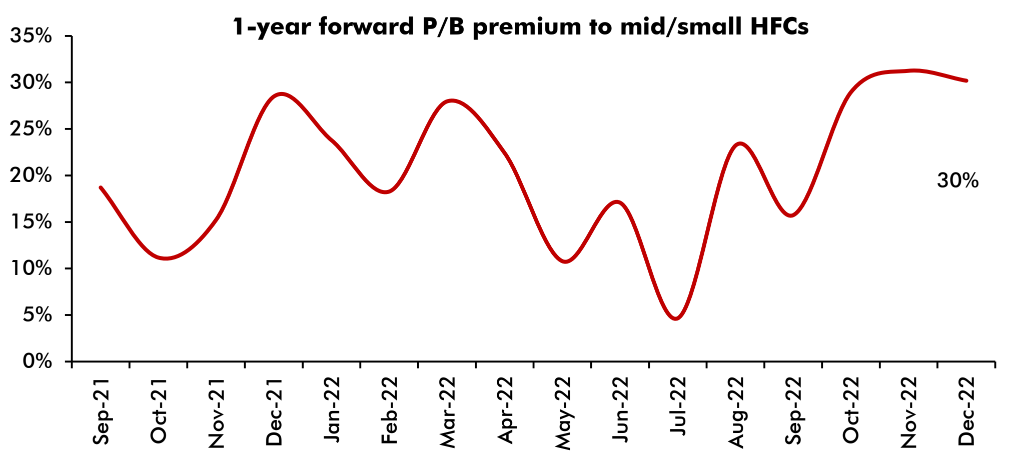


Source: Ambit Capital research, companies

Faltering growth rates can result in Aavas-like de-rating and narrow the premium gap

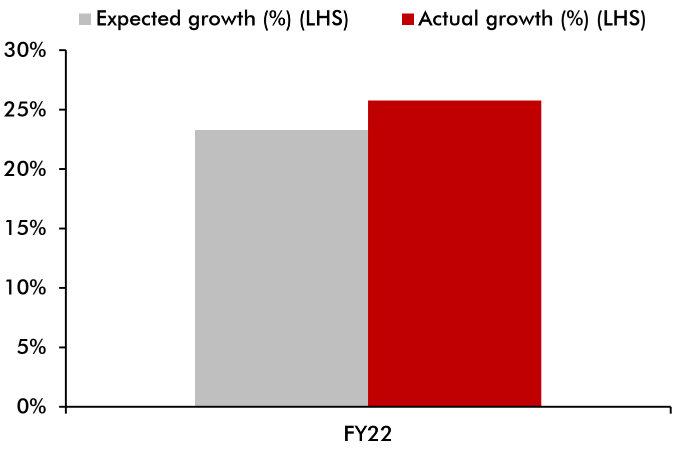
Going by current valuations, markets seem to believe Aptus' long-term AUM CAGR will be 400bps higher than industry's historical best. This is likely due to lower repayment rates, diversified product mix and a less competitive environment. The stock enjoys 30% premium over small/mid peers despite having a limited track record. We believe the current growth characteristics are unsustainable as the base grows larger and competition increases. We believe it would serve investors to recall de-rating for Aavas last year as market growth expectations were revised down from 28% to 20-22%.

Exhibit 39: Despite being half the size of Aavas, Aptus commands a similar premium of 30% to mid/small peers



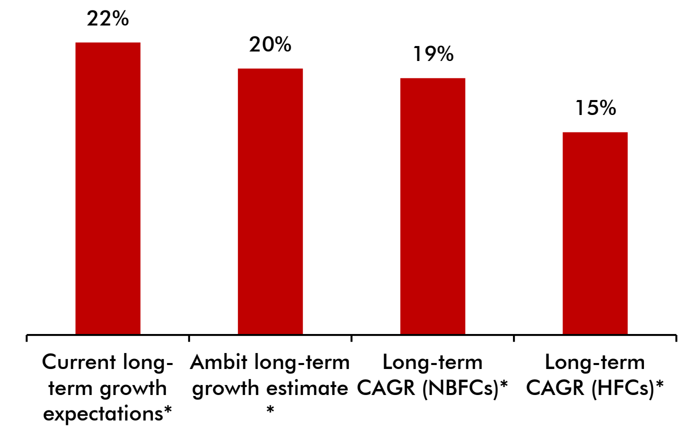
Source: Ambit Capital research, company, Bloomberg

Exhibit 40: Aptus' track record of growth delivery is limited



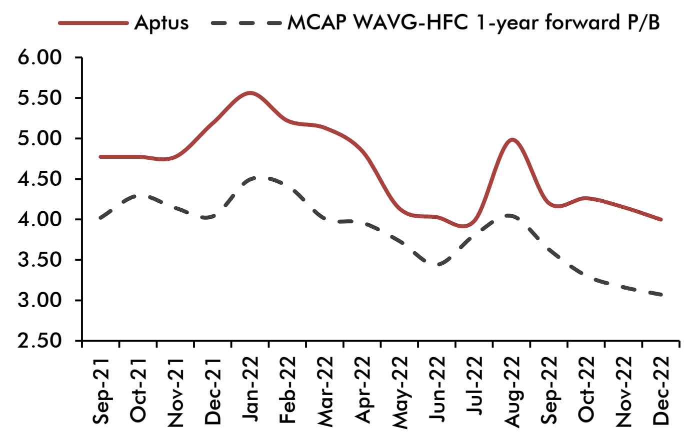
Source: Ambit Capital research, company

Exhibit 41: Expect long-term growth rates to be lower



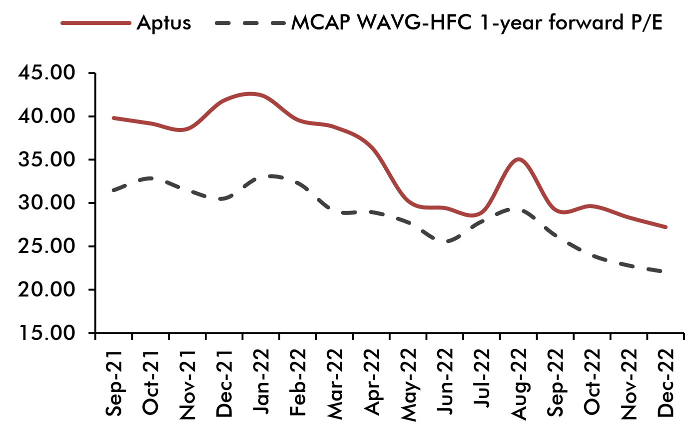
*Source: Ambit Capital research, company. *₹100bn AUM onwards.*

Exhibit 42: Aptus trades at 30% premium to mid/small HFCs on 1-year fwd P/B



Source: Ambit Capital research, company

Exhibit 43: Aptus trades at 23% premium to mid/small HFCs on 1-year fwd P/B



Source: Ambit Capital research, company

Risks & catalysts

Key risks

Increasing share of floating rate loans can aid NIM expansion: Currently, Aptus has 78% of loans are fixed rate. Ami rising cost of funds, it will lead to NIM compression. Declining share of fixed rate loans or limited increase in cost of funds would mean that NIM compression is lower.

Efficiency improvement can aid earnings: Currently, we are assuming that opex ratio will increase due to new branch opening, new state expansion and business acquisition. However, if the company is able to do all this more efficiently, opex ratios may not rise.

Catalysts

NIM contraction due to high share of fixed rate loans: Aptus' 78% of loans are fixed rate. In the current upward rate environment, where cost of funds is increasing, we expect NIMs to decline by 100bps in FY24E. Aptus' cost of funds is uncompetitive, which is unlikely to provide any support.

Elevated opex ratios: We expect opex/assets to increase by 21bps by FY24E on back of new branch opening, new state forays and sustained high growth in new business acquisition.

Exhibit 44: Explanation of our flags on the cover page

Segment	Score	Comments
Accounting	GREEN	We do not find anything unusual in the company's accounting policies and believe reported numbers are a true reflection of performance.
Predictability	GREEN	Aptus has reported stable earnings growth.
Earnings Momentum	GREEN	In the past six months, consensus has upgraded its FY23/24E EPS estimates by 7% each.

Source: Ambit Capital research, company

Financials

Income Statement

Particulars (₹mn)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net interest income	**3,182**	**4,363**	**6,151**	**7,819**	**9,311**	**11,038**
Non-interest Income	204	153	165	477	461	584
Total Income	**3,386**	**4,517**	**6,316**	**8,296**	**9,772**	**11,622**
Total opex	884	1,008	1,171	1,640	2,189	2,774
Pre provision profit	**2,501**	**3,509**	**5,145**	**6,656**	**7,582**	**8,848**
Provisions	28	58	345	329	447	491
Profit before tax	**2,473**	**3,451**	**4,800**	**6,327**	**7,135**	**8,358**
Tax	363	781	1,099	1,455	1,641	1,922
PAT - Consolidated	**2,110**	**2,669**	**3,701**	**4,872**	**5,494**	**6,435**

Source: Ambit Capital research, company

Balance Sheet

Particulars (₹mn)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net worth	17,090	19,808	29,162	33,059	37,454	42,602
Borrowings	20,150	25,080	27,206	42,442	60,267	81,662
Total liabilities	**37,467**	**45,202**	**56,840**	**76,088**	**98,299**	**124,980**
Loans (on-book)	31,171	39,898	50,787	66,076	84,179	105,929
Cash & investments	6,027	4,906	5,476	9,337	13,259	17,966
Other assets	270	398	577	675	861	1,085
Total assets	**37,467**	**45,202**	**56,840**	**76,088**	**98,299**	**124,980**
AUM	**31,830**	**40,680**	**51,800**	**67,490**	**86,149**	**108,516**

Source: Ambit Capital research, company

Key Ratios

Particulars (%)	FY20	FY21	FY22	FY23E	FY24E	FY25E
AUM growth (%)	41.7	27.8	27.3	30.3	27.6	26.0
Disbursements growth (%)	8.5	1.4	26.4	37.7	22.4	22.4
EPS growth (%)	55.2	26.0	34.3	31.6	12.8	17.1
Net interest margin (NIM) (%)	11.7	12.0	13.3	13.1	12.1	11.3
Cost to income (%)	26.1	22.3	18.5	19.8	22.4	23.9
Opex (% of AAUM)	3.3	2.8	2.5	2.8	2.9	2.9
Gross NPAs (%)	1.7	0.7	1.2	1.3	1.3	1.3
Credit costs (% of AAUM)	0.1	0.2	0.8	0.6	0.6	0.5
Provision Coverage (%)	11.3	27.5	25.3	30.0	35.0	35.0
Tier-1 (%)	82.2	73.8	85.4	72.9	64.0	57.2
Leverage (x)	2.5	2.2	2.1	2.1	2.5	2.8

Source: Ambit Capital research, company

Valuation

Particulars	FY20	FY21	FY22	FY23E	FY24E	FY25E
BVPS (₹) - Consol.	36	41	59	67	75	86
EPS (₹) - Consol.	4.4	5.5	7.4	9.8	11.1	13.0
ROA (%)	7.0	6.5	7.3	7.3	6.3	5.8
ROE (%)	17.5	14.5	15.1	15.7	15.6	16.1
P/E	67.8	53.9	40.1	30.5	27.0	23.1
P/BV	8.4	7.3	5.1	4.5	4.0	3.5

Source: Ambit Capital research, company

Annexure I: Management team has been stable

Management team is led by M Anandan, managing director, who is also the promoter. For most part of his working life, he was associated with Murugappa group. He started Aptus at the age of 60 years. Before starting Aptus, he was an investor across multiple BFSI companies.

Exhibit 45: Long vintage management team

Name	Designation	Background/work-ex	Remuneration (₹mn)	% of PBT	% of equity held
M Anandan	MD	He is the founder of Aptus. Has spent 4 decades in financial services as ED/ME of CIFC, MD of Chola General Insurance; was wholetime director of Equitas MFI between 2008-2015, independent director at Manappuram Finance, Chairman of Five Star Business Credits.	100.1	2.1%	23.9%
Balaji P	Chief financial officer	Several years of experience in finance, treasury, banking, fund raising	11.7	0.2%	
Subramaniam G	Chief of Business and Risk	Several years of experience in lending (financial products), risk management, operations and collections			
C.T. Manoharan	Executive Vice President - Business Development	Rich experience in housing finance industry across sales, channel and distribution management			
V. Krishnaswami	Sr. Vice President - Information Technology	Experience in strategizing and implementing digital technology solutions, IT designs and, infrastructure.			
Ramesh K	Vice President - Credit	Rich experience in areas of Credit & Risk Management, Fraud Control and operations in retail finance.			
N.Srikanth	Vice President - HR	Seasoned Professional with experience in HR planning, recruitment, training, induction, employee relations and engagement.			
Sundara Kumar V	Vice President - Legal & Receivables	Legal experience in title deed scrutiny, SARFAESI and arbitration procedures in housing finance / mortgages.			
John Vijayan	Chief Risk Officer	Experience in Financial Services in the areas of Operations, Finance, Customer Servicing and Internal Audit.			

Source: Ambit Capital research, company

Annexure II: Board is a mix of PE nominees and independent directors

Like Aavas/HFFC, Aptus too has PE-nominee directors on the board. However, there are other independent directors too. All board members have relevant industry experience. M Anandan, who is the promoter/MD, is also the board chair.

Exhibit 46: Board comprises of PE nominees and independent directors

Name	Designation	Background/work-ex	Industry experience	Other directorships
M. Anandan	Chairman & MD	He is the founder of Aptus. Has spent 4 decades in financial services as ED/ME of CIFC, MD of Chola General Insurance; was wholetime director of Equitas MFI between 2008-2015, independent director at Manappuram Finance, Chairman of Five Star Business Credits.	Yes	
S. Krishnamurthy	Independent director	Certified associate of Indian Institute of Bankers; former Dy. MD of SBI (served for 38 years in the bank); was MD/CEO of SBI Life.	Yes	
K.M. Mohandass	Independent director	Partner at KM Mohandass & Co., Chartered Accountants; has over 3 decades of experience in the financial services industry.		
Krishnamurthy Vijayan	Independent director	Has served as MD & CEO of IDBI Asset Management Limited, MD of J P Morgan Asset Management India Private Limited, and CEO of JM Financial Asset Management Private Ltd.	Yes	
Mona Kachhwaha	Independent director	Has multiple years of experience in the finance sector including Citibank N.A. and Caspian Advisors Private Ltd; also on the Board of Ujjivan Financial Services Limited and Impact Investors Council.	Yes	1
V.G. Kannan	Independent director	Has over 38 years of experience in the BFSI sector. A credit, treasury, risk management expert in the banking sector, he has handled leadership positions with SBI/its subsidiaries/group companies as MD of SBI. He is on the boards of AU SFB, Ageas Federal Life Insurance and OCM India Opportunities Arc Management.	Yes	1
Shailesh Mehta	Nominee director	Partner at Granite Hill Capital Partners; operating advisor at WestBridge Capital. Other directorships: Safari Industries, Manappuram Finance, India Shelter Finance Corporation and Vistaar Financial Services.	Yes	2
Sumir Chadha	Nominee director	Co-founder of WestBridge Capital; was director of Sequoia Capital India; other directorships: India Shelter Financial Corporation, Star Health and Allied Insurance Company, Mountain Managers, Kuhoo Technology Services and Kuhoo Finance.	Yes	1
K.P. Balaraj	Nominee director	He was the co-founder and MD at WestBridge Capital India Advisors Private Ltd and has several years of experience in the investment industry. He is currently a partner at Waimea Bay Advisors LLP.	Yes	
Suman Bollina	Non-executive director	Executive managing partner of Sri Santhi Corporation; has over 10 years of experience in development of residential lay outs and design, construction and sale of apartments.	Yes	

Source: Ambit Capital research, company

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Another brick in the PSU wall

CANF's key advantage - low cost of funds - cannot compensate for scale challenges due to lack of distribution strength. Also, stagnant productivity and geographic concentration will decelerate loan growth to industry levels by FY25. In view of CANF's focus on tier-1/2 locations/documented income, increasing ATS implies higher competition from large lenders. CANF's rate differential vs large lenders should reduce. Coupled with increasing CoF, we expect 33bps decline in NIMs by FY25. Overall, EPS growth would slow to 10% from FY24. FY19-22 EPS CAGR of 17% was aided by unsustainable combination of high liquidity and CPs. Moreover, ability to attract and retain talent at top management remains an issue. Maturing growth rates, laidback culture and lack of management bandwidth are resemblances of a PSU/quasi-PSU. FV of ₹450 implies 1.4x/9.4x FY24E BVPS/EPS. Risks: Improving growth and limited margin pressure.

Competitive position: MODERATE   Changes to this position: STABLE

Low CoF has solved for everything so far; but scale is catching up!

Competitive cost of funds enabled CANF to compete effectively for safe customer profiles in tier-1/2 locations. Hence, 26% loan CAGR, ~20bps average credit cost and median ROE of 18.2% over FY12-22 seem natural outcomes. However, CANF's lack of distribution strength will be a major challenge to growth, especially as branch productivity stagnates.

Growth levers are running out

We expect loan growth to decline to 15% by FY25E and closer to industry levels thereon (13-14%) because: (1) absolute new addition in branches is modest, (2) branch productivity has stagnated and (3) ATS will see limited increases, accompanied by growth/NIM trade-off. Despite operating since 1987, CANF has not shown vigor to tap non-south high-growth markets. Developer loans are an attempt to build scale/sustain margin but comes with high risk.

NIMs to decline amid increasing cost of funds and competition

Funding liabilities with high share of CPs cannot be a sustainable strategy, at least not on a large scale. CANF's CP share is already down 900bps YoY. On the asset side, we expect competitive price pressures to continue to build. We expect 33bps compression in NIMs by FY25E. Structurally, we see CANF's margin profile mirroring HDFC/LICHF (2% spreads) as the business matures with spreads declining to 2.1% by FY27E.

Valuation implies margin risks being underestimated

Present valuation implies 13-14% earnings CAGR over FY22-42E, likely underestimating the risks to current margin profile. CANF will find it difficult to replicate its performance over the last decade due to declining growth and margins, leading to lower/negative excess returns. Hence, >100% premium to PSU-sponsored HFCs) should narrow.

Key financials

Year to March	FY21	FY22	FY23E	FY24E	FY25E
Total Income (₹ mn)	8,101	8,350	9,942	11,067	12,407
Operating Profit (₹ mn)	6,861	6,820	8,209	9,088	10,158
Net Profit (₹ mn)	4,561	4,711	5,869	6,376	7,091
EPS (₹)	34.3	35.4	44.1	47.9	53.2
RoE (%)	19.2	16.6	17.5	16.3	15.7
P/E (x)	16.1	15.5	12.5	11.5	10.3
P/B (x)	2.8	2.4	2.0	1.7	1.5

Source: Ambit Capital research, company

BFSI

Recommendation

Mcap (bn):	₹73/US$0.9
6M ADV (mn):	₹719/US$8.9
CMP:	₹550
TP (12 mths):	₹450
Downside (%):	18

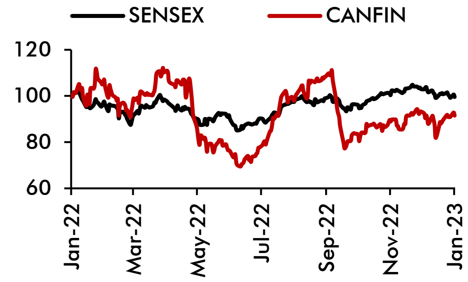
Flags

Accounting:	GREEN
Predictability:	GREEN
Earnings Momentum:	AMBER

Key catalysts

- Margin compression of 24bps over FY22-24E.
- Loan growth to decelerate to 16% by FY24E due to stagnant productivity and moderate branch expansion.

Performance (%)



Source: Bloomberg, Ambit Capital Research

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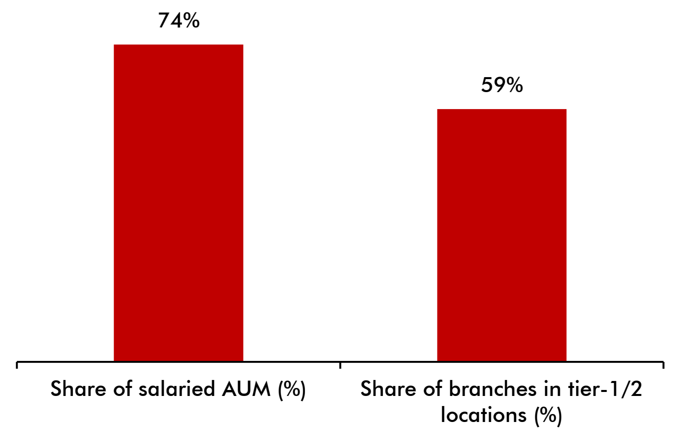
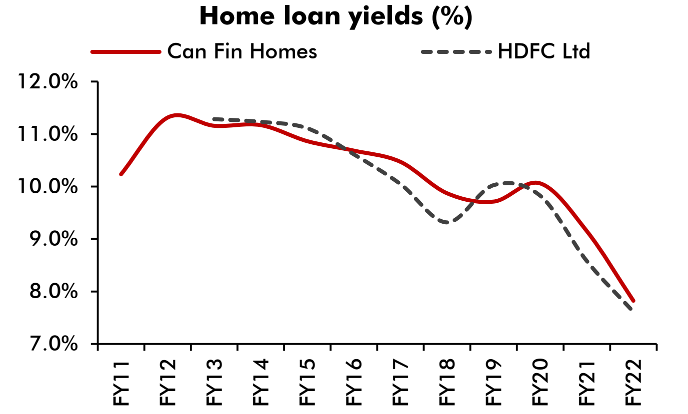
The Narrative in Charts

Exhibit 1: CANF focuses on a safer customer segment and mostly in urban centres



Source: Ambit Capital research, company

Exhibit 2: Marginal differential in yields indicates CANF is moving into a highly competitive territory



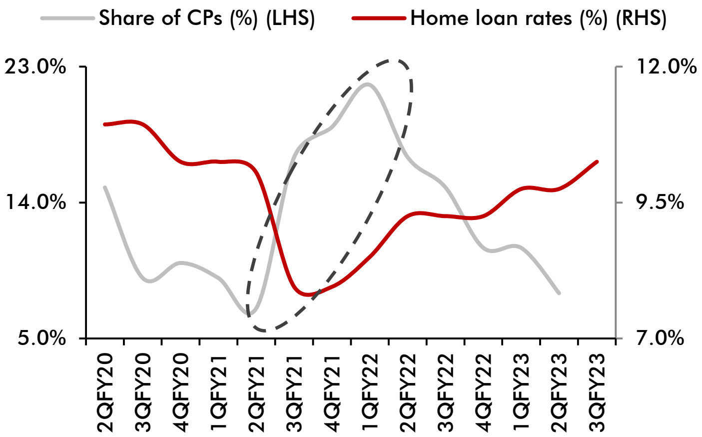
Source: Ambit Capital research, company

Exhibit 3: Stagnating branch productivity post FY23 implies growth rates will decline after hitting 21%+ YoY recently

Particulars	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
No. of loans disbursed (#)	13,773	18,304	22,598	26,622	28,928	30,237	30,450	21,730	39,424	42,101	45,489	48,940
Growth (%)	*29%*	*33%*	*23%*	*18%*	*9%*	*5%*	*1%*	*-29%*	*81%*	*7%*	*8%*	*8%*
No. of loans disbursed per branch (#)	166	156	161	157	167	160	154	109	197	196	198	200
Improvement/(deterioration) (%)	*7%*	*-6%*	*3%*	*-3%*	*7%*	*-4%*	*-4%*	*-29%*	*81%*	*-1%*	*1%*	*1%*
Avg ticket size (ATS) (Rsmn)	1.85	1.83	1.74	1.80	1.80	1.81	1.80	2.00	2.10	2.15	2.26	2.37
ATS Growth (%)	*9%*	*-1%*	*-5%*	*4%*	*0%*	*1%*	*-1%*	*11%*	*5%*	*2%*	*5%*	*5%*
Disbursements (Rsmn)	25,480	33,460	39,230	47,920	52,070	54,790	54,810	43,460	82,790	90,518	102,691	116,006
Growth (%)	*40%*	*31%*	*17%*	*22%*	*9%*	*5%*	*0%*	*-21%*	*90%*	*9%*	*13%*	*13%*
Loans outstanding (Rsmn)	58,744	83,018	107,146	134,114	157,430	183,820	206,885	221,048	267,112	312,221	361,834	416,329
Growth (%)	*46%*	*41%*	*29%*	*25%*	*17%*	*17%*	*13%*	*7%*	*21%*	*17%*	*16%*	*15%*
Repayment rate (%)	17%	16%	18%	20%	21%	18%	17%	14%	17%	17%	17%	17%
No. of branches (#)	83	117	140	170	173	189	198	200	200	215	230	245
Branch addition (#)	14	34	23	30	3	16	9	2	0	15	15	15

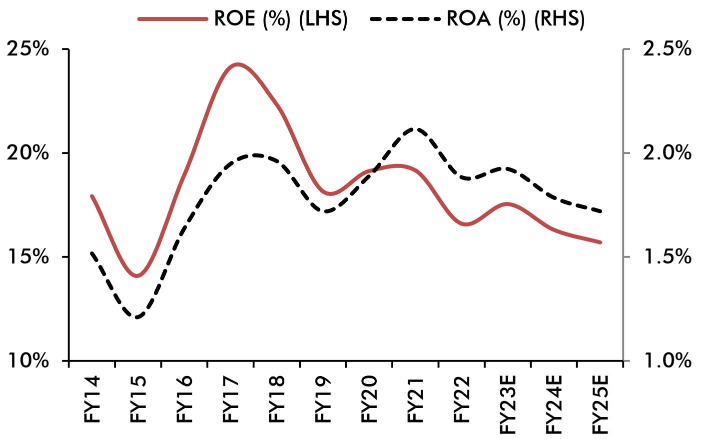
Source: Ambit Capital research, company

Exhibit 4: Declining share of CPs will impact margins/pricing advantage



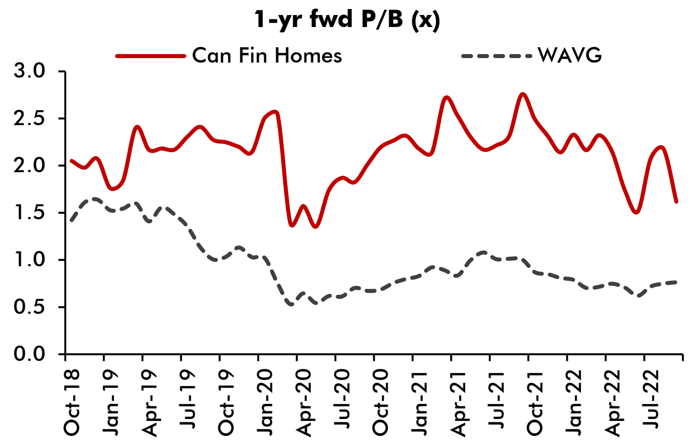
Source: Ambit Capital research, company

Exhibit 5: Increasing competition will drive down returns ratios



Source: Ambit Capital research, company

Exhibit 6: Valuation gap vs PSU-sponsored HFCs should narrow down as growth rates decline

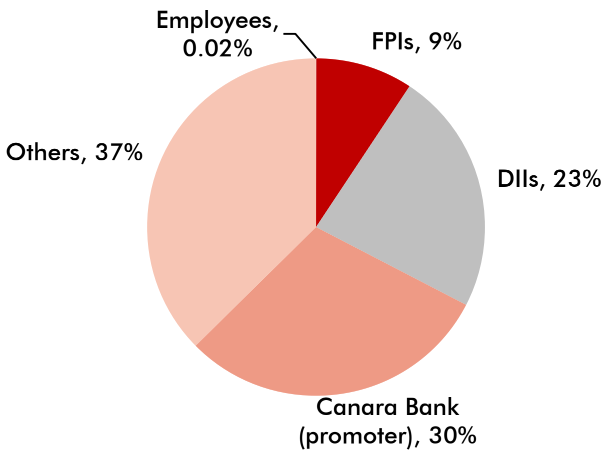


Source: Ambit Capital research, company; Note: WAVG: MCAP weighted average for PNB HF and LIC HF.

South-based, PSU-owned

CANF is a retail affordable Housing Finance company, incorporated in 1987 by Canara Bank in association with HDFC and UTI, in Karnataka. Canara Bank owns 30% stake. It draws majority business from south and has 1.1% market share in home loans. Due to PSU-bank parentage, cost of funds (FY22: 5.25%) has been low, which has helped compete effectively vs peers. Focus on a safer customer segment has aided average credit costs of 20bps over the last decade. For instance, the company does not take into account undocumented income. A construct of low CoF and low credit costs, with a differentiated focus on self-construction, has enabled the company to deliver average ROA/ROE of 1.8%/18% over the last decade. However, non-south execution has not been up to the mark given that south still accounts for 65-67% of the total business. Lack of management bandwidth is a key hurdle in successfully scaling up.

Exhibit 7: PSU bank parentage defines conservative culture



Source: Ambit Capital research, company

Exhibit 8: SWOT analysis – Cost of funds key advantage, stagnancy/south concentration to impact growth

Strengths	Weaknesses
▪ **Low cost of funds:** Highly competitive cost of funds enables company to compete effectively. ▪ **Stringent underwriting criteria/superior asset quality:** Long-term track record on asset quality has been superior compared to the industry owing to stringent underwriting criteria. ▪ **Reputed name in south:** Owing to its parentage, the company enjoys a reputed/recognizable brand name in south India.	▪ **Branch productivity has stagnated:** Over the last decade, number of loans disbursed per branch per annum has stagnated at 150-160. ▪ **Governance/disclosure standards not the best:** In last 12 months, there have been two instances (fraud discovery in May-22 and large stock price decline preceding CEO resignation news) which indicate that governance/disclosure standards are lax at the company. ▪ **Weak non-south execution:** Despite being in operations for a long period of time, the company has not been able to diversify geographically (south: 67%). ▪ **Weak management bandwidth:** Last MD/CEO resigned recently. Currently, there is no MD/CEO. Also, overall management bandwidth perception is weaker compared to peers. Besides CEO, the company is also looking to replace CRO externally.
Opportunities	**Threats**
▪ **Industry to see 13-14% CAGR over next 2 decades:** Mortgage industry is expected to grow at 13-14% p.a. over the next 2 decades. ▪ **Expanding to other regions:** Currently, CANF draws majority business from the south. The company has an opportunity to expand into other regions (north/west/central).	▪ **High pre-payments:** Despite having a highly competitive cost of funds, company saw BT pressure from banks in the latest cycle. As financialization and credit maturity improves for CANF's customers, BT is a long-term risk as well. ▪ **Stake sale by Canara Bank:** CANF enjoys favourable credit ratings/low cost of funds partially because of its parentage. Canara Bank exit impact credit rating/cost of funds adversely.

Source: Ambit Capital research, company

Follows a hybrid approach

CANF follows a hybrid model. Originations are outsourced with DSA contributing ~80%. Such a sourcing/origination model is similar to the one followed by large HFCs (HDFC/LICHF). Underwriting is kept in-house. Collections for early buckets is carried out by in-house/branch staff. However, for hard buckets, the company also involves external agencies. Given that the company only relies on documented income proofs, manpower requirement for subjective credit evaluation is low.

Exhibit 9: CANF follows a hybrid model, similar to large HFCs

Functions	In-house/outsourced	Comments
Sales	Hybrid	Currently, ~80% of loans are sourced via DSAs (vs 50-55% earlier).
	(in-house, DSAs)	In-house sales is entirely carried out by the branch level employees.
		Every single customer which is on-boarded is met by the company's employee.
		In case of a DSA-sourced loan, the external agent only originates the lead, attaches certain minimum documents and hands over the file to the company.
Underwriting	In-house	Underwriting is carried out at the branch and central level.
		For loans sourced via DSAs and ticket sizes above certain threshold, underwriting is carried out centrally (at the CPC).
		Majority of the underwriting happens at the CPC (branch level underwriting is not significant).
Legal/technical/valuation	Outsourced	The company employs external lawyers and valuers.
Collections	Hybrid	Collections are carried out by branch teams, central teams as well as external agencies.
	(external agencies, in-house)	Overall collections strategy is driven centrally. Where branches are involved, the strategy is formulized centrally after receiving feedbck from the branches.
		For early buckets (1-60 dpd), branch staff is deployed.
		For hard buckets (61-90 dpd and 90+ dpd), a blend of in-house and external agencies is deployed.
		For 180+ dpd, external agencies are used.

Source: Ambit Capital research, company

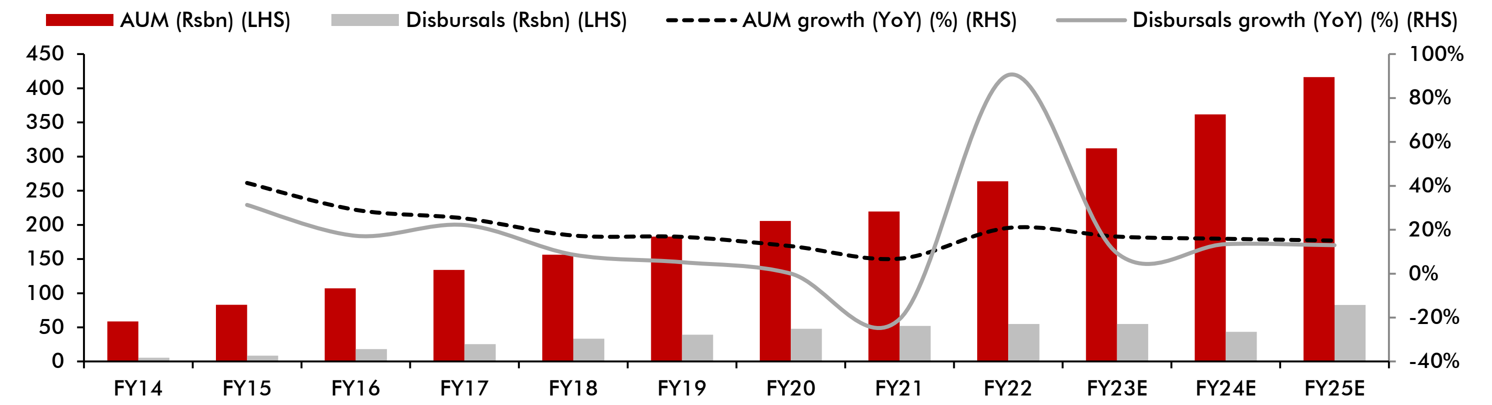
Low cost producer in a commodity business

CANF has delivered AUM/disbursements CAGR of 18%/14% since FY15. It has been able to gain market share profitably owing to a very competitive cost of funds. Focus on salaried/documented income segment has yielded pristine asset quality track record with credit costs averaging 20bps over the last decade. A combination of remunerative spreads, efficient operations and superior asset quality has aided profitability. On cross-cycle basis, CANF has reported ROA/ROE of 1.8%/18%. Over FY15-22, PPOP per share/EPS have grown at 24%/27% CAGR. This has led to stock commanding >100% valuation premium over other PSU-sponsored HFCs.

Higher than industry growth has aided market share gains

CANF's AUM/disbursements have increased at 18%/14% CAGR since FY15. This has resulted in the company gaining a total industry market share of 1.1% (FY22). Within HFCs, we estimate the company has increased market share to 3.3% in FY22 vs 2.2% in FY17. Key reason why CANF has been able to achieve such a feat is a highly competitive cost of funds (discussed later).

Exhibit 10: CANF has a been steady growth company but higher base/competition will lead to lower decelerating growth going ahead

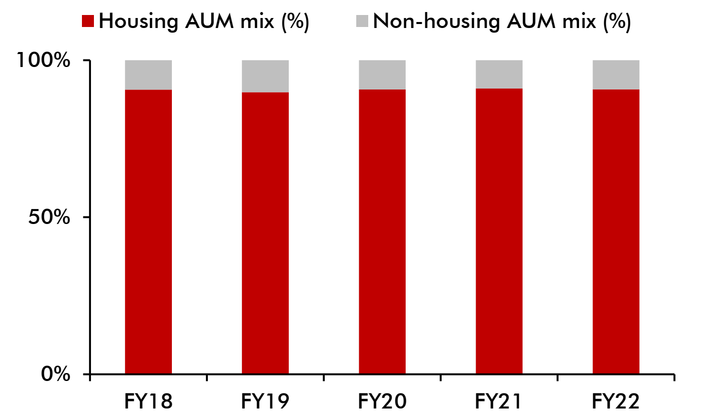


Source: Ambit Capital research, company

Product-focus: Housing. Region-focus: South.

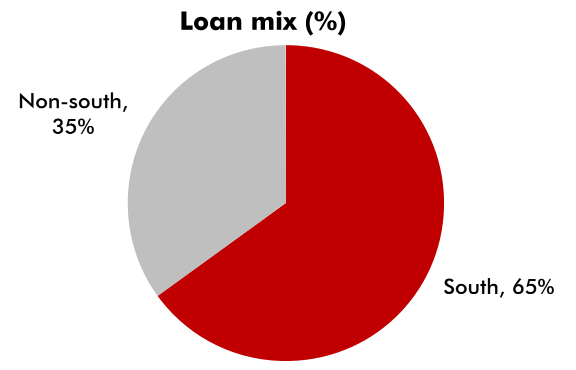
In terms of products, 90% of the AUM comprises home loans (including top-up). Although the company offers non-housing loans too, major focus is home loans. Geographically, business is focused on south India (~2/3rd of business). Karnataka and Telangana are the biggest markets accounting 21% each. The south tilt can be attributed to Karnataka being the company's home state. Within Karnataka, Bangalore contributes significantly.

Exhibit 11: CANF has mostly focused on housing loans



Source: Ambit Capital research, company

Exhibit 12: South is the key market for CANF

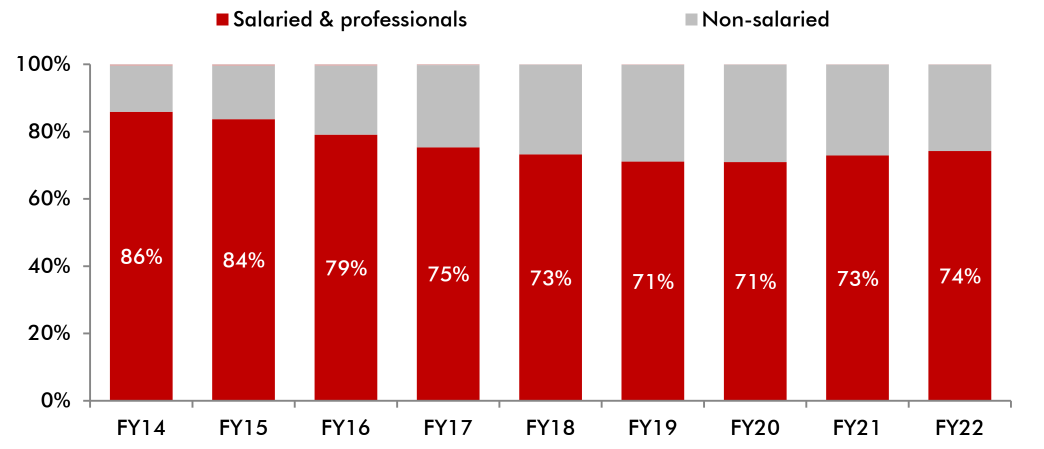


Source: Ambit Capital research, company

Customer-wise, highly risk-averse

Salaried/documented income borrowers, most sought after by lenders as they are least risky, is the company's main target segment (74%). Being low-risk, such customer segments have low spreads/margins due to high competition. However, CANF's low cost of funds (biggest advantage) has enabled it to underwrite such low-risk customers competitively. A key characteristic to note about CANF's underwriting philosophy is that it strictly prohibits taking into account any undocumented income.

Exhibit 13: Loan mix (%) – Salaried/documented income segment has been the major focus, aided by low cost of funds

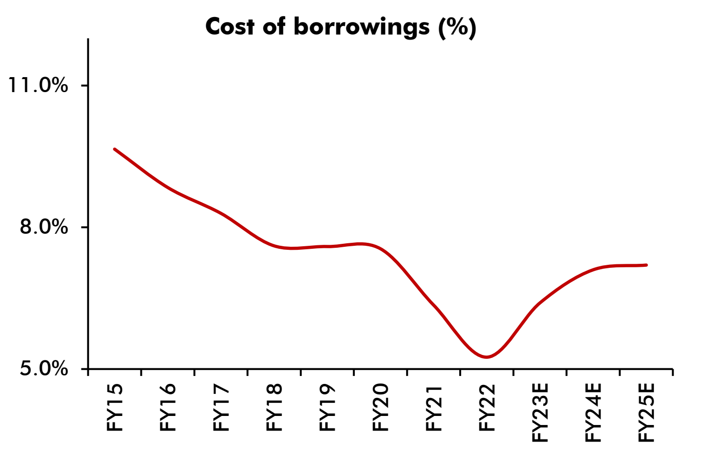


Source: Ambit Capital research, company

Low cost of funds – the biggest advantage

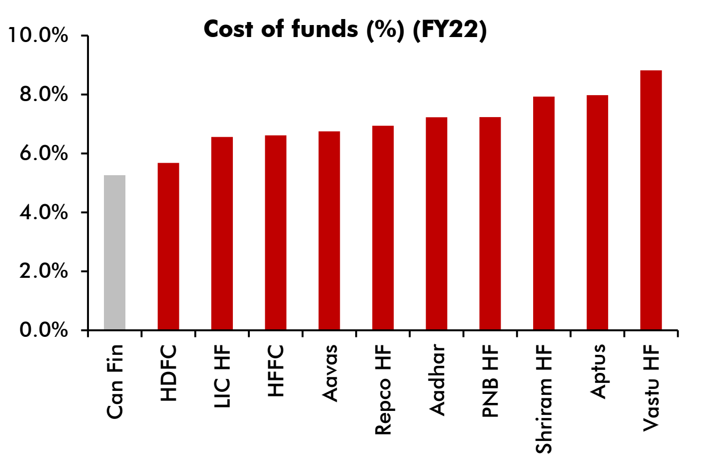
A highly competitive cost of funds is the key source of advantage with respect to most business outcomes. It is important to understand CANF's cost of funds in context of its operating turf (salaried customers/tier-1 focus) which is a highly competitive one. CANF's cost of funds is 5.25% (FY22), which is even lower than HDFC (5.68%) and LIC HF (6.56%) and ~220bps lower on average vs AHFCs. Being in a commodity business (home loans), low cost of funds has enabled the company to compete effectively for growth.

Exhibit 14: PSU bank parentage and CPs aided low cost of funds



Source: Ambit Capital research, company

Exhibit 15: CANF has the lowest cost of funds among peers

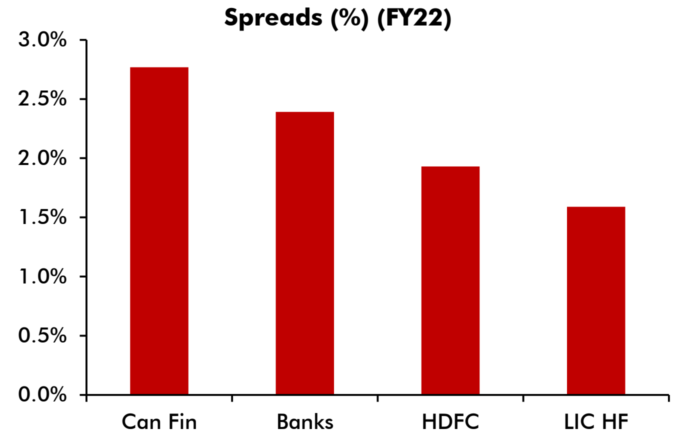


Source: Ambit Capital research, company

Spreads have been higher than banks/large HFCs

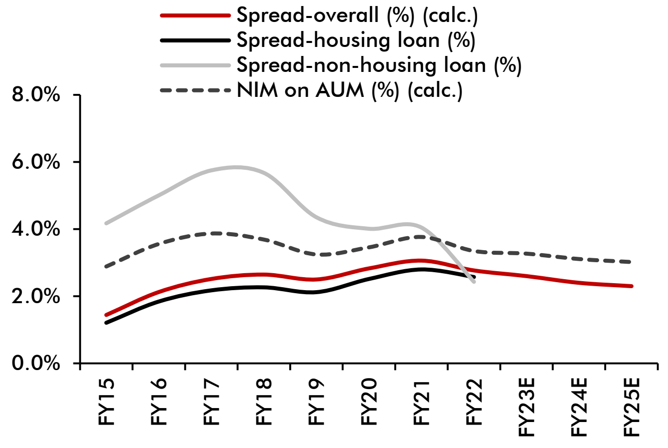
Despite operating on a highly competitive turf, CANF has been able to generate slightly better spreads compared to banks/large HFCs. Part of this can be attributed to low cost of funds.

Exhibit 16: CANF's spreads are 38-118bps higher than banks/large HFCs



Source: Ambit Capital research, company, Bloomberg; Note: Banks' HL spread determined based on HL WALR (as per RBI) and weighted average cost of deposits.

Exhibit 17: Spreads/NIM likely to remain steady post witnessing compression in FY23E

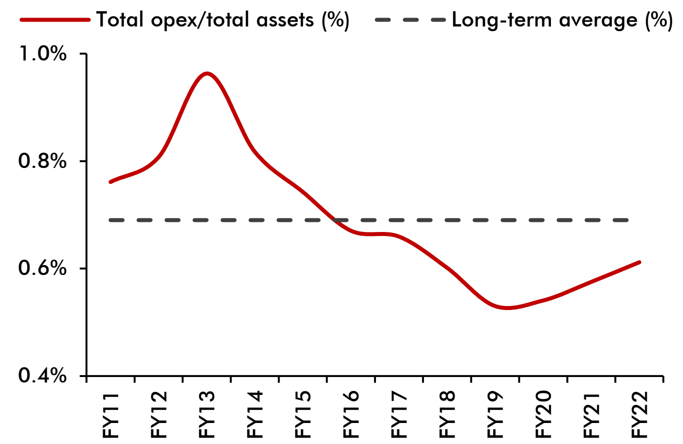


Source: Ambit Capital research, company

Lower opex ratios is a function of higher ATS, lower repayment rates, outsourced originations

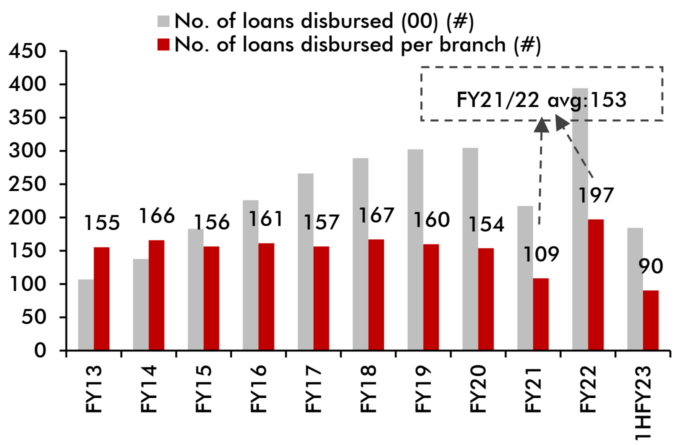
Higher ATS (₹2.1-2.2mn vs <₹1mn for most AHFCs) and lower repayment rates (vs AHFCs) has led to lower opex/assets for CANF (0.6% vs >2.5% for most AHFCs). Given the stagnation in branch productivity over the last decade, CANF is probably operating at its efficient best.

Exhibit 18: Opex ratios are most likely at their best



Source: Ambit Capital research, company

Exhibit 19: Per branch disbursal (nos.) has been stagnant

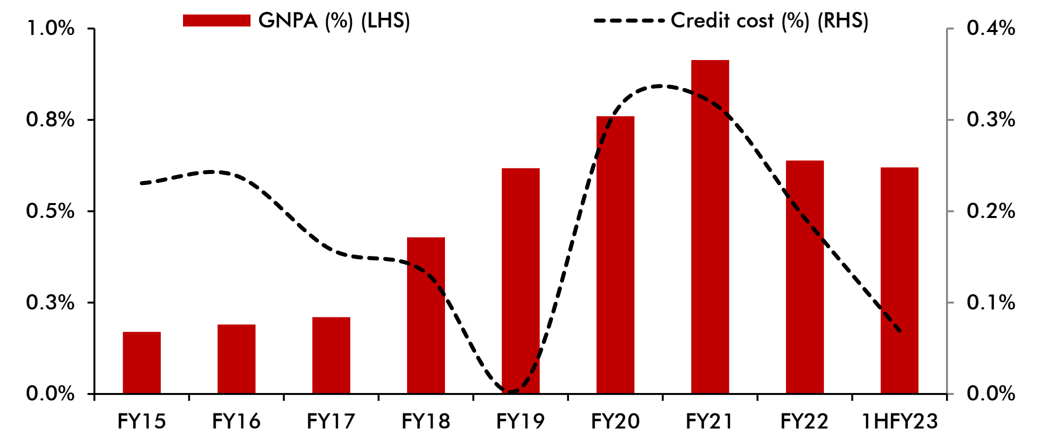


Source: Ambit Capital research, company

Low-risk customer focus has aided industry-best asset quality

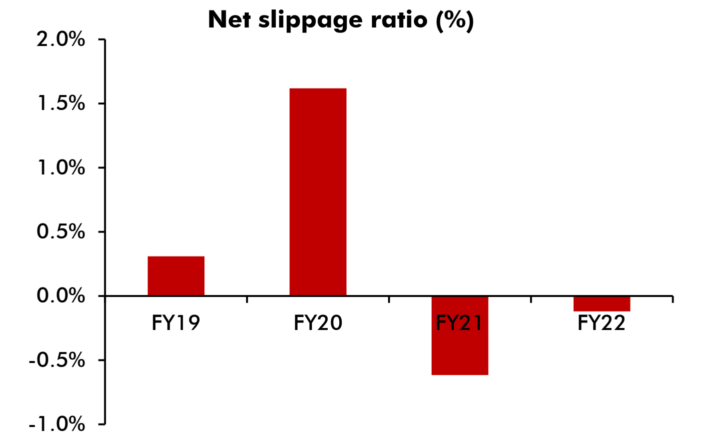
As discussed above, CANF's target customer segment is salaried/documented income given they are low-risk. As a result of such segment focus, the company's NPAs/credit costs have been fairly low. Over the last decade (FY12-22), annual credit cost has averaged <20bps.

Exhibit 20: Lower than industry NPAs/credit cost is a strong indicator of the company's low-risk appetite



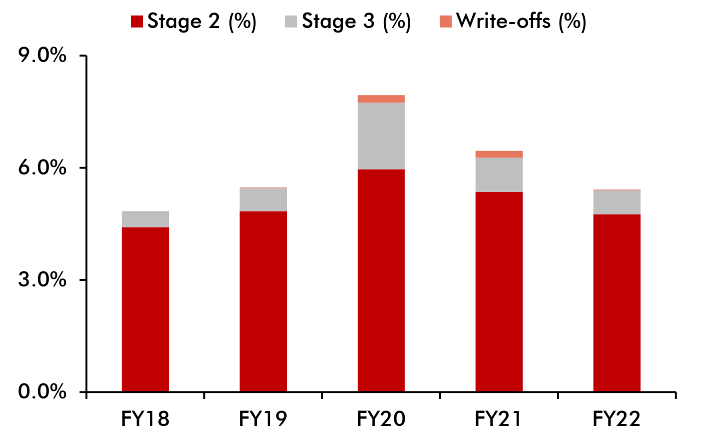
Source: Ambit Capital research, company

Exhibit 21: Focus on safer customer segment has kept slippages low…



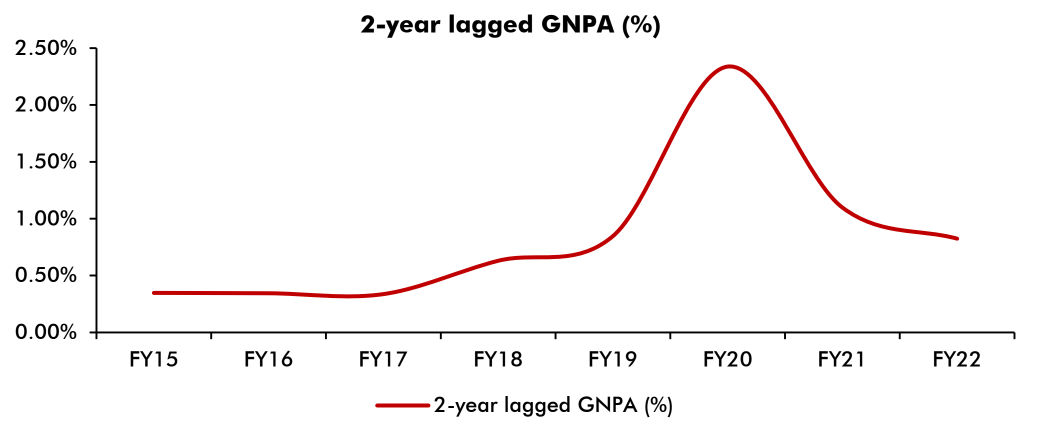
Source: Ambit Capital research, company

Exhibit 22: …aiding superior overall asset quality



Source: Ambit Capital research, company

Exhibit 23: Even on 2-year lagged basis, NPAs are <1%

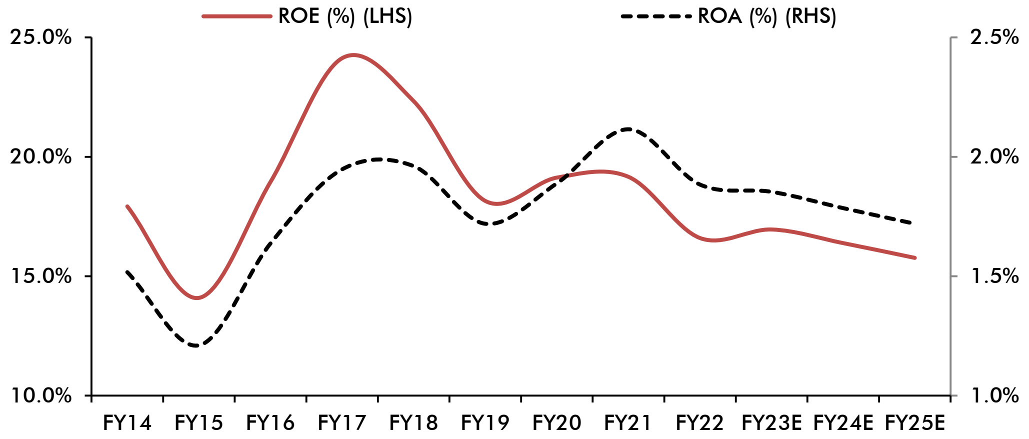


Source: Ambit Capital research, company

A combination of remunerative spreads, efficient operations and superior asset quality has aided profitability

On cross-cycle basis, CANF has delivered ROA/ROE of 1.8%/18%. Over FY15-22, PPOP per share/EPS have grown at 24%/27% CAGR. This has been possible due to relatively better spreads despite the high competition, operating at efficient best (keeping opex/assets low) and keeping credit costs low (<20bps average over last decade). We believe the entire gamut of business outcomes can be tied down to a highly competitive cost of funds.

Exhibit 24: Cross-cycle profitability has been better than many



Source: Ambit Capital research, company

Exhibit 25: Expect ROA/ROE to settle lower vs historical trend

Du-pont analysis (%)	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
NII (NIM)	3.4%	3.6%	3.2%	3.1%	2.9%	3.6%	3.9%	3.7%	3.2%	3.4%	3.8%	3.3%	3.3%	3.1%	3.0%
Other income	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net operating income	3.4%	3.7%	3.2%	3.1%	2.9%	3.6%	3.9%	3.7%	3.3%	3.4%	3.8%	3.3%	3.3%	3.1%	3.0%
Opex	0.8%	0.8%	1.0%	0.8%	0.7%	0.7%	0.7%	0.6%	0.5%	0.5%	0.6%	0.6%	0.6%	0.6%	0.5%
Operating profit	2.7%	2.8%	2.3%	2.3%	2.1%	2.9%	3.2%	3.1%	2.7%	2.9%	3.2%	2.7%	2.7%	2.5%	2.5%
Credit cost	0.1%	0.4%	0.1%	0.2%	0.2%	0.2%	0.2%	0.1%	0.0%	0.3%	0.3%	0.2%	0.1%	0.1%	0.1%
PBT	2.6%	2.4%	2.2%	2.1%	1.9%	2.7%	3.1%	3.0%	2.7%	2.6%	2.9%	2.5%	2.6%	2.4%	2.3%
Tax	0.7%	0.7%	0.6%	0.6%	0.7%	1.0%	1.1%	1.0%	1.0%	0.7%	0.7%	0.7%	0.7%	0.6%	0.6%
PAT (ROA)	1.9%	1.8%	1.6%	1.5%	1.2%	1.6%	1.9%	2.0%	1.7%	1.9%	2.1%	1.9%	1.9%	1.8%	1.7%
Leverage (x)	7.6	7.6	9.2	11.8	11.6	11.6	12.4	11.4	10.6	10.1	9.1	8.8	9.1	9.1	9.1
ROE	14.2%	13.6%	14.8%	17.9%	14.1%	18.9%	24.1%	22.3%	18.2%	19.1%	19.2%	16.6%	17.5%	16.3%	15.7%

Source: Ambit Capital research, company

Will the recent growth rates sustain? We think not

In the last 4 quarters, the company delivered growth rates (YoY) of 19-24%. The last CEO's guidance was for 18-20% sustained annual growth in loans/disbursements. As CANF's growth levers run out, its growth trajectory will, at best, match the industry level of 14%. We say this considering the company's modest branch expansion plans, stagnant productivity, moderate increases in ATS.

Days of high loan growth are behind

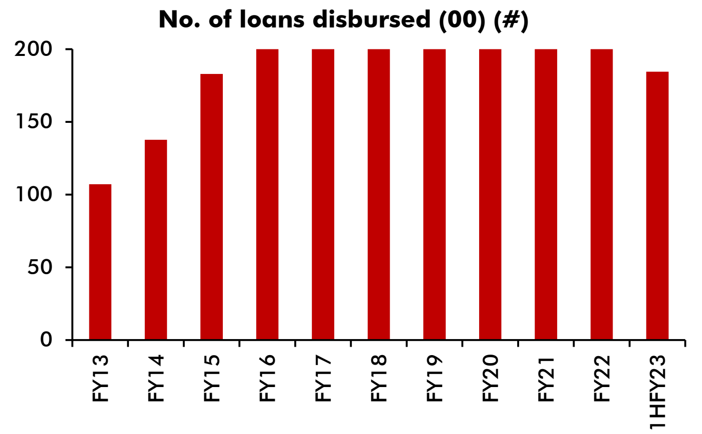
Post a DSA-led upward reset in FY23, we expect branch productivity to stagnate. In the last 4 quarters, the company has delivered 19-24% loan growth (YoY), in line with long-term guidance given by the recently departed CEO. However, from FY24E, we expect loan growth to start declining to industry levels. ATS increase, a key growth enabler in FY21/22, is unlikely to contribute. South still contributing >65% of business implies failure to capture growth in non-south high growth markets. CANF is now attempting to tap developer loans, an attempt at building scale, but given the high fatality rate, we would be skeptical.

Stagnant branch productivity, limited ATS increase to impact growth

Being in a retail business, distribution network and sales infra productivity are the most important determinants of growth. As per our analysis, CANF's medium-term loan growth will settle at 14-16% vs 19-24% (YoY) reported in last 4 quarters vs 17-18% being expected by the market. We believe this would happen as branch productivity stagnates from FY24 onwards. Our reasoning is based on the following arguments:

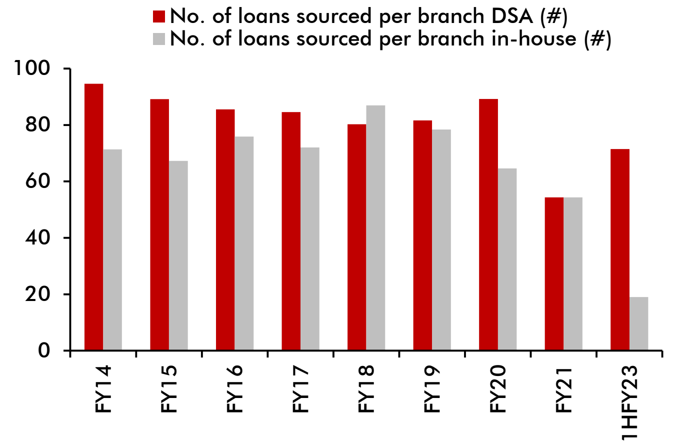
- Historically, at 50-55% DSA sourcing, overall branch productivity maxed out at 155-160 number of loans disbursed. Increasing DSA-sourcing to ~80% may lead to ~200 number of loans disbursed per branch. But this seems like a short-term growth booster than a long-term/structural trend.
- Considering the new per branch productivity (~200), annual branch expansion of 15 will not be enough to drive >15% growth on average. In fact, our calculation shows that branch productivity will need to improve by 10% annually to sustain 18% loan CAGR. Achieving such a feat looks unlikely given the PSU culture and historical performance.
- Over FY20-22, loans outstanding have increased at 14% CAGR. ~60% of this growth was driven by increase in ATS (increased at 8% CAGR). With ATS increase expected to be limited/lower, it is unlikely to contribute majorly to growth any further.

Exhibit 26: CANF's branch productivity has improved in FY23…



Source: Ambit Capital research, company

Exhibit 27: …led by higher DSA sourcing (80% vs 50-55% earlier)



Source: Ambit Capital research, company

Exhibit 28: But we believe that loan growth will settle at 15% by FY25E

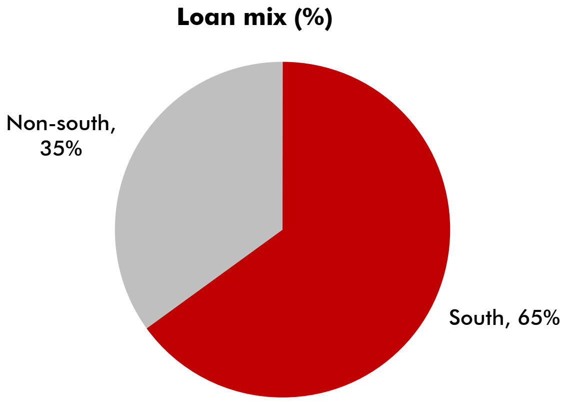
Particulars	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
No. of loans disbursed (#)	13,773	18,304	22,598	26,622	28,928	30,237	30,450	21,730	39,424	42,101	45,489	48,940
Growth (%)	*29%*	*33%*	*23%*	*18%*	*9%*	*5%*	*1%*	*-29%*	*81%*	*7%*	*8%*	*8%*
No. of loans disbursed per branch (#)	166	156	161	157	167	160	154	109	197	196	198	200
Improvement/(deterioration) (%)	*7%*	*-6%*	*3%*	*-3%*	*7%*	*-4%*	*-4%*	*-29%*	*81%*	*-1%*	*1%*	*1%*
Avg ticket size (ATS) (₹mn)	1.85	1.83	1.74	1.80	1.80	1.81	1.80	2.00	2.10	2.15	2.26	2.37
ATS Growth (%)	*9%*	*-1%*	*-5%*	*4%*	*0%*	*1%*	*-1%*	*11%*	*5%*	*2%*	*5%*	*5%*
Disbursements (₹mn)	25,480	33,460	39,230	47,920	52,070	54,790	54,810	43,460	82,790	90,518	102,691	116,006
Growth (%)	*40%*	*31%*	*17%*	*22%*	*9%*	*5%*	*0%*	*-21%*	*90%*	*9%*	*13%*	*13%*
Loans outstanding (₹mn)	58,744	83,018	107,146	134,114	157,430	183,820	206,885	221,048	267,112	312,221	361,834	416,329
Growth (%)	*46%*	*41%*	*29%*	*25%*	*17%*	*17%*	*13%*	*7%*	*21%*	*17%*	*16%*	*15%*
Repayment rate (%)	17%	16%	18%	20%	21%	18%	17%	14%	17%	17%	17%	17%
No. of branches (#)	83	117	140	170	173	189	198	200	200	215	230	245
Branch addition (#)	14	34	23	30	3	16	9	2	0	15	15	15

Source: Ambit Capital research, company

Weak non-south execution does not instill confidence to be a national player

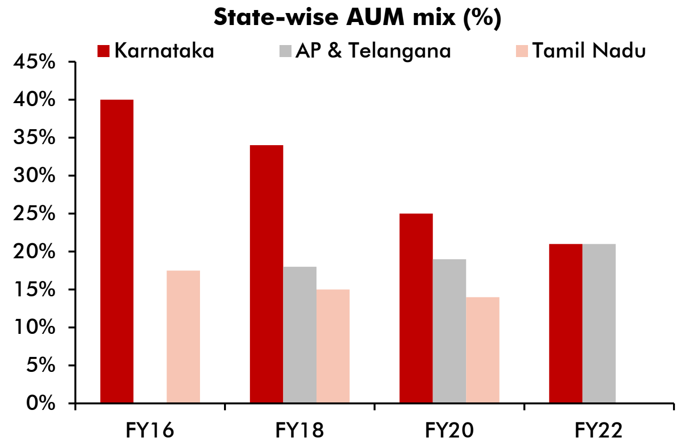
Having been in operation for several years, the company still draws 65% of its business from southern states. In light of increasing competition going ahead, it is imperative for the company to improve its execution in non-south states, in order to chart new growth areas. The company's commentary indicates that south is expected to remain its key markets. Hence, aforesaid reasons do not instill confidence on the company's ability to execute in non-south states.

Exhibit 29: South still accounts for 65% of total business



Source: Ambit Capital research, company

Exhibit 30: Karnataka is the largest market for CANF

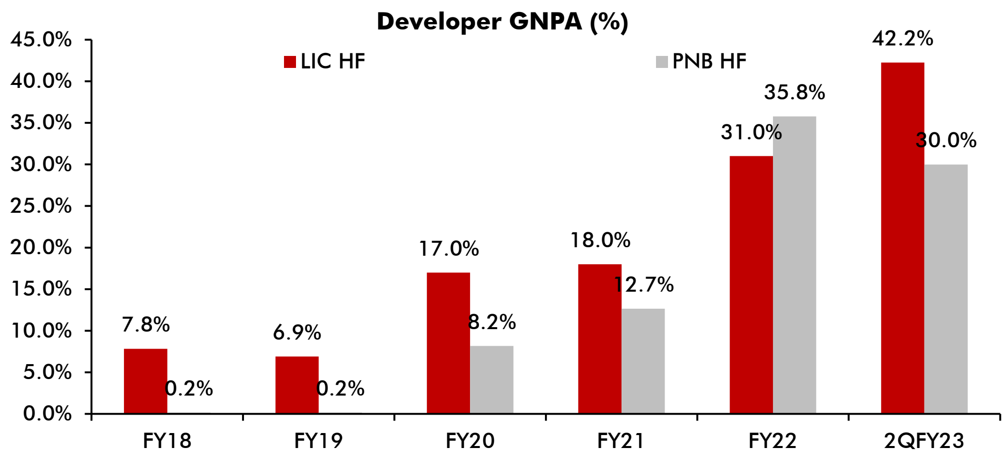


Source: Ambit Capital research, company

Developer loans – it adds to scale but fatality rate is also high

Recently, the company has highlighted that it will be looking at developer loans in the near to medium term. If the underwriting experience is satisfactory, the company might look to scale it up, thus adding to growth/scale. However, even if this product adds to scale initially, we would await gaining confidence on asset quality. Past industry experience (LIC HF, PNB HF to name a few) has not been too pleasant due to massive asset quality issues. Therefore, at this point, we cannot count on developer loans to build scale profitably for the company.

Exhibit 31: Recent developer asset quality experience has been unpleasant



Source: Ambit Capital research, company

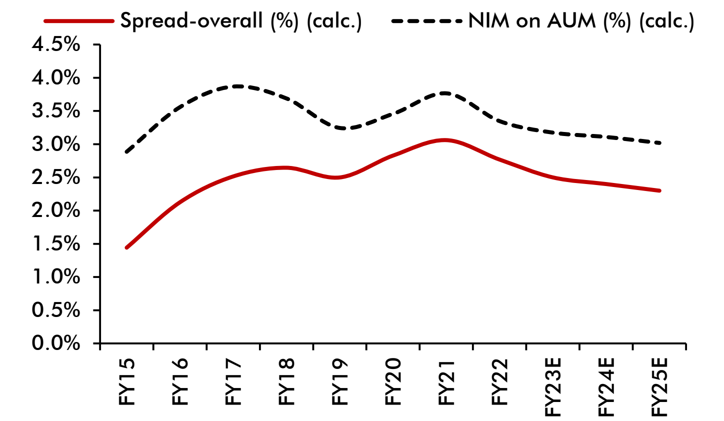
Rate hikes/competition will impact margins

Even though cost of funds shall continue to be highly competitive vs peers, we expect spreads/NIMs to compress by 47bps/33bps by FY25E. Key reason would be increasing cost of funds, especially as share of CP funding has declined to 8%. Yields will continue to face competitive pressure as the company matures. The company's last bout of competitive pricing (6.95% in Nov-20) amid high competition was an unsustainable attempt at growth/customer retention.

Spreads will compress

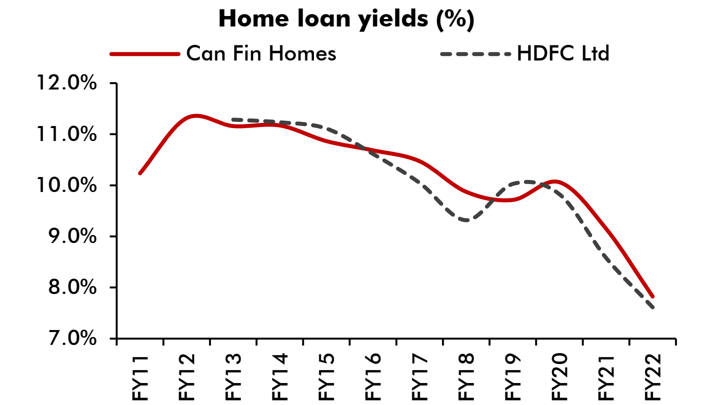
As the company matures, we expect it to continue to face competitive yield pressure. Its spreads are only 38-118bps higher than banks/large HFCs. On the cost of fund side, we expect acceleration to be higher vis-à-vis loan yields given that share of CP funding has been coming down successively every quarter. Since peaking at 4.07% in 4QFY22, NIM was down 52bps in 2QFY23. By FY25E, we expect spread/NIMs to compress further by 47bps/33bps to 2.3%/3%.

Exhibit 32: We expect spreads/NIMs to decline



Source: Ambit Capital research, company

Exhibit 33: Pricing moves in line with large-sized competitors

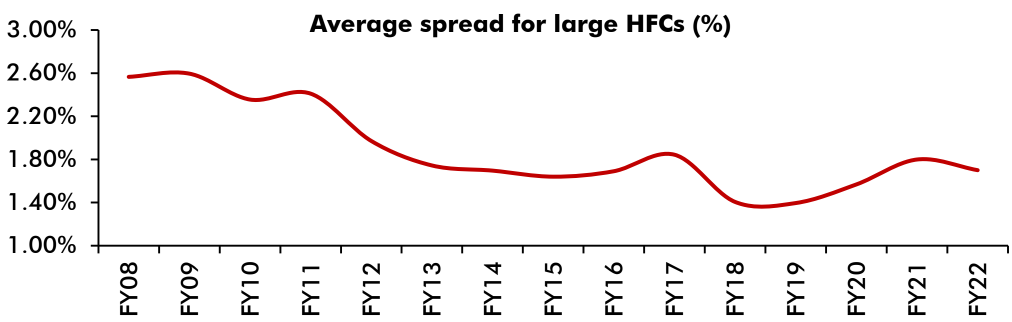


Source: Ambit Capital research, company

Spreads/NIMs to fall in line with HDFC/LICHF as the company matures

We believe that CANF is reaching a stage where its characteristics will resemble that of large HFCs (HDFC/LICHF). As highlighted before, its pricing/yields closely track HDFC's. Further, our management interaction indicates ATS will gradually increase towards HDFC/LICHF's levels in next 2-3 years. In the near-to-medium term, company would be testing the waters with respect to developer funding and scale it up thereafter if the experience is satisfactory. One of the primary motives to get into developer funding is to build balance sheet scale. These strategy moves are a clear indication of competitive pressures on growth and margins. As a result of such evolution, we expect spreads to compress by 47bps by FY25E. Long-term NII/assets will average 2.7% vs 3.5% (FY18-22 average).

Exhibit 34: A long-term perspective on how average spreads declined for large HFCs due to competition

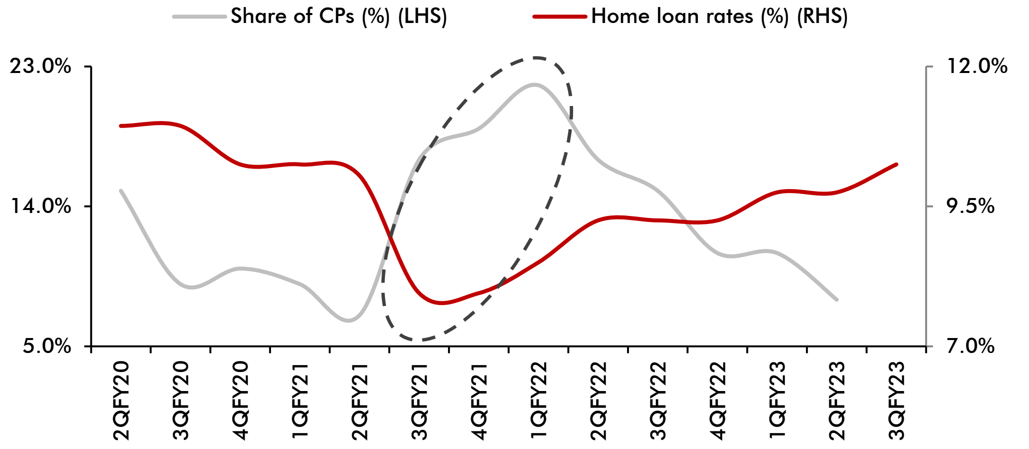


Source: Ambit Capital research, company. Note: Average of HDFC and LIC HF

Last attempt at competitive pricing amid high competition was unsustainable

In the last downward rate cycle (during the Covid wave), CANF had witnessed BT pressures on growth. As a measure to control customer retention, the company dropped rates to as low as 6.95-7.50% (Nov-20 to Sep-21). This period of low pricing coincided with high share of CP funding (17-21% between 3QFY21-2QFY22). Therefore, we conclude that such pricing was supported by high share of CP funding. Since such a pricing/funding strategy is unsustainable, given the negative ALM mismatch it creates, the low pricing advantage was short-lived (lasted <6 months).

Exhibit 35: Pricing strategy built on back of high share of CP funding is unsustainable



Source: Ambit Capital research, company

Governance controls, management bandwidth seem inadequate

Based on certain instances recently, we believe the company lacks proper and adequate governance controls. Additionally, we also see lack of/inadequate management bandwidth as a challenge to business execution.

We note the following:

- **Delay in fraud disclosure:** Last year, the fraud at company's Rajasthan branches were disclosed with a 3-4 month delay. It was only after Canara Bank's press meet that public investors became aware of the fraud at CANF. This highlighted weak internal/disclosure processes at the company.
- **Untimely dissemination of sensitive information:** Even after the fraud was discovered/disclosed (substantial event), the company did not host a call to address public investors on the same. The subsequent concern among investors with respect to the fraud clearly made it a substantial event.
- **Volatile stock price movement before CEO resignation disclosure:** The day Girish Kousgi resigned, the stock was down 8% even before his resignation was disclosed to the exchanges/public. In fact, the resignation disclosure was an after-market event. This again highlights the weak internal/disclosure processes at the company.
- **Inadequate management bandwidth:** Girish Kousgi was originally appointed for a period of 5 years but he resigned within 3 years. At present, the company is looking for an external candidate as his replacement. The company is also looking to replace the CRO externally. Overall, we believe the management bandwidth is weak at the company.

Maturing growth/quasi-PSU don't justify premium valuation

FV of ₹450, based on excess earnings (COE: 14%), implies 1.4x/9.4x FY24E BVPS/EPS. As scale increases, we expect AUM growth at par with the industry. Cost of funds advantage won't compensate for weak branch metrics, geographical concentration and limited ATS increase. What is such advantage worth if it can't produce high growth? As CANF further matures, we see spreads declining to 2.1% by FY27E. Over FY22-25E, we expect ROEs to decline vs market expectation of stable ROEs. Short-term tricks (CP-funded low pricing) don't inspire business model confidence. Developer loans, segment with high fatality rate, is a risky attempt at scaling up. Ability to attract/retain talent at top management remains an issue. In view of aforesaid concerns, CANF resembles PSU/quasi-PSU. Hence, we don't see any reason for the stock to command >100% premium over PSU counterparts.

Exhibit 36: Expect growth to taper as branch productivity stagnates

	FY20	FY21	FY22	FY23E	FY24E	FY25E	Comments
Assumptions							
YoY AUM growth	12.5%	6.8%	20.8%	16.9%	15.9%	15.1%	Expect AUM growth to taper down as branch productivity stagnates. Building disbursements growth (YoY) of 10-11%. Assuming repayment rate of 17%.
Yield on AUM (calc.)	10.4%	9.4%	8.0%	9.0%	9.5%	9.5%	Pricing should move in line with broader competition as CANF is already quite competitive. Company has already raised card rates.
Cost of funds (calc.)	7.5%	6.4%	5.3%	6.4%	7.1%	7.2%	Expect CoF to increase in the current upward rate environment.
NIM (calc.)	3.5%	3.8%	3.3%	3.3%	3.1%	3.0%	In view of increasing competition, NIMs will decline.
Opex to income (%)	15.7%	15.3%	18.3%	17.4%	17.9%	18.1%	We are not building any significant improvement in opex ratios as current structure is already quite efficient.
Opex to asset ratio (%)	0.5%	0.6%	0.6%	0.6%	0.6%	0.5%	
Credit cost (%)	0.3%	0.3%	0.2%	0.1%	0.1%	0.1%	Credit costs reflect company's superior asset quality vs industry.
Output (₹bn)							
AUM	206	220	264	312	362	416	
NII	6.9	8.1	8.3	9.9	11.1	12.4	
Operating profit	5.8	6.9	6.8	8.2	9.1	10.2	
Net profit	3.8	4.6	4.7	5.9	6.4	7.1	
EPS (₹)	28.2	34.3	35.4	44.1	47.9	53.2	
BVPS (₹)	161	196	230	272	315	363	
ROA (%)	1.9%	2.1%	1.9%	1.9%	1.8%	1.7%	
ROE (%)	19.1%	19.2%	16.6%	17.5%	16.3%	15.7%	

Source: Ambit Capital research, company

Our EPS estimates are 8-16% lower than consensus due to lower loan growth and margin compression. We believe the market is likely underestimating the margin impact of increasing cost of funds and increasing competitive pressure on pricing.

Exhibit 37: Ambit vs consensus – we are up to 16% below consensus on EPS

₹mn	Consensus estimates			Ambit estimates			Difference (%) (Ambit vs cons.)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Net operating income	10,246	12,227	14,787	9,942	11,067	12,407	-3%	-9%	-16%
PAT	5,926	7,044	8,463	5,869	6,376	7,091	-1%	-9%	-16%
EPS (₹)	44	52	63	44	48	53	0%	-8%	-16%
BVPS (₹)	272	320	382	272	315	363	0%	-1%	-5%
ROA (%)	1.9%	1.9%	2.0%	1.9%	1.8%	1.7%	0bps	-15bps	-26bps
ROE (%)	17.6%	17.7%	17.9%	17.5%	16.3%	15.7%	-6bps	-141bps	-215bps

Source: Ambit Capital research, company, Bloomberg

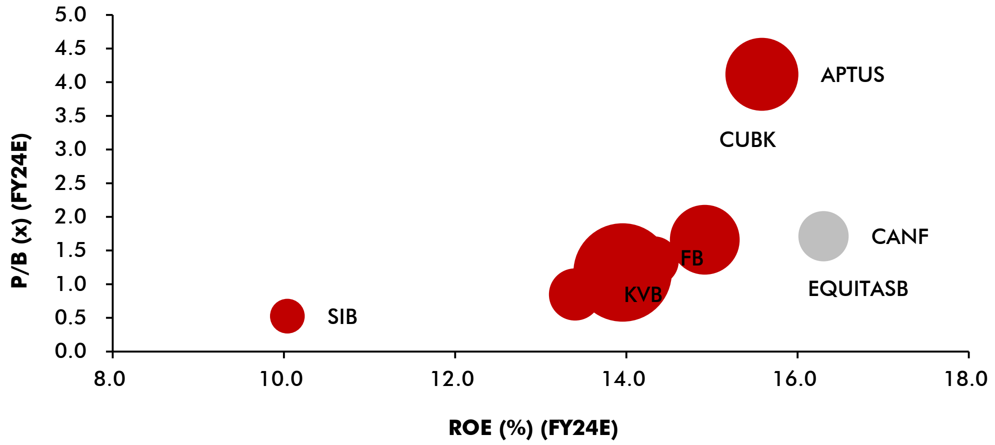
Our TP of ₹450 is arrived at based on assumptions discussed above and assumed cost of equity (Ke) of 14%.

Exhibit 38: Sensitivity of valuations to long-term growth and ROE assumptions

FY26-42E	Bear case	Base case	Bull case	Comments
Average assets growth	11.4%	14.4%	16.0%	In bear case, we are assuming that competitive intensity will be higher as arbitrage between banks and HFCs diminishes. In bull case, we are assuming that CANF will be able to gain a competitive edge with its low cost of funds, resulting in higher loan growth.
Average ROA	1.1%	1.5%	1.5%	Bear case average NIM/credit cost: 2.3%/0.3%. Bull case average NIM/credit cost: 2.8%/0.2%.
Average ROE	9.9%	13.6%	14.6%	
Target price (₹)	**189**	**450**	**605**	
Implied P/E - FY24E	3.9	9.4	12.6	
Implied P/B - FY24E	0.6	1.4	1.9	

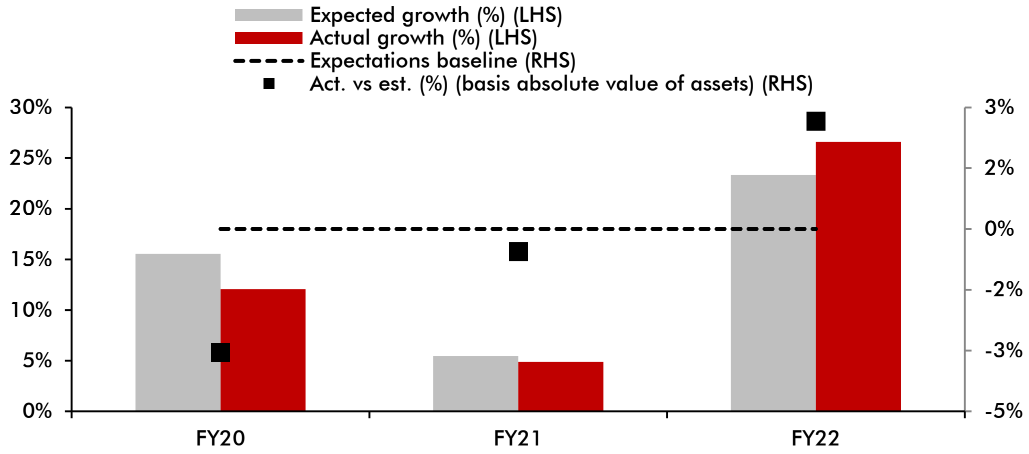
Source: Ambit Capital research, company

Exhibit 39: CANF trades at premium to most regional counterparts



Source: Ambit Capital research, company

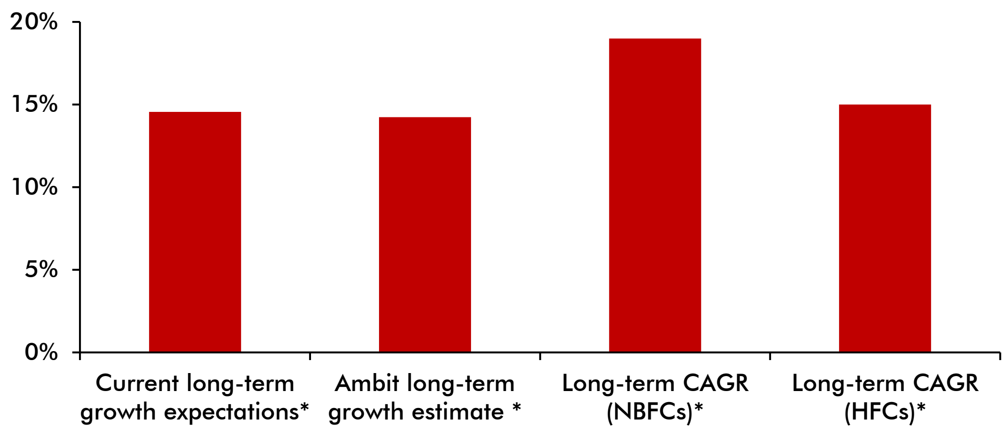
Exhibit 40: CANF's growth delivery has been mixed. Growth in FY22 was led by higher ATS



Source: Ambit Capital research, Company, Bloomberg

Long-term growth expectations are nearly in line with our estimates. But we expect earnings growth would lag considerably as market is underestimating risks to margins.

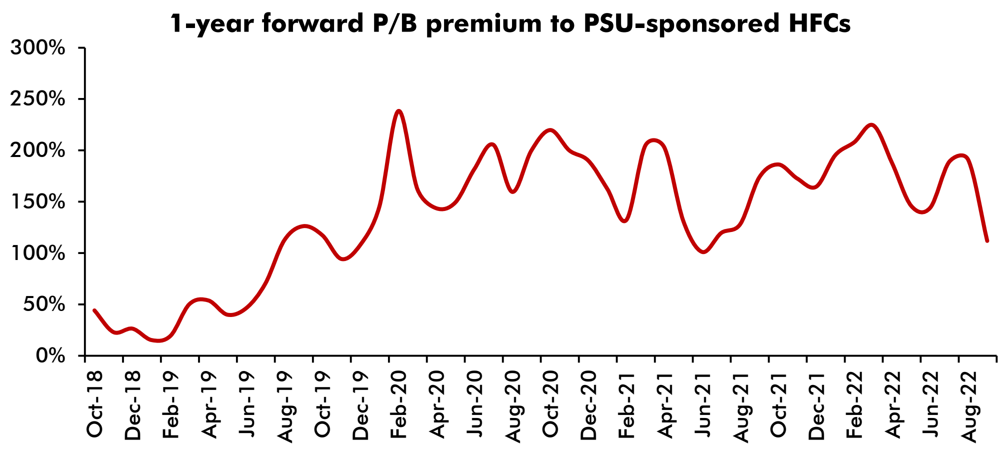
Exhibit 41: Long term, CANF should grow at par with the industry



Source: Ambit Capital research, company

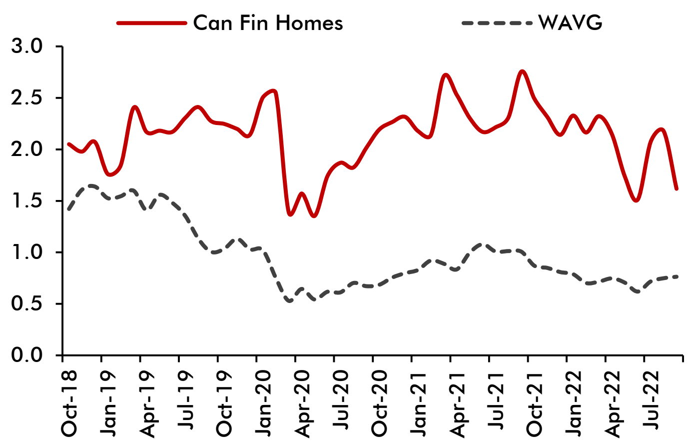
CANF has traded at an average premium to 138% to other PSU-sponsored HFCs. We expect the valuation to gap to narrow.

Exhibit 42: CANF has traded at an average premium of 138% to PSU-sponsored HFCs



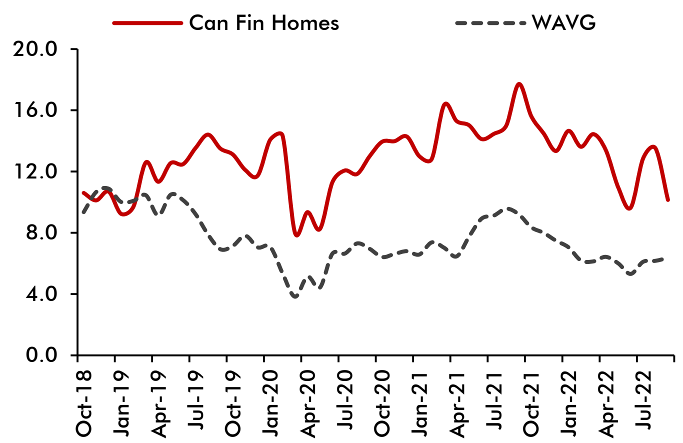
Source: Ambit Capital research, Company, Bloomberg

Exhibit 43: CANF trades at a 112% premium to PSU-sponsored HFCs on 1-year fwd P/B



Source: Ambit Capital research, company, Bloomberg; WAVG = LIC HF, PNB HF

Exhibit 44: CANF trades at a 59% premium to PSU-sponsored HFCs on 1-year fwd P/E



Source: Ambit Capital research, company, Bloomberg; WAVG = LIC HF, PNB HF

Risks & catalysts

Key risks

Branch productivity improves/higher branch expansion: If branch productivity improves from current levels or if new branch openings are higher than our expectations, loan growth could be higher.

Increase in CPs will aid margins: Currently, we are building in NIM compression. If the company decides to increase share of low-cost CP-funding, it would have positive implications for margin.

Catalysts

Stagnating branch productivity will impact loan growth: We expect loan growth to drop to 16% in FY24E vs management guidance of 18%. Limited ATS increase, stagnating branch productivity, moderate branch expansion plans are key reasons.

Competition will drive down NIMs: Cost of funds will witness double whammy as share of CPs decline and systemic rate increase. Competition will ensure pricing remains under pressure. Hence, we expect NIMs to decline by 24bps over FY22-24E.

Exhibit 45: Explanation of our flags on the cover page

Segment	Score	Comments
Accounting	**GREEN**	We do not find anything unusual in the company's accounting policies and believe reported numbers are a true reflection of performance.
Predictability	**GREEN**	CANF has reported stable earnings growth.
Earnings Momentum	**AMBER**	In the past six months, consensus has upgraded FY23E EPS/downgraded FY24E EPS estimates by 4%/5%.

Source: Ambit Capital research, company

Financials

Income Statement

Particulars (₹mn)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net interest income	**6,862**	**8,098**	**8,343**	**9,934**	**11,057**	**12,396**
Non-interest Income	0	3	7	8	9	11
Total Income	**6,862**	**8,101**	**8,350**	**9,942**	**11,067**	**12,407**
Total opex	**1,076**	**1,240**	**1,530**	**1,733**	**1,979**	**2,249**
Employee Expenses	542	700	768	863	981	1,110
Other Expenses	534	540	762	870	998	1,139
Pre provision profit	**5,786**	**6,861**	**6,820**	**8,209**	**9,088**	**10,158**
Provisions	603	685	469	278	472	575
Profit before tax	**5,183**	**6,176**	**6,351**	**7,931**	**8,616**	**9,583**
Tax	1,422	1,615	1,640	2,062	2,240	2,491
PAT - Standalone	**3,761**	**4,561**	**4,711**	**5,869**	**6,376**	**7,091**

Source: Ambit Capital research, company

Balance Sheet

Particulars (₹mn)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net worth	21,501	26,098	30,666	36,242	41,980	48,362
Borrowings	187,484	192,929	246,477	292,814	339,665	390,614
Total liabilities	**210,436**	**220,737**	**279,443**	**330,855**	**383,449**	**441,186**
Loans (on-book)	205,701	219,512	263,781	312,221	361,834	416,329
Cash & investments	4,167	711	14,501	17,276	20,040	23,046
Other assets	567	514	1,162	1,359	1,574	1,812
Total assets	**210,436**	**220,737**	**279,443**	**330,855**	**383,449**	**441,186**

Source: Ambit Capital research, company

Key Ratios

Particulars (%)	FY20	FY21	FY22	FY23E	FY24E	FY25E
AUM growth (%)	12.5	6.8	20.8	16.9	15.9	15.1
Disbursements growth (%)	0.0	-20.7	90.5	9.3	13.4	13.0
EPS growth (%)	26.6	21.3	3.3	24.6	8.6	11.2
Net interest margin (NIM) (%)	3.5	3.8	3.3	3.3	3.1	3.0
Cost to income (%)	15.7	15.3	18.3	17.4	17.9	18.1
Opex (% of AAUM)	0.6	0.6	0.6	0.6	0.6	0.6
Gross NPAs (%)	1.8	0.9	0.6	0.6	0.6	0.6
Credit costs (% of AAUM)	0.3	0.3	0.2	0.1	0.1	0.1
Provision Coverage (%)	28.9	33.6	52.9	45.0	45.0	45.0
Tier-1 (%)	20.5	23.7	21.1	22.1	21.7	21.3
Leverage (x)	10.1	9.1	8.8	9.1	9.1	9.1

Source: Ambit Capital research, company

Valuation

Particulars	FY20	FY21	FY22	FY23E	FY24E	FY25E
BVPS (₹)	161	196	230	272	315	363
EPS (₹)	28.2	34.3	35.4	44.1	47.9	53.2
ROA (%)	1.9	2.1	1.9	1.9	1.8	1.7
ROE (%)	19.1	19.2	16.6	17.5	16.3	15.7
P/E	19.5	16.1	15.5	12.5	11.5	10.3
P/BV	3.4	2.8	2.4	2.0	1.7	1.5

Source: Ambit Capital research, company

Annexure I: Key management deputed from parent

Currently, the company does not have a CEO as Girish Kousgi resigned in Sep-22. The company is working with agencies to hire externally. The company has not had a consistent management team. Till now, all executive positions were filled by employees deputed from Canara Bank. Overall, salary/incentive structure is PSU-oriented.

Exhibit 46: Key management executives have been deputed from Canara Bank

Name	Designation	Background/work-ex	Remuneration (₹mn)	% of PBT
Amitabh Chatterjee	Dy. MD	MBA, CAIIB; has held different position in Canara Bank.	0.0	0.00%
Prashanth Joishy	Chief Financial Officer	Commerce graduate; joined the company in 1989; has wide exposure in operations and has headed branches across multiple states.	2.1	0.00%
Shamila M	General Manager	Joined the company in February 1988 as a management traineel has headed several branches of the company over the years and has handled various functions. Presently, she oversees the overall functioning of the company.	2.6	0.10%
Veena G Kamath	CS	Joined as legal officer in 1998; has degree in business management and law.	2.2	0.00%
Ajay Kumar G Shettar	Head - Legal	-		
B M Sudhakar	Head - Credit	-		
Prashanth Shenoy	Head - Product & strategy	-		
Prakash Shanbhogue	Head - Collections	-		
Sikhin Tanu Shaw	Head - IT	-		
Arun Kumar V	Head - CPC	-		
Uthaya Kumar	Chief Risk Officer	-		
Ajay Kumar Singh	Head - RBIA	-		

Source: Ambit Capital research, company; Girish Kousgi, who was MD/CEO, resigned in Sep-22. His remuneration of ₹12.1mn was 0.3% of PBT.

Annexure II: Board almost entirely made up of independent directors

Board is mostly comprised of independent directors, nearly all of whom have varied experienced in the banking industry.

Exhibit 47: Board majorly comprises of independent directors

Name	Designation	Background/work-ex	Industry experience	Other directorships
Lingam Venkata Prabhakar	Chairman (promoter)	Currently MD/CEO of Canara Bank (promoter). 35+ years of banking experience. Earlier associated with PNB. Has handled various verticals such as credit, treasury, HR.	Yes	1
Debashish Mukherjee	Promoter director	Executive director in Canara Bank. Prior to Canara Bank, he was associated with PNB. Has vast experience in corporate credit, credit monitoring, recovery.	Yes	1
G Naganathan	Independent director	Currently, partner in MSKC % Associates (CA firm). Area of expertise: statutory and related attestation services, consultancy in direct taxes, management advisory services. Has been involved in audit of banking and insurance companies and monitoring of large sick companies of behalf of banks.		0
Amitabh Chatterjee	Dy. Managing director	Prior to CANF, he was Dy GM in Canara Bank.	Yes	0
Satish Kumar Kalra	Independent director	Served as MD/CEO of Andhra Bank for 6 months (served as WTD/ED from Oct-12 to Aug-17). Prior to Andhra Bank, he has worked in Allahabad Bank. He has provided strategic guidance to the banks in areas of NPA, credit, international banking, treasury management, HR (total of 38 years of banking experience).	Yes	3
Shubhalakshmi Aamod Panse	Independent director	Fomer member of External Advisory Committee set up by RBI for vetting payments banks applications. Has experience in balance sheet management, funds management, treasury, corporate credit appraisal, credit monitoring, business planning. She has 40 years of banking experience.	Yes	2
Ajai Kumar	Independent director	Has >40 years of experience in public sector banking. Expertise: risk management, treasury, investment and money market operations, HR, retail banking operations, project management.	Yes	1
Anup Sankar Bhattacharya	Independent director	Served as Chairman/MD of Bank of Maharashtra. Across his career, he has handled various functions/roles/responsibilities in the banking industry.	Yes	0
Arvind Narayan Yennemadi	Independent director	Has >45 years of experience in audits of public/private sector banks.		0

Source: Ambit Capital research, company

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What the tech!?

As HFFC strives to be a mortgage fintech, we are unable to see any benefits! Despite higher tech spends/lean processes, opex ratios are not materially lower than Aavas which has all functions in-house. Further, operating in urban locations, partly overlapping with large lenders, HFFC isn't immune to BTs. Credit costs averaging 60bps, higher than peers, question proprietary underwriting models. In the near term, inability to fully transmit rate hikes will impair spreads by 48bps by FY25E. Branch expansion/new business growth will keep opex elevated. Average credit costs (FY22-25E) of 44bps are ~15bps higher than Aavas'. Gruh, which followed a similar originations strategy, witnessed growth deceleration post ₹100bn AUM (FY16). At 3.1x FY24E BV, market expects 21% long-term growth, a tall task considering 15-19% industry's historical best. FV of ₹601 implies 2.6x/21x FY24E BVPS/EPS. Risks: Better asset quality, spread improvement.

Competitive position: MODERATE Changes to this position: STABLE

Tech at the heart of everything

HFFC's pride is its tech across functions, from app-based lead generation via connectors (TAT: 48 hours) to proprietary ML aiding credit underwriting and bounce prediction. It added Anuj Srivastava (founder, livspace) to the board to benefit from his tech background. Yet, CTO is missing. On the business front, AUM/disbursements have increased at 49%/38% CAGR since FY15.

New branch openings, competition to keep opex elevated

~70% branch expansion by FY24E will increase opex ratios to 3.3%. Infra cost per unit is >2x of Aavas/Aptus due to urban focus (higher rentals)/graduate-level hiring. Despite lean branch spread, productivity has declined. BT risks in competitive markets could drive up new acquisition costs. Expect opex CAGR of 34% vs 30% AUM CAGR over FY22-25E.

NIMs to decline by 77bps over FY22-25E

Expect spreads/NIMs to decline 48bps/77bps by FY25E given: (1) geographical overlap with large lenders implies higher competition, hence pricing pressure, (2) limited transmission of rate hikes in the current rate cycle, while cost of funds increases. Expect NII CAGR of 25% vs 30% AUM CAGR (FY22-25E).

Market overlooking competitive risks to growth/earnings

~21% growth expectations (FY22-42E) are high given industry's best of 15-19%, increasing regulatory scrutiny, competition. Benefits of tech are missing; no visibility either! Declining margins and high opex will cause earnings growth to lag AUM growth. Premium valuation to small/mid-peers is unjustified.

Key financials

Year to March	FY21	FY22	FY23E	FY24E	FY25E
Total Income (₹ mn)	2,718	3,800	4,749	6,030	7,542
Operating Profit (₹ mn)	1,662	2,513	2,924	3,569	4,468
Net Profit (₹ mn)	1,001	1,861	2,144	2,535	3,164
EPS (₹)	11.5	21.2	24.5	28.9	36.1
RoE (%)	8.7	12.6	12.8	13.2	14.4
P/E (x)	63.0	34.0	29.5	25.0	20.0
P/B (x)	4.6	4.0	3.5	3.1	2.7

Source: Ambit Capital research, company

BFSI

Recommendation

Mcap (bn):	₹63/US$0.8
6M ADV (mn):	₹153/US$1.9
CMP:	₹725
TP (12 mths):	₹601
Downside (%):	17

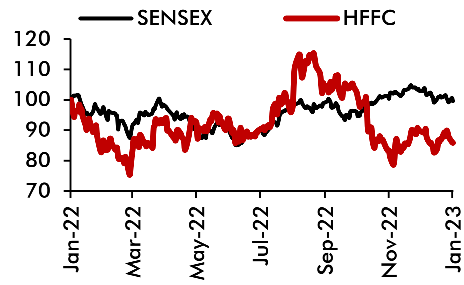
Flags

Accounting:	GREEN
Predictability:	GREEN
Earnings Momentum:	GREEN

Key catalysts

- Branch expansion and new business acquisition to keep opex ratio elevated at 3.2% in FY24E.
- Limited rate transmission amid increasing cost of funds to impact NIMs by 23bps in FY24E.

Performance (%)



Source: Bloomberg, Ambit Capital Research

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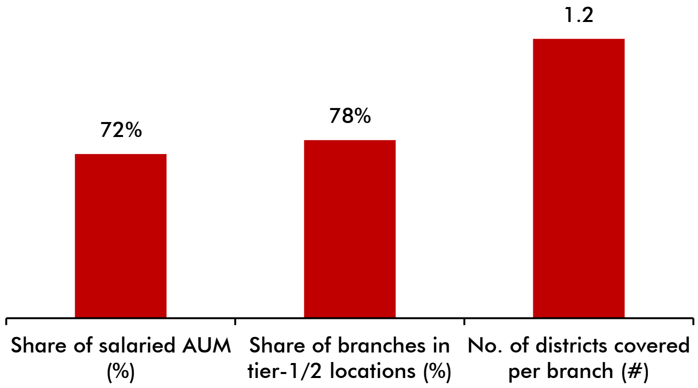
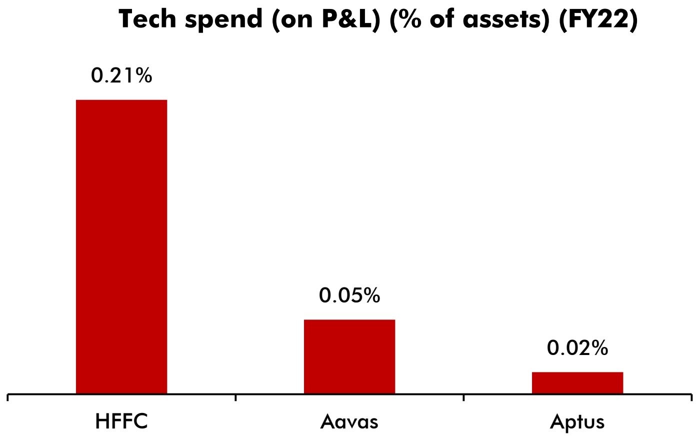
The Narrative in Charts

Exhibit 1: Underlying rationale to focus on urban locations is to target densely populated markets



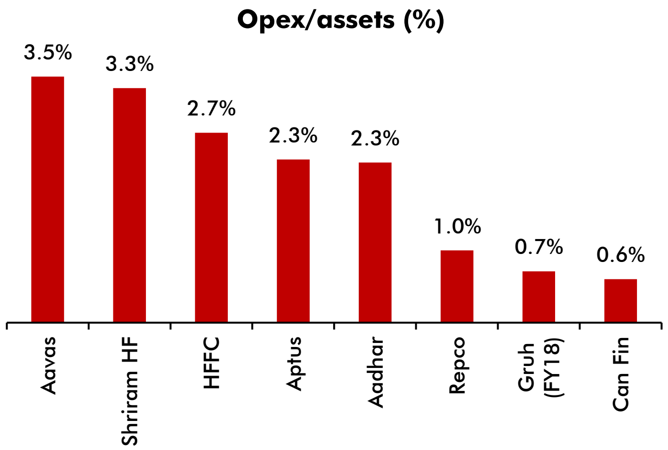
Source: Ambit Capital research, company

Exhibit 2: Higher tech spends highlight HFFC's aspiration to be a mortgage fintech



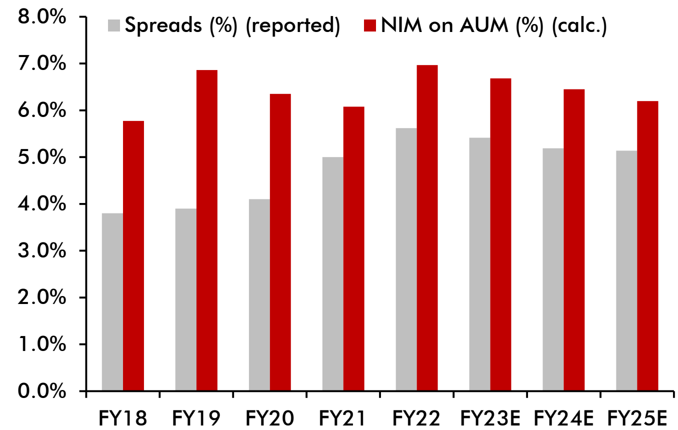
Source: Ambit Capital research, company

Exhibit 3: Despite the dense population argument and higher tech spend, opex is one of the highest



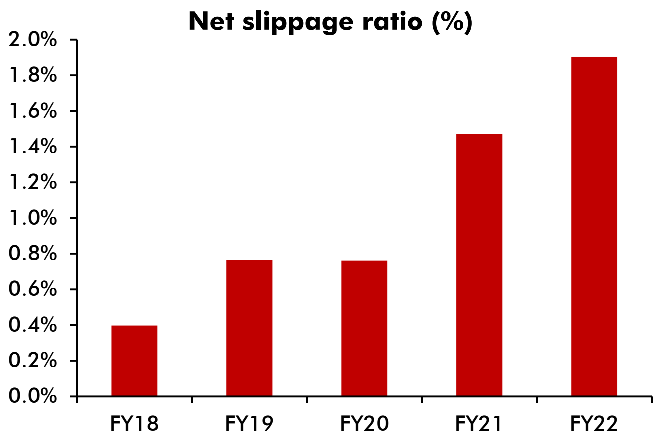
Source: Ambit Capital research, company

Exhibit 4: Higher competition and limited rate hike transmission will lead to NIM decline



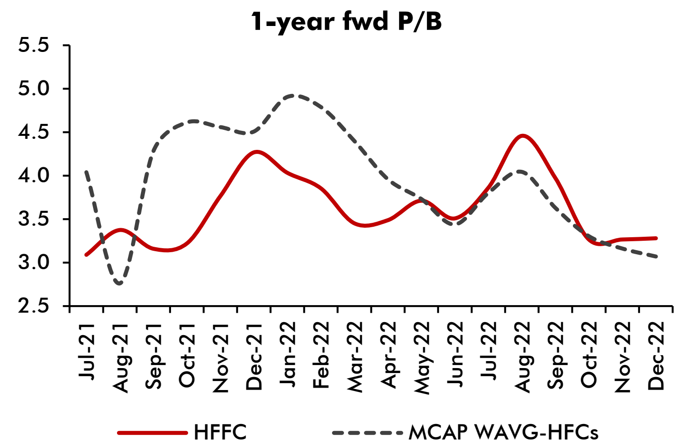
Source: Ambit Capital research, company

Exhibit 5: Despite higher tech spend on asset quality predictors, slippages have been increasing



Source: Ambit Capital research, company

Exhibit 6: In view of sub-par performance, premium valuation is unsustainable

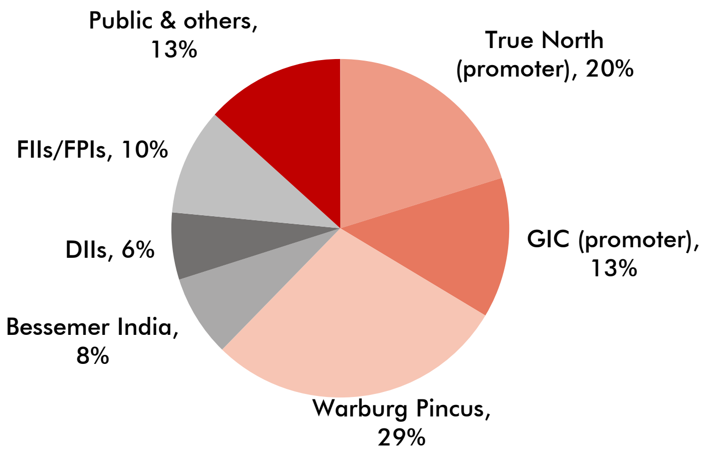


Source: Ambit Capital research, company

Tech-enabled urban, low-income player

HFFC was incorporated as a retail affordable HFC in 2010 in Bengaluru, Karnataka. It received its series A round from Bessemer Venture Partners in 2011 and started operations in Gujarat and Tamil Nadu in 2012. HFFC's strength lies in its tech across functions, from app-based lead generation (TAT: 48 hours) to proprietary ML aiding credit underwriting/bounce prediction. The underwriting team is assisted by data-science-backed (>100 data points) customer-scoring model to evaluate a customer's creditworthiness. HFFC's ATS is ₹1mn; 90% AUM from HL. Focus is on (1) informal salaried class (earning <₹50k/month), (2) urban locations with dense population/volume and (3) apartments/row houses. Like other AHFCs, HFFC's cost of funds is higher than large lenders, making it relatively uncompetitive in urban regions. Note that HFFC's slippage ratio has been higher than Aptus/Aavas, resulting in average credit costs being higher. Lastly, high PE ownership is discomforting due to possibility of ownership change.

Exhibit 7: Holding structure similar to other AHFCs



Source: Ambit Capital research, company

Exhibit 8: SWOT analysis

Strengths	**Weaknesses**
▪ **Informal income customer:** HFFC specializes in financing salaried customers (earning <₹50k monthly) who are neglected by banks. Share of both main/co-applicant being formally salaried is only 10%. ▪ **Focus on self-construction:** Apartment funding is 25% of disbursements. Self-construction, which is a less contested space, is 25% of disbursements. ▪ **High on tech:** Use of tech has aided one of the best TAT in the industry. 89% of loans are approved within 48hrs.	▪ **Uncompetitive cost of funds:** HFFC's cost of funds is not the most competitive among the larger set of lenders, esp. vs banks. ▪ **Focus on urban centres:** HFFC is focusing on urban centres where large banks/HFCs are already present. This raises competitive/growth risks. ▪ **Productivity is declining:** HFFC's productivity has been declining in last few years. Despite investing in new branches/employees/tech, growth in new business sourced has not kept pace. ▪ **High PE ownership may restrict leverage, impacting growth/ROE:** High PE ownership has always remained a concern due to possibility of sudden ownership change driven by PE's own fund mandates. Plus, credit rating agencies find PE ownership less comforting. ▪ **Asset quality discomforting:** Asset quality experience has been worse off than peers as indicated by higher slippage ratio and high overall stress levels.
Opportunities	**Threats**
▪ **Industry to see 13-14% CAGR over next 2 decades:** Mortgage industry is expected to grow at 13-14% p.a. over the next 2 decades. ▪ **Expand in north:** HFFC's primary markets are south/west. Given the opportunity in north/central, it can choose to focus on these regions too.	▪ **High pre-payments:** Uncompetitive cost of funds can result in high pre-payments/BTs, leading to impact on AUM growth. ▪ **High attrition:** Recently, the attrition in the industry has been high. Continued high attrition can threaten business performance especially when the reliance on RMs is high.

Source: Ambit Capital research, company

Following a centralized strategy by leveraging tech

HFFC's higher inclination towards tech is reflected in its business processes. As a result of its front/back-end tech capabilities, the companies has sought to club functions across the value chains (from originations to final disbursements). For example, the sales RM (branch-based) is also the person who collects all the customer-relevant information required for determining loan eligibility and then passes it on to the central credit team for evaluation. Sales RM also perform the collections function. Overall, the company follows a centralized model (Aavas is decentralised). Given HFFC's tech capabilities, investments in branch network is lower vs peers. For this reason, the company is able to serve more than 1 district per branch (Aavas has ~2 branches in each district).

Exhibit 9: There is scope for improving business processes by segregating functions

Functions	In-house/outsourced	Comments
Sales	Outsourced	The leads generated by connectors are managed through a mobile application.
		Fresh customer leads are logged into the system by sales RMs.
Initial screening	In-house	All customer interaction/initial screening/document verification is done by sales RMs.
		Each lead is checked against KYC/credit bureau scores/third-party databases.
		Sales RMs conduct home/workplace visits for data collection and verification purposes.
Underwriting	In-house	The company follows a centralised model wherein the underwriting team sits at a centralised location.
		The underwriting team is assisted by data science backed customer-scoring model to evaluate a customer's creditworthiness.
		The company captures >100 data points on a customer from point of inception of the lead. This helps in gathering data around the customer.
		The company uses proprietary ML credit scoring models, which bifurcate the customers into different risk buckets. This is reviewed by the underwriters to take a final decision.
Legal/technical/valuation	Outsourced	Internal teams initiate legal/technical assessment of property through third-party vendors (verification of technical documents, legal title title, market value).
		Before disbursing the amount, the company obtains original documents (stage of construction, legal/technical reports, demand letter, NOC, possession letter in case of developer-built apartment).
Collections	In-house	All borrowers are registered for automated debit facility.
		Customers are reminded about repayments through text messages and automated calls.
		The company uses proprietary machine learning models to predict probability of bounce, which helps in obtaining early signals of potential and initiate appropriate actions.
		Collections are entirely managed by branch teams. RMs are responsible for collections (as well as sales).
		Incentive is 20% of total CTC for an RM. Out of this 20%, 10% is linked to collections.
		At 1-dpd, front-end field teams call customers and visit them to understand reasons for default.
		At 30-dpd, default notice/loan recall notice is sent to the customer.
		At 60-dpd, pre-SARFAESI notice is sent to the customer. Customer visit frequency also increases.
		Post 90-dpd, cases are resolved through SARFAESI.

Source: Ambit Capital research, company

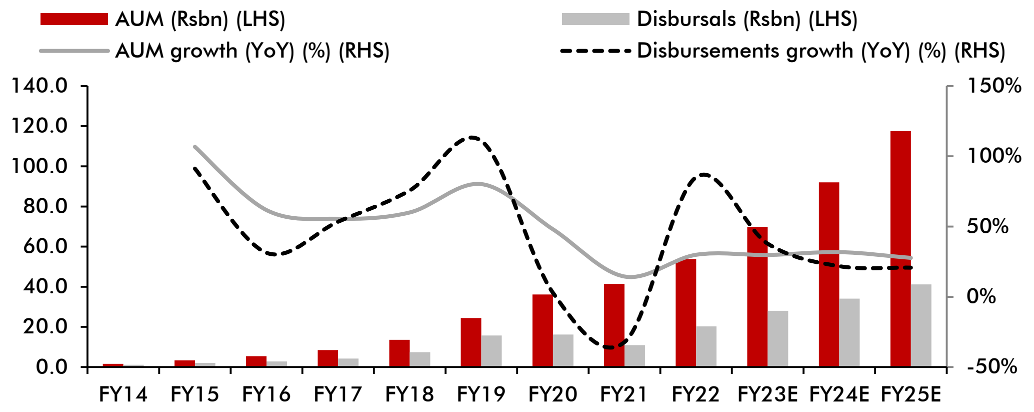
Playing on a highly competitive turf

West/south are core focus markets. Focus is on urban markets and salaried customers (72% of AUM), one that is un/under-serviced by large lenders. This explains the pricing premium (spread: 5.95%) charged by HFFC over large lenders (spread: 2-2.5%). Operating in an urban set up, per unit cost of infra has been higher than peers, leading to elevated opex ratios. Asset quality has been weaker than peers, leading to higher average net credit costs (60bps over FY18-22). Large spreads/improving opex efficiency have aided operating profit margin expansion but we are yet to see full-year ROE at =/>13%.

Steady market share in <₹1mn ticket segment

HFFC's AUM/disbursements have increased at 45%/37% CAGR since FY17. The company has minuscule market share (0.2%) as of Mar-22. However, in the sub-₹1mn ticket size segment, it has held a 7-10% market share in last few years. Given that the book has been built in last 4-5 years (FY17 AUM: ₹8.5bn), it is still unseasoned.

Exhibit 10: Higher base, lack of diversification, competition in urban markets will impact AUM growth

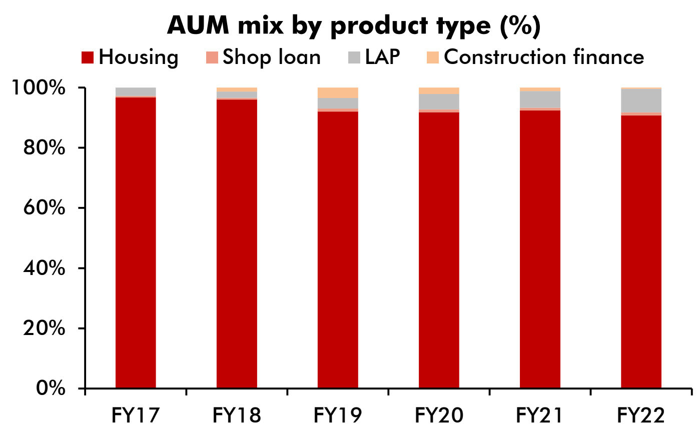


Source: Ambit Capital research, company

Majority of the business comes from home loans

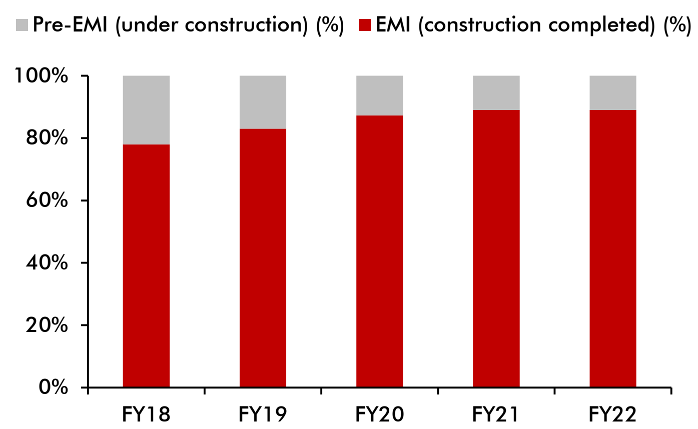
HFFC offers multiple products but majority of the business comes from home loans, which accounts for 91% of the total AUM. Share of LAP has been increasing (8% in FY22 vs 2% in FY18), it is not expected increase beyond 15%. This indicates that even in the long term, housing loans will remain the mainstay. Our management interaction corroborates this.

Exhibit 11: Majority of the business comes from housing loans and is expected to remain so



Source: Ambit Capital research, company

Exhibit 12: Traditionally, focus has been on apartment units but share of self-construction is now increasing

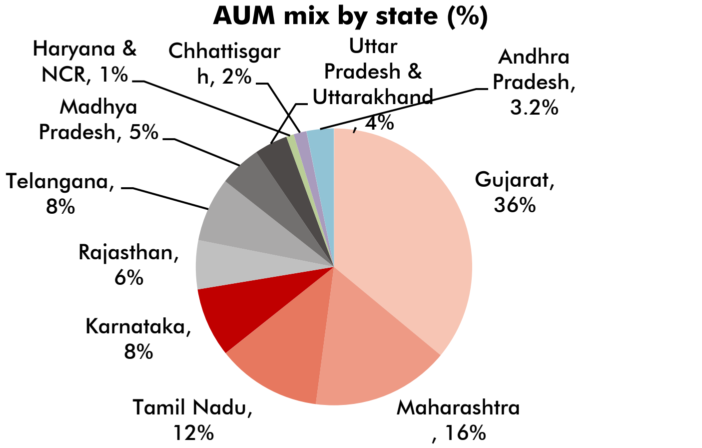


Source: Ambit Capital research, company

Gujarat-based. Urban-focused. South/west to be the core markets.

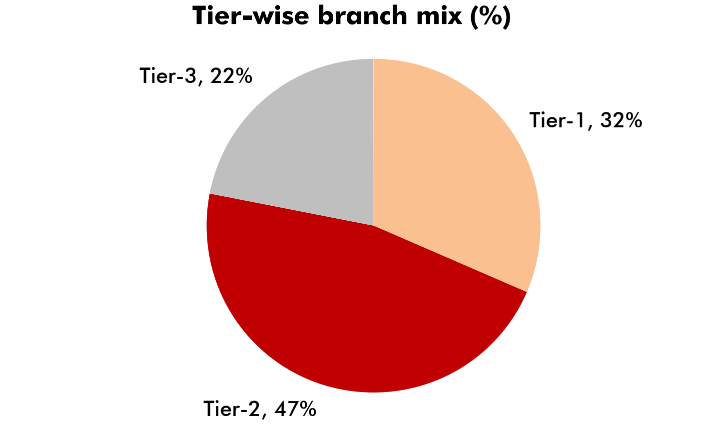
HFFC is currently present in 11 states with Gujarat accounting for 36% of the total AUM, followed by Maharashtra with 16% share. Focus is on urban centres (tier-1/2 locations: 78% of branches) which have dense population and therefore, offer volumes. The management indicated that its geographical strategy is essentially a trade-off between competitive intensity and opportunity size. Established markets provide large opportunity size but also come with high competition. The management has outlined six states where it wants to focus: Gujarat, Maharashtra, Tamil Nadu, Karnataka, Andhra Pradesh and Telangana. Customer segment is majorly comprised of salaried (72% of AUM), most of whom earn <₹50k monthly.

Exhibit 13: West/south are core markets...



Source: Ambit Capital research, company

Exhibit 14: ...with focus on urban locations

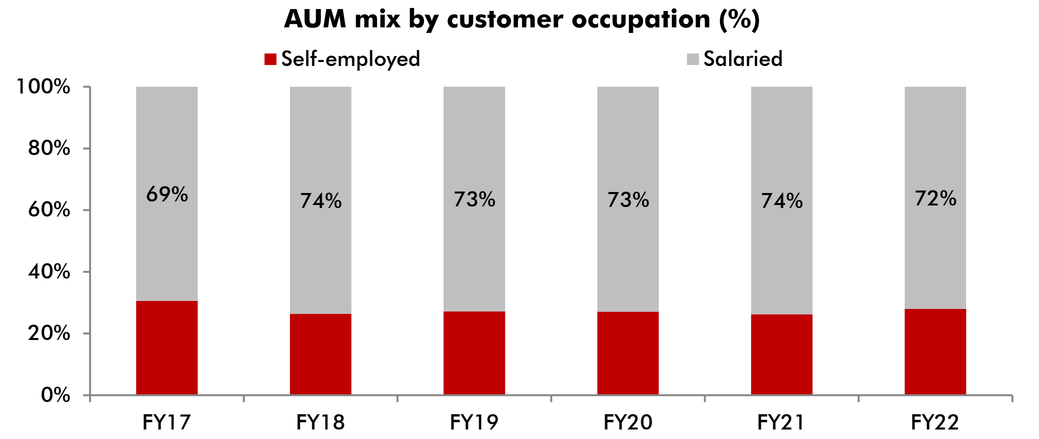


Source: Ambit Capital research, company

Urban inclination has naturally led to salaried-focus

As highlighted in our industry section, share of salaried segment in total working population is higher in urban centres. Accordingly, given HFFC's geographical strategy, the share of salaried segment has been higher.

Exhibit 15: Inclination is higher towards salaried segment (earning <₹50k monthly; un/under-serviced by banks)

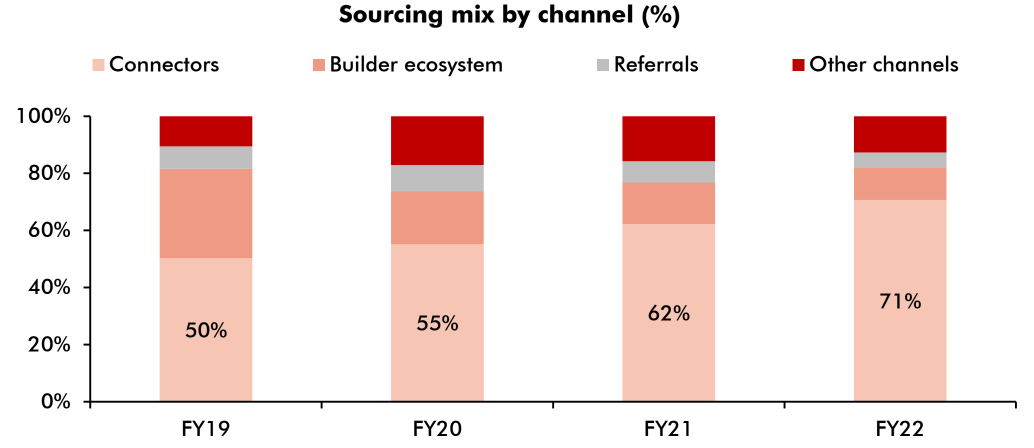


Source: Ambit Capital research, company

Connector-led distribution model is asset-light

A key differentiator is HFFC's connector-led distribution strategy (71% of sourcing). Connectors are various participants in the housing ecosystem, such as builders, hardware store owners, CAs and lawyers to name a few categories. Once a loan referred by them is disbursed, they receive 20-40bps as referral fee.

Exhibit 16: Connectors, a low/variable cost sales infra, dominate sourcing

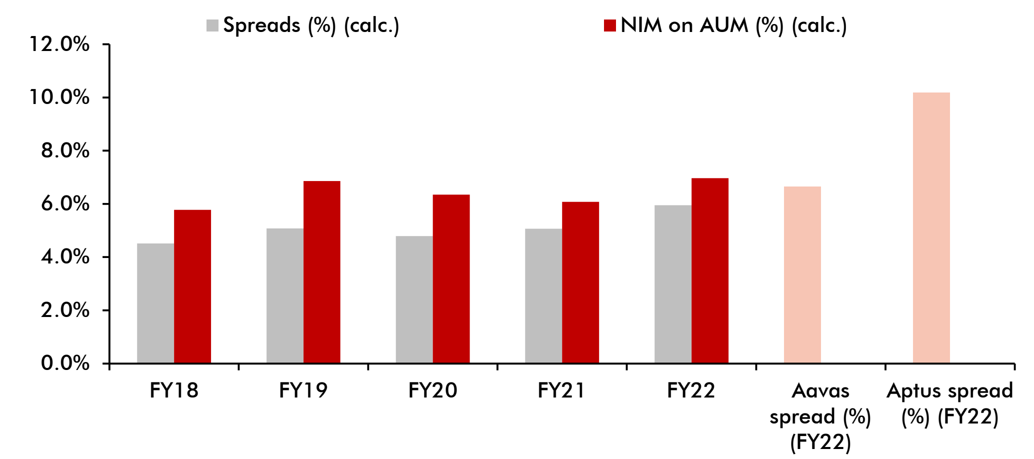


Source: Ambit Capital research, company

On-book spreads are lower than Aavas/Aptus, reflecting higher competition

HFFC's spreads are 70bps/420bps lower than Aavas/Aptus owing to higher competition it faces in urban centres. However, spreads are still higher than banks/large HFCs, reflecting a customer segment which is un/under-serviced by large lenders.

Exhibit 17: Lower spreads than Aavas/Aptus reflect customer/geographical strategy

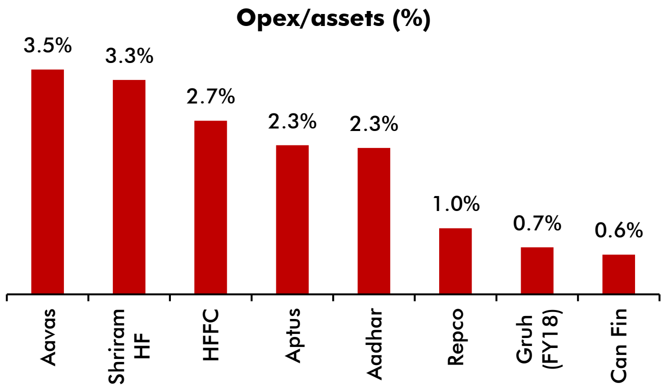


Source: Ambit Capital research, company

Opex ratios at >3% in line with broader industry trend for AHFCs

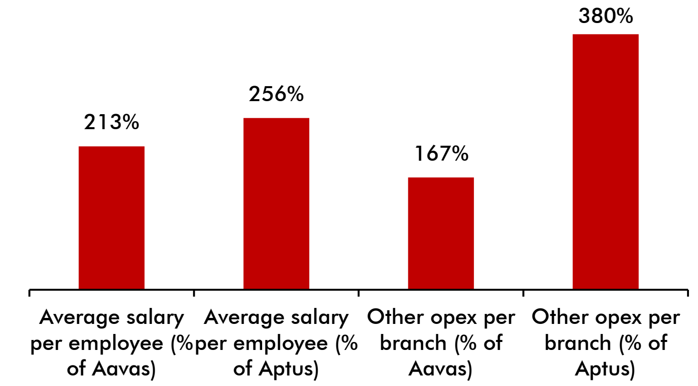
Though HFFC follows an asset/branch-light strategy, operating in ubran centres (high rentals) and hiring MBA graduates add to costs. HFFC's salary per employee is 2.1x/2.6x of Aavas/Aptus. Having said that, a lean business model has led to higher productivity vs Aavas/Aptus. As highlighted before, at HFFC, single RM performs multiple functions (sales, data collection/verification, customer visits, collections). Currently, the company has a network of 101 branches. By end-FY23/FY24, it is expected to increase to 110/130. On account of planned branch expansion over the next two years, coupled with continued high disbursements growth, opex/assets is expected to remain elevated at 3-3.2%.

Exhibit 18: HFFC's opex ratio is at the higher end



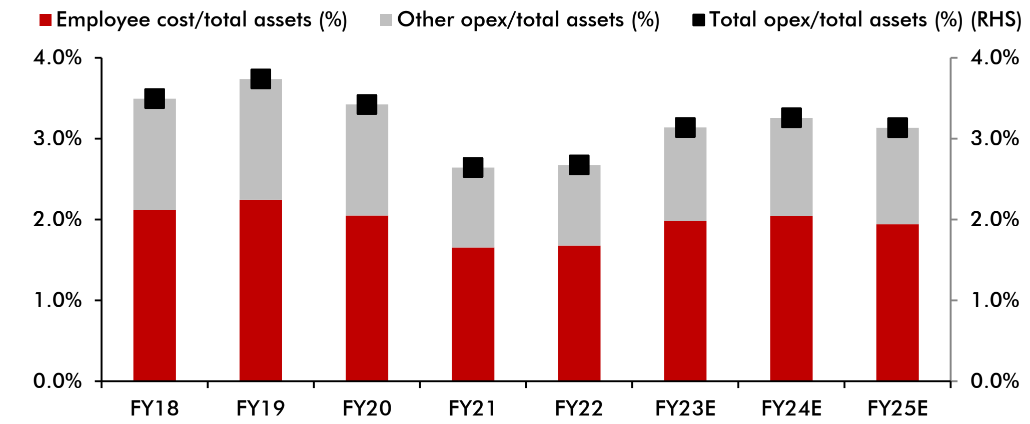
Source: Ambit Capital research, companies

Exhibit 19: Absolute expense levels are higher than peers



Source: Ambit Capital research, companies

Exhibit 20: New business acquisition and branch expansion will keep opex ratios elevated

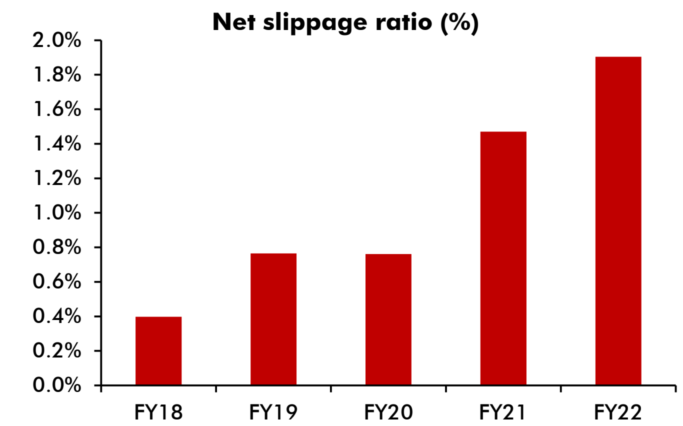


Source: Ambit Capital research, company

HFFC's underwriting is backed by data-science

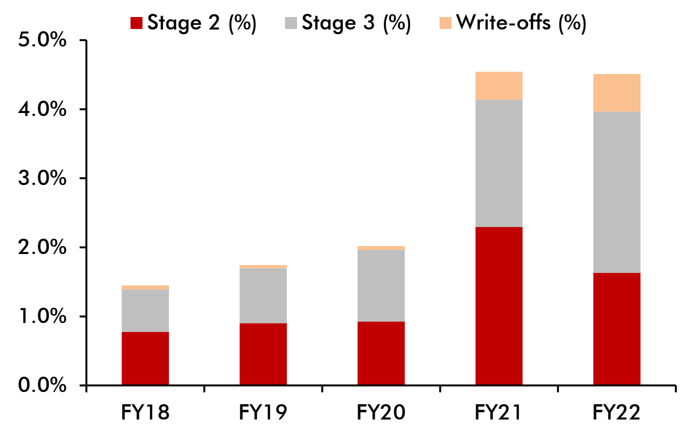
As highlighted earlier under business processes, HFFC's has a tech-enabled value chain. In the underwriting function, the company uses proprietary ML credit scoring models backed by >100 data points on a customer, which helps in assessing creditworthiness. However, we note that stress formation for the company has been higher than peers, resulting in average credit costs of 60bps (FY18-22), higher than peers. The company follows conservative stress recognition practices. HFFC's restructuring was lower, at 0.4% vs 1.5% for Aavas (FY22).

Exhibit 21: Average net slippage ratio is >2x of Aavas/Aptus/Aadhar/Can Fin; lower than Repco



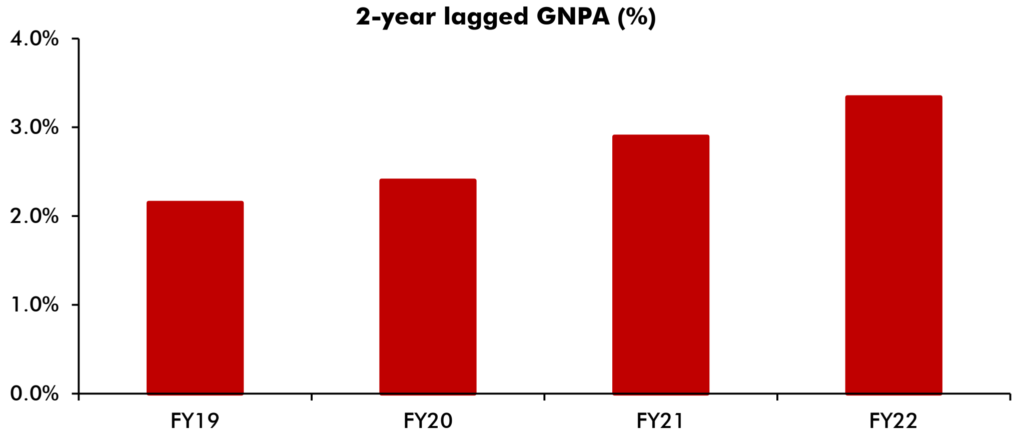
Source: Ambit Capital research, company

Exhibit 22: Total stress accentuated likely due to Covid impact on customers



Source: Ambit Capital research, company

Exhibit 23: Even on lagged basis, NPAs have been increasing



Source: Ambit Capital research, company

Large spreads and improving efficiency have aided operating margins

Over FY18-22, a combination of NIM expansion and improving efficiency ratios have aided operating profit margin expansion. While credit costs have also increased during this period, it has not held back improvement in net profitability. FY22 ROA/ROE was 3.9%/12.6%. The company is targeting ROE of 15% by FY25E.

Exhibit 24: Declining NIMs amid rising CoF/inability to pass on rates and increasing opex will dent PPOP margins

Du-pont analysis (%)	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
NII (NIM)	3.8%	3.8%	4.0%	4.4%	5.4%	6.8%	6.5%	5.9%	6.9%	7.1%	6.9%	6.6%
Other income	2.5%	2.1%	1.5%	0.4%	0.4%	0.7%	1.1%	0.9%	1.0%	1.1%	1.1%	1.1%
Net operating income	6.3%	5.9%	5.4%	4.7%	5.8%	7.5%	7.6%	6.8%	7.9%	8.2%	8.0%	7.7%
Opex	5.0%	4.2%	3.3%	3.2%	3.5%	3.7%	3.4%	2.6%	2.7%	3.1%	3.3%	3.1%
Operating profit	1.3%	1.7%	2.1%	1.5%	2.3%	3.8%	4.2%	4.2%	5.2%	5.0%	4.7%	4.6%
Credit cost	0.0%	0.3%	0.2%	0.2%	0.2%	0.4%	0.6%	0.8%	0.5%	0.3%	0.4%	0.4%
PBT	1.3%	1.4%	1.9%	1.3%	2.1%	3.4%	3.6%	3.4%	4.7%	4.7%	4.3%	4.1%
Tax	0.0%	25.0%	33.3%	35.5%	34.1%	30.0%	25.9%	25.3%	17.8%	22.0%	22.0%	22.0%
PAT (ROA)	1.3%	1.0%	1.3%	0.8%	1.4%	2.4%	2.7%	2.5%	3.9%	3.7%	3.4%	3.2%
Leverage (x)	2.1	2.9	3.7	3.4	3.7	4.5	4.1	3.5	3.3	3.5	3.9	4.5
ROE	2.7%	3.0%	4.7%	2.9%	5.1%	10.8%	10.9%	8.7%	12.6%	12.8%	13.2%	14.4%

Source: Ambit Capital research, company

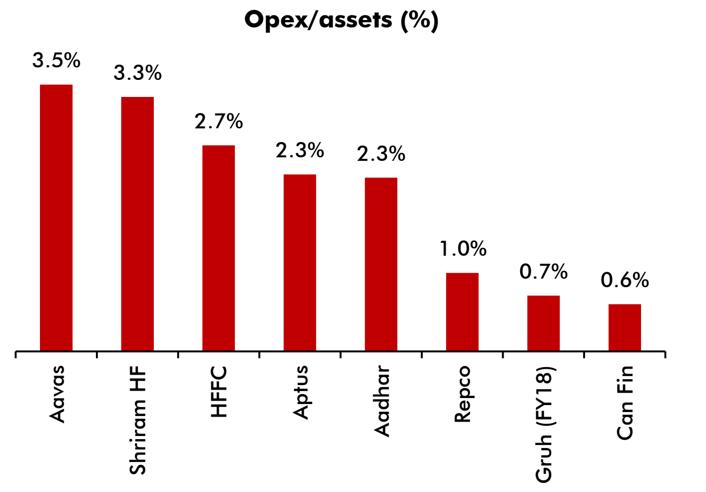
High-growth mode, expansion to keep opex elevated

We expect opex/assets to increase to 3.3% by FY24E due to planned branch expansion. Being in a high-growth mode, opex will continue to grow at a rapid pace. We also note that HFFC's per unit cost of growth infra is >2x of Aavas/Aptus. This is likely due to urban focus which entails higher rentals and salaries. This in turn makes high productivity imperative. However, like many other HFCs, HFFC too has seen a deteriorating trend in productivity. Operating in a competitive market also presents BT risks, which in turn can result in high opex in order to achieve a targeted level of AUM growth.

Lower productivity, urban focus have to lead to high opex ratios

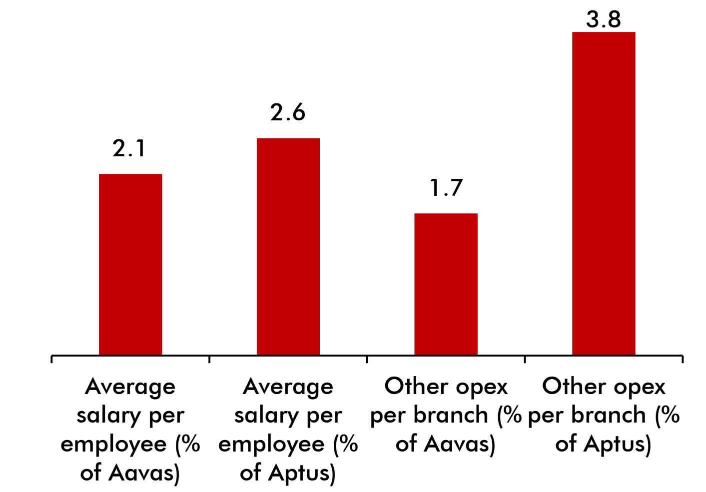
HFFC's opex/assets (2.7% in FY22) is lower than Aavas (3.5%) but higher than large HFCs/Gruh. Despite relying on connectors and digital/virtual branches for sales (outsourced originations) and a centralized system for credit/disbursals, HFFC's opex ratio is relatively high. We attribute this to lower productivity and urban focus which adds to the cost as salaries/rentals in such regions are higher. HFFC's salary per employee is 2.1x/2.6x of Aavas/Aptus given that the company hires MBA fresh graduates directly from campuses.

Exhibit 25: HFFC's opex ratio is at the higher end



Source: Ambit Capital research, companies

Exhibit 26: Absolute expense levels are 1.7-3.8x of peers

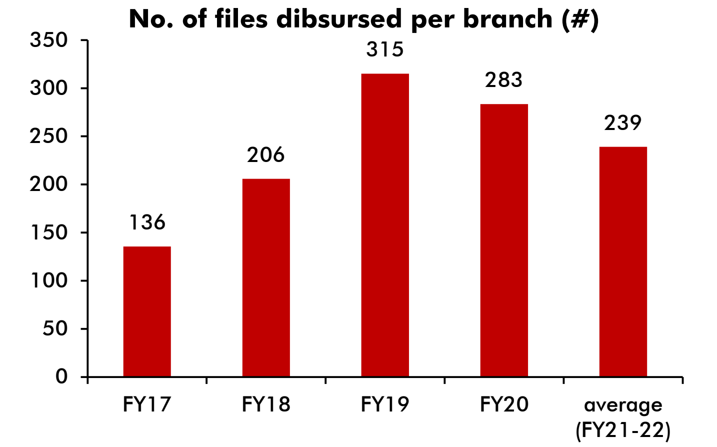


Source: Ambit Capital research, companies

Productivity has been deteriorating

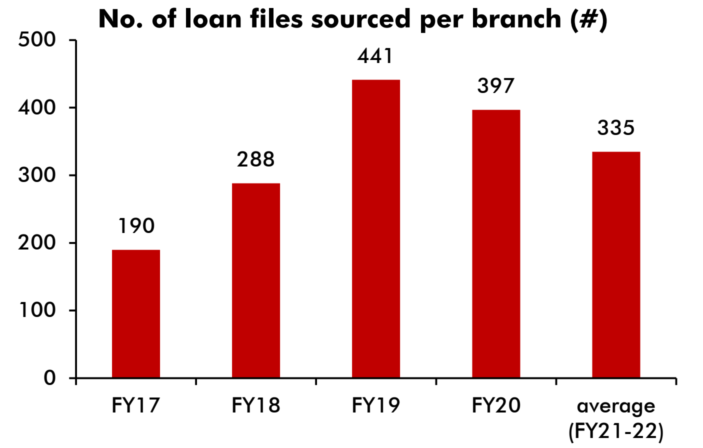
In context of our discussion (industry section) on deteriorating files sourcing/disbursal per branch, HFFC is no stranger to declining productivity levels. Despite having a strong tech front/back-end, numbers of files sourced per branch has declined after peaking in FY19 (pre-Covid). Despite allowing sufficient period for maturity (branch network up 33% in 3 years), productivity has declined. Over FY22-25E, as branch network expands, we do not expect productivity levels to improve as new branches take time to mature.

Exhibit 27: Disbursement productivity has been declining…



Source: Ambit Capital research, company

Exhibit 28: …and so is the sourcing productivity

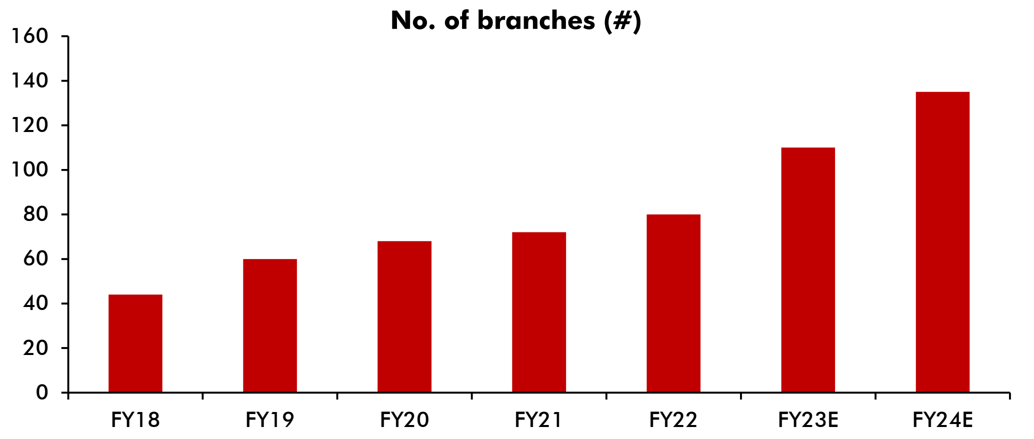


Source: Ambit Capital research, company. Sourced files based approval/rejection rates disclosed by each company

New business acquisition and branch expansion to keep opex elevated

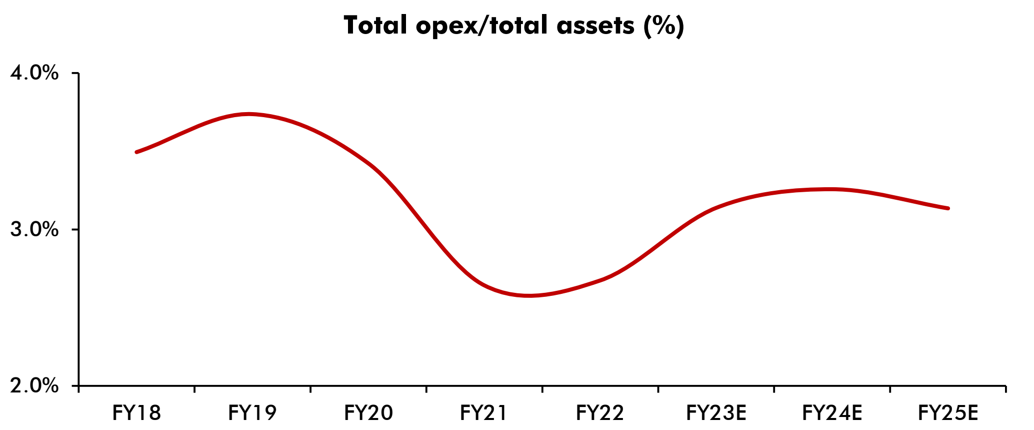
In the near to medium-term, we expect opex/assets to inch up to 3-3.3% as the company is planning to undertake branch expansion (expect 130-140 branches by end-FY24 vs 80 as of FY22). Further, strong disbursements growth will also add to opex.

Exhibit 29: HFFC plans to have 140 branches by end-FY24



Source: Ambit Capital research, company

Exhibit 30: Opex/assets expected to increase to 3.2% over the medium term

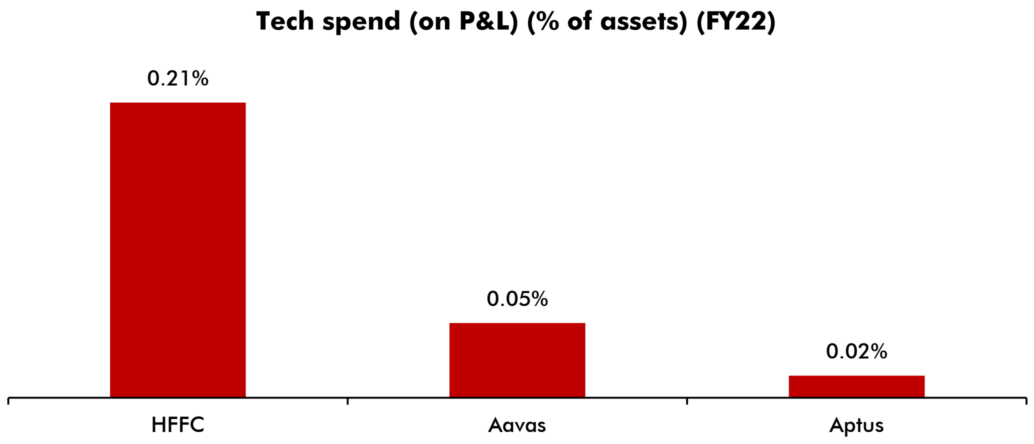


Source: Ambit Capital research, company

Where is the benefit of tech in operations?

We question this because opex ratios are only a notch lower than Aavas, which has been most aggressive in making investments. We also see declining productivity as a concern, especially as the company strives to be a tech-based player.

Exhibit 31: Despite high tech spends, there is no visible benefit as opex ratios are not materially lower than Aavas



Source: Ambit Capital research, company

Competition will drive margins lower

HFFC's focus on urban markets implies higher competition. Historically, lenders focusing on such markets (LIC HF/HDFC/banks) have earned spreads of 1.1-2.5%. While HFFC maybe catering to a neglected customer segment, it does not have any locational advantage. Over the long term, eroding information asymmetry with respect to customers will drive down pricing premium. Hence, we believe that HFFC faces higher competition vs peers. Further, we also see near-term spread/NIM headwinds as rate hike pass on is unlikely despite cost of funds increasing. Over FY22-25E, we expect spreads/NIMs to decline by 48bps/77bps to 5.1%/6.2%. In light of competitive pressure on spreads/NIMs, we see ROA dipping 64bps to 3.2% by FY25E.

No benefit of rising rate cycle

HFFC is in a peculiar situation, where despite having higher share of floating rate loans, we expect it to face higher spread compression vs Aavas/Aptus (77bps vs 36-76bps for Aavas/Aptus over FY22-25E). The reason is that the company did not pass on the benefit of a downward rate movement to customer in the last cycle. As a result, even though cost of funds is increasing, HFFC will be unable to fully transmit/pass on the rate increases to customers. We highlight management commentary on this topic below:

Exhibit 32: Excerpt from 1QFY23 earnings call

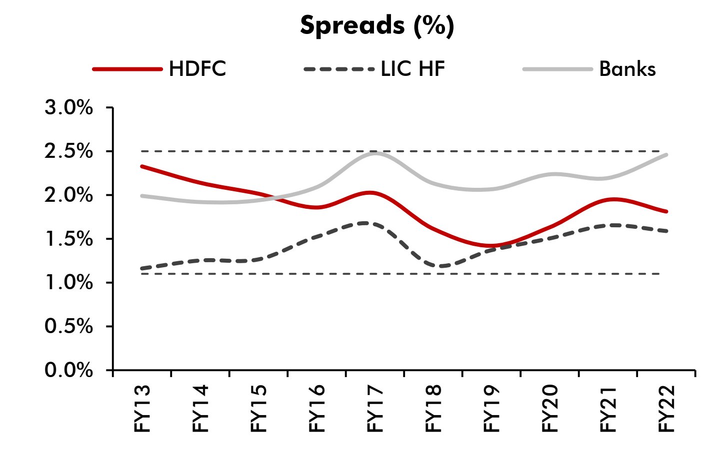
Participant's question	On the margin front or spread front again, so Manoj just mentioned that post full transmission we could see a spread of around 5.25%. Is it fair to assume that we will not be able to pass on the entire rate hike to our borrowers, the cost of fund hike to our borrowers given that we did not pass it on in the downcycle as well?
Management answer	It is a fair practice since we have not passed on the full benefit, we are also looking at absorbing some of it but we will have to see how it plays out and how much the real transmission or the total transmission is and we will take a call on that basis.

Source: Ambit Capital research, company

Competitive landscape to ensure spreads/margins head south

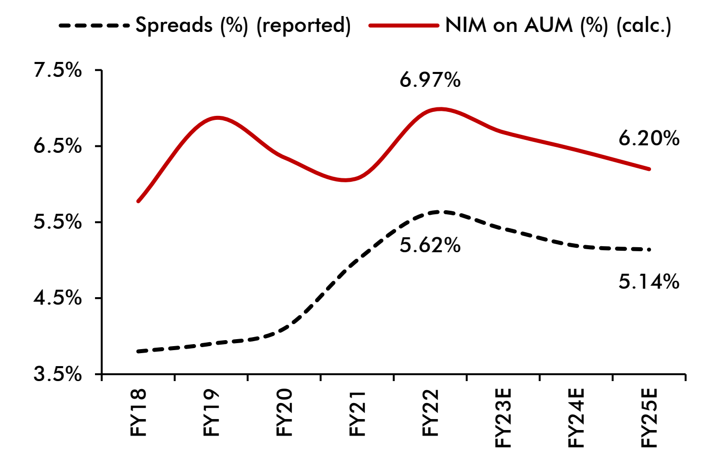
Historical experience of lenders operating in urban markets indicates that competition drives down spreads. We see similar risks playing out for HFFC over the long term given that it primarily operates in urban markets. As credit information asymmetry erodes over time, HFFC will face higher competitive pressure on pricing.

Exhibit 33: Urban-focused lenders have seen lower spreads



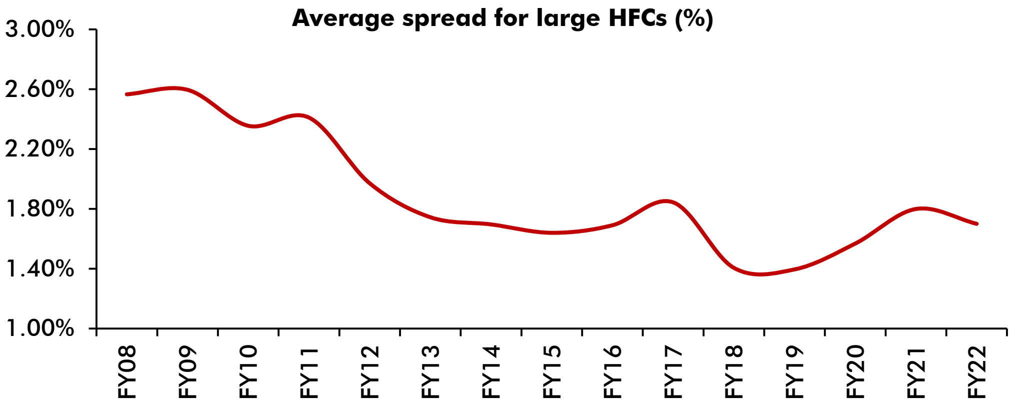
Source: Ambit Capital research, company

Exhibit 34: HFFC faces spread/NIM decline in the near-term



Source: Ambit Capital research, company

Exhibit 35: A longer-term perspective on how average spreads have declined for large HFCs due to competition

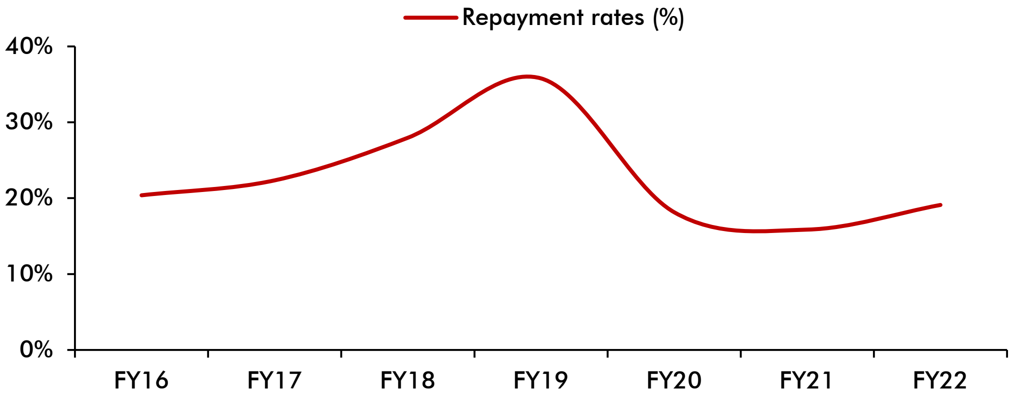


Source: Ambit Capital research, company. Note: Average of HDFC and LIC HF

Competition-led prepayment will impact back-book margins

Prepayments do not only impact AUM growth, but margins too. As HFFC gains scale and faces higher competition from other low-cost lenders, it is likely to face a growth/NIM trade-off. More importantly, besides facing competitive pricing pressure on new originations, BT pressure will impact pricing/margins on the back-book.

Exhibit 36: Like most other HFCs, HFFC too faced BT pressure in FY22 due to aggression from banks

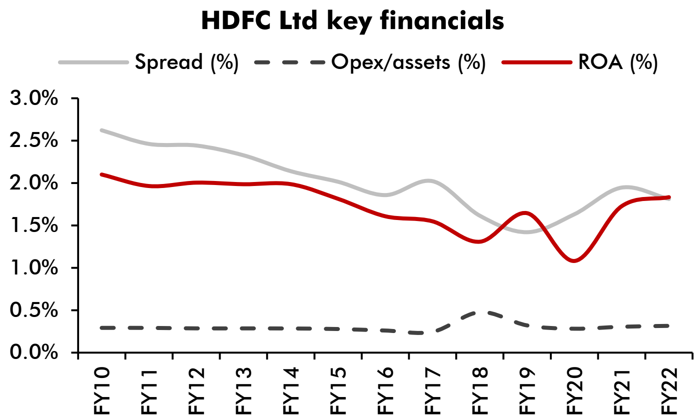


Source: Ambit Capital research, company

Efficiency improvement is limited, competition is forever

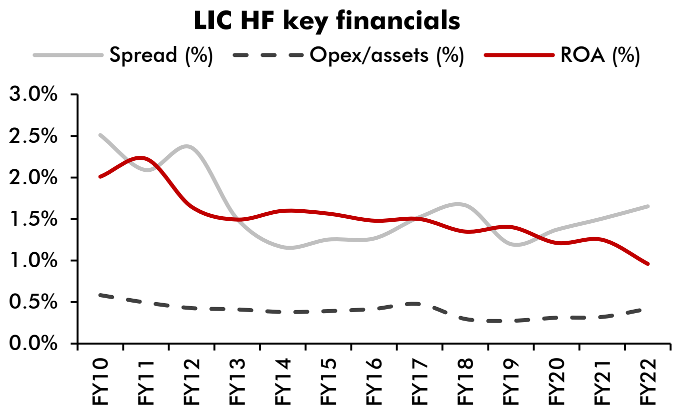
Even if we assume a blue sky scenario that in the long-term efficiency improvement will eventually play out, long-term ROA is destined to decline as indicated by HDFC/LICHF's experience.

Exhibit 37: Despite competitive CoF, ROA has declined…



Source: Ambit Capital research, company

Exhibit 38: …and so is the case with LIC HF



Source: Ambit Capital research, company

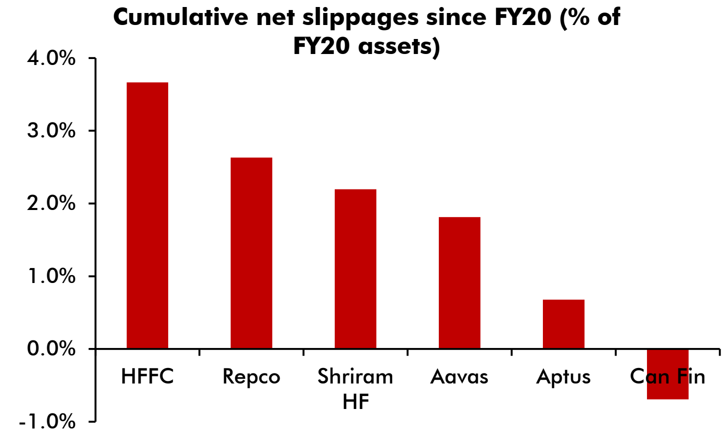
Asset quality experience not pleasant

HFFC's delivery on asset quality has been weaker than peers. We say this because new stress formation (during Covid period) and average net credit costs (60bps over FY18-22) have been higher than peers. Hence, we are building 44bps average credit cost over FY23-25E. A typical RM at HFFC handles sales, customer data collection/verification and collections. Industry interactions indicate separate functions are preferred so as to align incentives.

Stress formation has been higher than peers

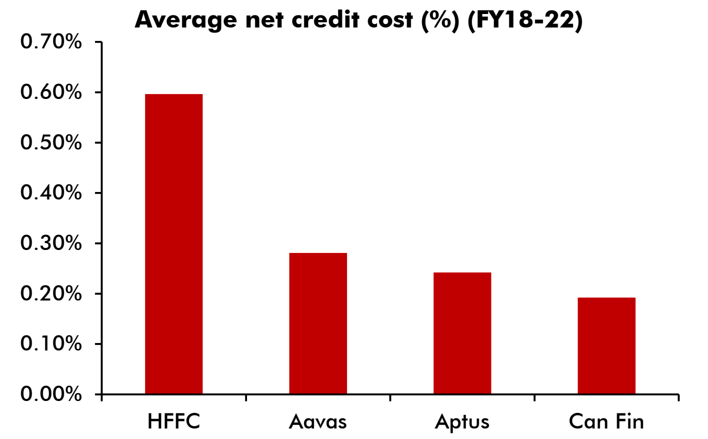
HFFC has seen higher stress vs peers as indicated by cumulative net stress formation since FY20. As a result, average net credit costs (FY18-22) has also been higher.

Exhibit 39: Stress formation has been the highest for HFFC through the pandemic period…



Source: Ambit Capital research, companies

Exhibit 40: …resulting in higher average net credit costs compared to peers



Source: Ambit Capital research, companies

Credit costs to remain elevated

We are factoring average credit costs of 44bps (FY23-25E) for HFFC owing to weaker asset quality as indicated by higher slippage ratio as well as higher overall stress levels.

Exhibit 41: Expect credit costs to be higher vs peers

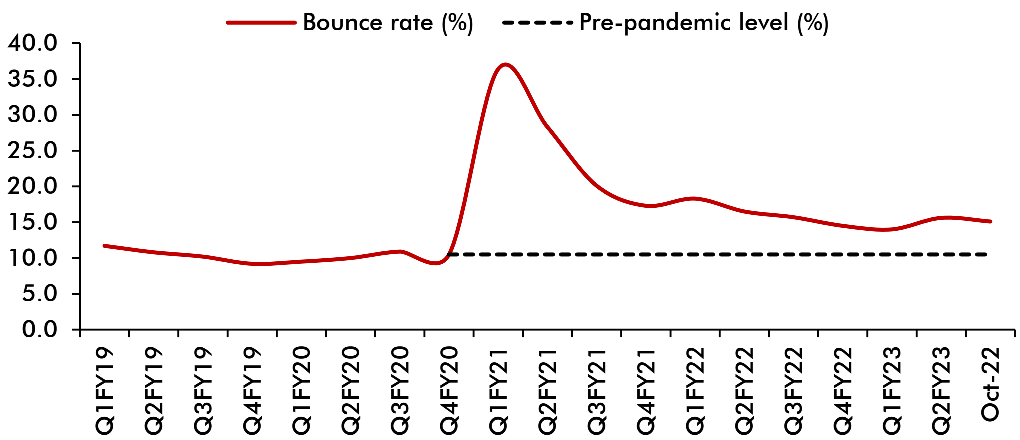
Asset quality	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
Gross stage 2 (%)	0.9%	0.9%	2.3%	1.6%	1.4%	1.4%	1.4%
Gross stage 3 (%)	0.8%	1.0%	1.8%	2.3%	1.8%	1.7%	1.7%
Total	**1.7%**	**2.0%**	**4.1%**	**4.0%**	**3.2%**	**3.2%**	**3.1%**
ECL coverage - stage 2 (%)	8.3%	12.2%	14.0%	13.0%	14.0%	14.0%	14.0%
ECL coverage - stage 3 (%)	24.9%	25.8%	36.0%	24.9%	27.0%	32.0%	35.0%
Total ECL coverage (%)	**0.6%**	**0.9%**	**1.3%**	**1.1%**	**1.0%**	**1.1%**	**1.2%**
Write-offs (% of AUM)	0.1%	0.1%	0.4%	0.5%	0.1%	0.1%	0.1%
Net slippage (%)			0.4%	0.8%	0.8%	1.5%	1.9%
Net credit cost (% of gross loans)	**0.4%**	**0.6%**	**1.0%**	**0.6%**	**0.4%**	**0.5%**	**0.5%**

Source: Ambit Capital research, company

Industry experience on similar structures has not been good

HFFC currently clubs sales and collections responsibility with the same person. Based on our interactions and observations across industry/business models, we believe domain experts are a necessary requirement. Clubbing sales and collections with the same person may not be an optimal design as neither of the functions would receive laser focus. Worst case would be that sale/growth happens at the cost of poor/dropping collections. While there is no evidence that suggests HFFC's worse off asset quality being a by-product of its business processes, it remains a risk for reasons stated above.

Exhibit 42: Bounce rates will take time to revert to pre-pandemic levels



Source: Ambit Capital research, company

How good are the predictive models?

HFFC's underwriting is backed by data-science, supported by >100 data points around the customer collected since lead generation. HFFC explicitly states that the proprietary credit scoring models bifurcate customers into different risk buckets and help in bounce prediction. Given the current bounce rates (500bps higher than pre-Covid), we question the accuracy of HFFC's bounce predictors.

Valuation ignoring competitive risks

Fair value of ₹601, based on excess earnings (COE: 14%), implies 2.6x/21x FY24E BVPS/EPS, 42%/21% discount to Aavas/Aptus. Against mortgage industry CAGR of 13-14% over FY22-42E, affordable housing financiers are expected to grow 200-300bps higher. This stems from their focus on tier-3/below location as banks have made limited in-roads here. Hence, AHFCs enjoy premium valuations over larger counterparts (large HFCs/NBFCs, banks) due to higher growth runway and specialized nature of operations. Given HFFC enjoys only customer advantage (informal salaried) and no locational advantage, its premium to small/mid-HFCs is lower at 7% vs >30% for Aavas/Aptus. While small base and distinct customer focus will aid 30% AUM CAGR over FY22-25E, we see long-term AUM CAGR (FY25-42E) at 19%. Market is likely underestimating competitive risks to growth and total cost of intermediation.

Exhibit 43: Competitive pressures, inability to pass on rate increases and elevated opex will impact growth/earnings

	FY20	FY21	FY22	FY23E	FY24E	FY25E	Comments
Assumptions							
YoY AUM growth	48.1%	14.4%	29.9%	29.8%	31.8%	27.7%	Expect AUM growth to taper down as base grows larger - in line with historical industry trend. Competition pressures too will impact growth rates as HFFC operates in urban centres.
Yield on AUM (calc.)	12.7%	11.7%	11.5%	11.3%	11.5%	11.5%	In current upward rate environment, yields are unlikely to increase much as the company did not pass on low rate benefit to customers in the last cycle.
Cost of funds (calc.)	8.8%	7.8%	6.6%	7.1%	7.4%	7.4%	In view of current rate scenario, cost of funds will increase.
NIM (calc.)	6.4%	6.1%	7.0%	6.7%	6.5%	6.2%	NIM will decline in view of stagnant yields and increasing cost of funds.
Opex to income (%)	45.2%	38.8%	33.9%	38.4%	40.8%	40.8%	Branch expansion in next 2-3 years will weigh on opex ratios. Opex/income impact magnified due to NIM compression/slower NII growth.
Opex to asset ratio (%)	3.4%	2.6%	2.7%	3.1%	3.3%	3.1%	
Credit cost (%)	0.6%	1.0%	0.6%	0.4%	0.5%	0.5%	Stress formation has been higher vs peers. Hence, assuming higher credit costs.
Output (₹bn)							
AUM	36	41	54	70	92	118	
NII	1.9	2.4	3.3	4.1	5.2	6.5	
Operating profit	1.2	1.7	2.5	2.9	3.6	4.5	
Net profit	0.8	1.0	1.9	2.1	2.5	3.2	
EPS (₹)	10.2	11.5	21.2	24.5	28.9	36.1	
BVPS (₹)	119	158	180	204	233	269	
ROA (%)	2.7%	2.5%	3.9%	3.7%	3.4%	3.2%	
ROE (%)	10.9%	8.7%	12.6%	12.8%	13.2%	14.4%	

Source: Ambit Capital research, company

Our EPS estimates are 8-9% lower than consensus due to increasing opex and elevated credit costs. We expect new branch expansion to keep opex elevated. Further, historically asset quality experience has been unpleasant. Therefore, we expect credit costs to remain elevated.

Exhibit 44: Ambit vs consensus – we estimate earnings to be up to 9% below consensus

₹mn	Consensus estimates			Ambit estimates			Difference (%) (Ambit vs cons.)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Net operating income	4,855	6,124	7,624	4,749	6,030	7,542	-2%	-2%	-1%
PAT	2,213	2,779	3,468	2,144	2,535	3,164	-3%	-9%	-9%
EPS (₹)	25	31	40	24	29	36	-3%	-8%	-9%
BVPS (₹)	203	235	274	204	233	269	0%	-1%	-2%
ROA (%)	3.8%	3.8%	3.6%	3.7%	3.4%	3.2%	-16bps	-41bps	-34bps
ROE (%)	13.1%	14.3%	15.5%	12.8%	13.2%	14.4%	-36bps	-108bps	-116bps

Source: Ambit Capital research, company, Bloomberg

Our TP of ₹601 is arrived at based on assumptions discussed above and assumed cost of equity (Ke) of 14%. Current valuations are stretched in context of the expected near-term earnings trajectory (FY22-25E EPS CAGR: 19% vs AUM CAGR: 30%) as well as long-term AUM/earnings growth potential.

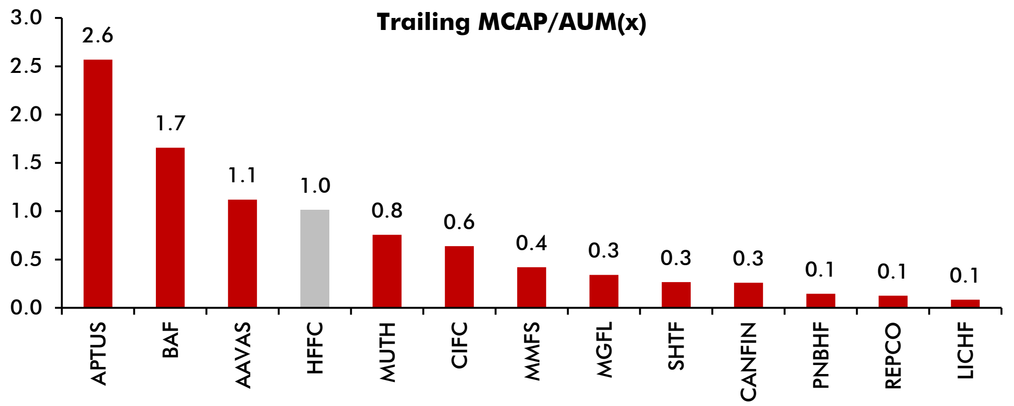
Exhibit 45: Sensitivity of valuations to long-term growth and ROE assumptions

FY26-42E	Bear case	Base case	Bull case	Comments
Average assets growth	17.5%	20.1%	22.4%	In bear case, we are assuming competitive intensity (new business as well as BT) to be higher as arbitrage between banks and HFCs diminishes. In bull case, we are assuming that HFFC will be able to defend against competition and add new scale-accreive products.
Average ROA	2.8%	3.0%	3.2%	Bear case average NIM/credit cost: 5.4%/0.5%. Bull case average NIM/credit cost: 5.9%/0.3%.
Average ROE	14.4%	16.4%	17.2%	
Target price (₹)	**292**	**601**	**928**	
Implied P/E - FY24E	10.1	20.8	32.1	
Implied P/B - FY24E	1.3	2.6	4.0	

Source: Ambit Capital research, company

HFFC enjoys premium valuations over most other NBFCs/HFCs despite having a limited track record and facing high competition. Asset quality delivery has been weaker too.

Exhibit 46: HFFC is trading nearly at the same level as Aavas and above most other NBFCs/HFCs

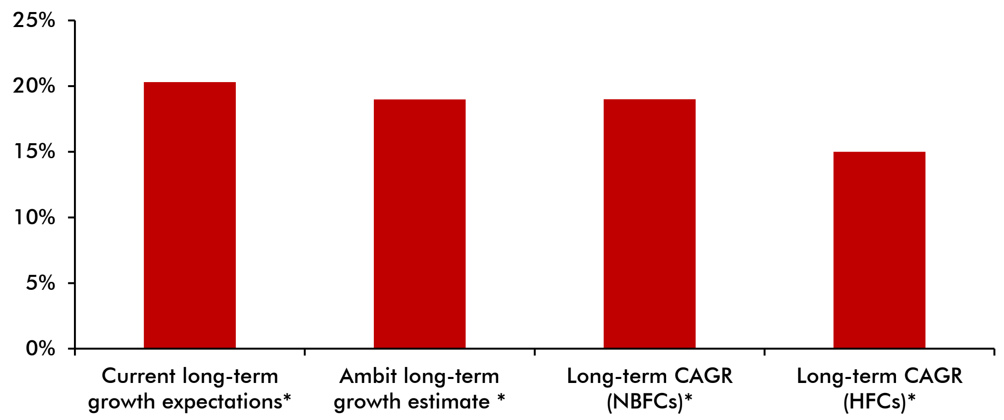


Source: Ambit Capital research, companies

Current valuations pricing in better-than-industry growth prospects

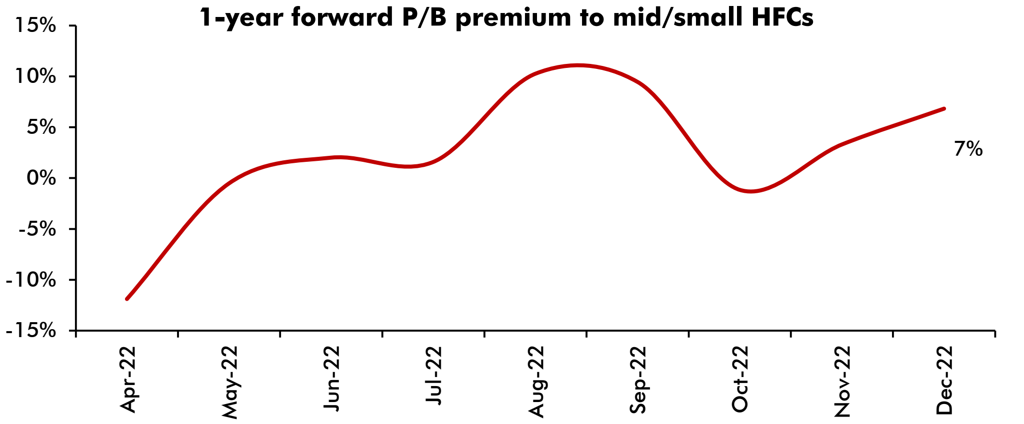
At present valuations, the market is pricing in HFFC to deliver long-term AUM growth higher than industry's historical-best. We think that given the competitive risks, missing on growth expectations is a highly probably event, which can lead to stock de-rating.

Exhibit 47: Current valuations pricing long-term growth 200bps higher than industry's historical best



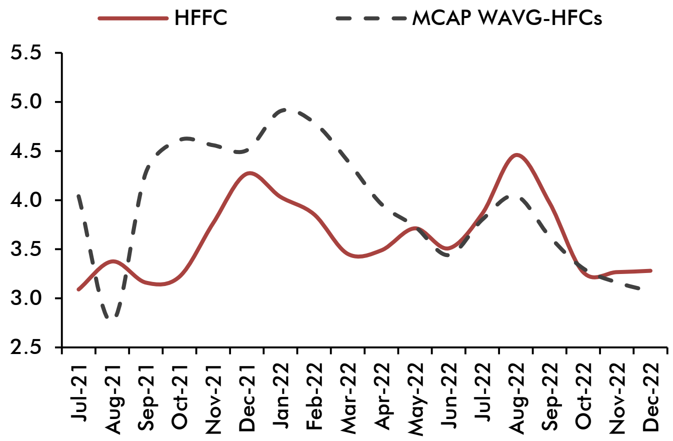
Source: Ambit Capital research, company

Exhibit 48: HFFC's valuation premium to mid/small peers is lower than Aavas/Apus, likely reflecting higher competition



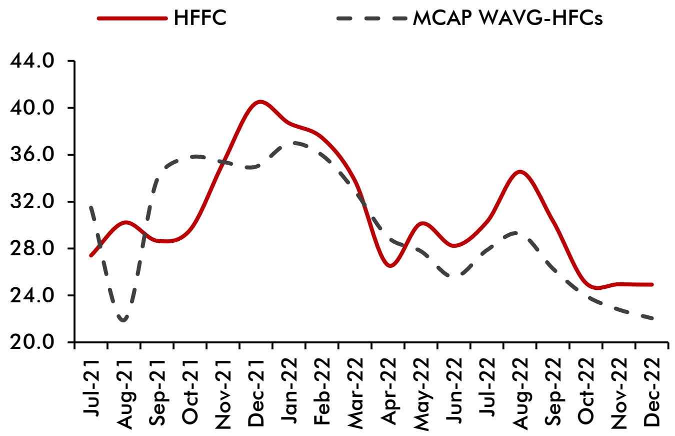
Source: Ambit Capital research, company, Bloomberg

Exhibit 49: HFFC trades at a 7% premium to mid/small HFCs on 1-year fwd P/B



Source: Ambit Capital research, company, Bloomberg

Exhibit 50: HFFC trades at a 13% premium to mid/small HFCs on 1-year fwd P/E



Source: Ambit Capital research, company, Bloomberg

Risks & catalysts

Risks

Growth rates sustain or improve: We are currently expecting AUM growth rate to decline to 28% by FY25E from >30% currently. On long-term basis, we expect increasing competition to impact new business generation as well as repayment rates, resulting in further slowing down of growth rates. If HFFC is able to manage competitive pressure/customer retention/launch new products, growth rates may not decline as much as we expect.

Better asset quality: We are currently building higher credit costs (44bps vs 31bpsfor Aavas) as stress formation has been higher for the company. If HFFC can control its slippage rates and improve on its recoveries, it could warrant lower credit costs, thus aiding profitability.

NIMs sustain or improve: We are currently building 77bps NIM contraction by FY25E due to competitive pressures, rising cost of funds, inability to fully transmit systemic rate movements. If the company is able to manage pricing better, NIMs may not contract as much as we expect.

Catalysts

Limited rate transmission: HFFC's ability to pass on rate hikes in the current upward rate cycle is limited as it did not pass on the benefit of lower rates. Therefore, as cost of funds increases, we expect NIMs to decline by 23bps in FY24E.

Elevated opex ratios: HFFC's opex/assets will increase to 3.3% in FY24E due to new business growth and branch expansion.

Exhibit 51: Explanation of our flags on the cover page

Segment	Score	Comments
Accounting	GREEN	We do not find anything unusual in the company's accounting policies and believe reported numbers are a true reflection of performance.
Predictability	GREEN	HFFC has met consensus earnings.
Earnings Momentum	GREEN	In the past six months, consensus has upgraded its FY23E EPS estimates by 3%. FY24E EPS is flat.

Source: Ambit Capital research, company

Financials

Income Statement

Particulars (₹mn)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net interest income	**1,925**	**2,357**	**3,317**	**4,131**	**5,220**	**6,494**
Non-interest Income	334	360	484	618	809	1,048
Total Income	**2,258**	**2,718**	**3,800**	**4,749**	**6,030**	**7,542**
Total opex	**1,020**	**1,056**	**1,287**	**1,825**	**2,461**	**3,074**
Employee Expenses	611	661	808	1,154	1,543	1,903
Other Expenses	409	394	479	671	918	1,171
Pre provision profit	**1,238**	**1,662**	**2,513**	**2,924**	**3,569**	**4,468**
Provisions	165	322	250	176	318	411
Profit before tax	**1,073**	**1,340**	**2,263**	**2,749**	**3,251**	**4,057**
Tax	278	339	402	605	715	893
PAT - Standalone	**796**	**1,001**	**1,861**	**2,144**	**2,535**	**3,164**

Source: Ambit Capital research, company

Balance Sheet

Particulars (₹mn)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net worth	9,334	13,805	15,737	17,881	20,416	23,581
Borrowings	24,938	30,537	34,668	46,281	64,100	84,612
Total liabilities	**34,802**	**45,102**	**51,169**	**65,131**	**85,969**	**110,140**
Loans (on-book)	30,139	33,265	43,049	55,980	73,733	94,086
Cash & investments	3,676	10,549	6,678	7,405	9,935	13,115
Other assets	987	1,288	1,442	1,746	2,301	2,939
Total assets	**34,802**	**45,102**	**51,169**	**65,131**	**85,969**	**110,140**
AUM	**36,184**	**41,411**	**53,803**	**69,828**	**92,038**	**117,543**

Source: Ambit Capital research, company

Key ratios

Particulars (%)	FY20	FY21	FY22	FY23E	FY24E	FY25E
AUM growth (%)	48.1	14.4	29.9	29.8	31.8	27.7
Disbursements growth (%)	2.9	-32.2	85.2	37.8	21.8	20.8
EPS growth (%)	40.7	12.8	85.3	15.2	18.3	24.8
Net interest margin (NIM) (%)	6.4	6.1	7.0	6.7	6.5	6.2
Cost to income (%)	45.2	38.8	33.9	38.4	40.8	40.8
Opex (% of AAUM)	3.4	2.7	2.7	3.0	3.0	2.9
Gross NPAs (%)	1.0	1.8	2.3	1.8	1.7	1.7
Credit costs (% of AAUM)	0.6	1.0	0.6	0.4	0.5	0.5
Provision Coverage (%)	25.8	36.0	24.9	27.0	32.0	35.0
Tier-1 (%)	48.0	55.8	58.0	51.1	44.2	39.9
Leverage (x)	4.1	3.5	3.3	3.5	3.9	4.5

Source: Ambit Capital research, company

Valuation

Particulars	FY20	FY21	FY22	FY23E	FY24E	FY25E
BVPS (₹)	119	158	180	204	233	269
EPS (₹)	10.2	11.5	21.2	24.5	28.9	36.1
ROA (%)	2.7	2.5	3.9	3.7	3.4	3.2
ROE (%)	10.9	8.7	12.6	12.8	13.2	14.4
P/E	71.1	63.0	34.0	29.5	25.0	20.0
P/BV	6.1	4.6	4.0	3.5	3.1	2.7

Source: Ambit Capital research, company

Annexure I: Management team well experienced in lending business

The management team is led by CEO Manoj Viswanathan, who has spent considerable amount of time in Citi's retail lending. The management team (listed below) carries depth as all are experienced in the role-relevant consumer finance/lending business domains. The company has dedicated heads for south/west markets given they are strategically important. Management owns around 5-6% of the company.

Exhibit 52: Management team well experienced in lending industry. Total KMP remuneration is 2.1% of PBT.

Name	Designation	Background/work-ex	Remuneration (₹mn)	% of PBT
Manoj Viswanathan	MD & CEO	Ex-Citi, where he was heading branch-based consumer lending business.	18.8	1.0%
Ajay Khetan	Chief Business Officer	22 years of experience in consumer finance, operations and risk management. Past work-ex includes Macquarie Finance, HP Financial Services, CitiFinancial Consumer Finance.		
Gaurav Mohta	Chief Marketing Officer	19 years of experience in consumer finance, marketing and product management. Past work-ex includes Kotak Mahindra Bank, CitiFinancial Consumer Finance, Foodworld Supermarkets.		
Vilasini Subramaniam	Head – Strategic Alliances	19 years of experience in consumer finance and credit. She has handled credit udnerwriting, product development, analytics and business strategy. Past work-ex includes Citibank India, Janalakshmi Financial Services, Micro HF.		
Nutan Gaba Patwari	Chief Financial Officer	Qualified CA with >15 years of experience in finance. Past work experience includes True North, HUL, ITC.		
Ramakrishna Vyamajala	Chief HR Officer	16 years of experience in HR, rewards and recognition, compensation and benefits. Past work-ex includes Sterlite Tech and IDFC Bank.		
Abhijeet Jamkhindikar	Business Head - Maharashtra	19 years of experience in construction finance, valuations, technical appraisals and business development.		
Arunchandra Jupalli	Business Head - South	>20 years of experience in consumer lending business handling various products such as consumer durable finance, PL, insurance, GL, LAP. Past work-ex includes Atlantic Duncans, India Office Solutions, CitiFinancial Consumer Finance.		
Ashishkumar Darji	Chief Risk Officer	Risk management professional with 17 years of experience in banking and financial services sector. Experience spans regulatory compliance, risk management and risk modeling. Past work-ex includes KPMG, SBI, Kotak Securities.		

Source: Ambit Capital research, company

Annexure II: High board representation by independent directors

Board is a mix of independent directors and PE-nominees. Chairman is a very well experienced financial services industry veteran. As indicates below, most board members have relevant industry experience.

Exhibit 53: Substantial representation by PE nominated directors

Name	Designation	Background/work-ex	Industry experience	Other directorships
Deepak Satwalekar	Chairman and independent director	Ex-HDFC Life MD/CEO and HDFC Ltd MD. Besides HDFC group, has also worked with Infosys and TATA Power. Has experience in housing finance, leadership and strategic planning, finance, business operations.	Yes	2
Manoj Viswanathan	MD/CEO	Ex-Citi, where he was heading branch-based consumer lending business.	Yes	
Geeta Dutta Goel	Independent director	Finance professional. Currently associated with Dell foundation, managing their strategy and implementation.	Yes	1
Anuj Srivastava	Independent director	Co-founder/CEO of Livspace. Previously, was in products/tech at Google.		
Sucharita Mukherjee	Independent director	Co-founder of a neo-bank. Previsouly, co-founded IFMR and Northern Arc Capital.	Yes	1
Divya Sehgal	Nominee director	Representing True North. Currently, partner at True North, leading their investments in financial services.	Yes	
Maninder Singh Juneja	Nominee director	Representing True North. Previously, was group head for ICICI Bank retail banking group.	Yes	
Vishal Gupta	Nominee director	Representing Bessemer. Has extensive experience in consumer internet, fintech and health tech.		
Narendra Ostawal	Nominee director	Representing Warburg. Currently, MD at Warburg, looking at health care and financial services.		1

Source: Ambit Capital research, company

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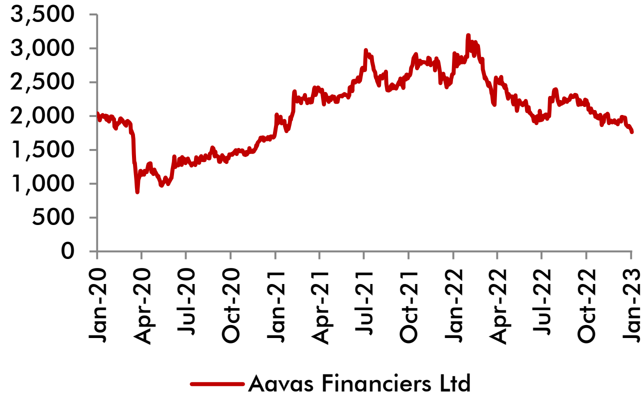
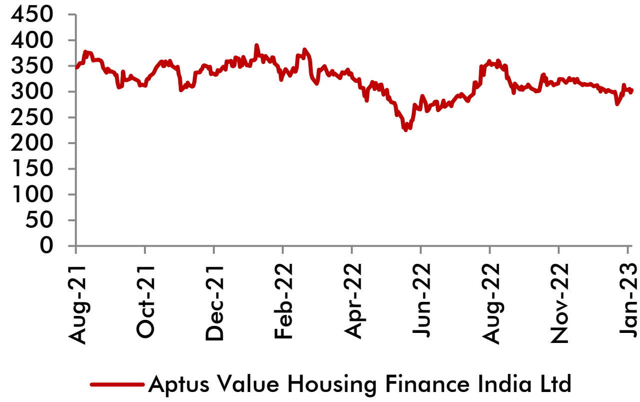
Aavas Financiers (AAVAS IN, BUY)



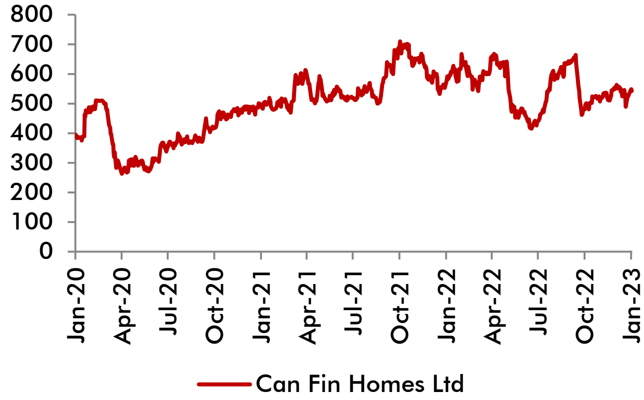
Source: Bloomberg, Ambit Capital research

Aptus Value Housing Finance India (APTUS IN, SELL)



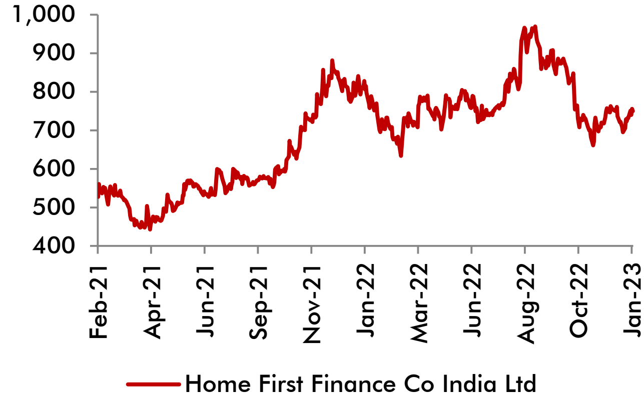
Source: Bloomberg, Ambit Capital research

Can Fin Homes (CANF IN, SELL)



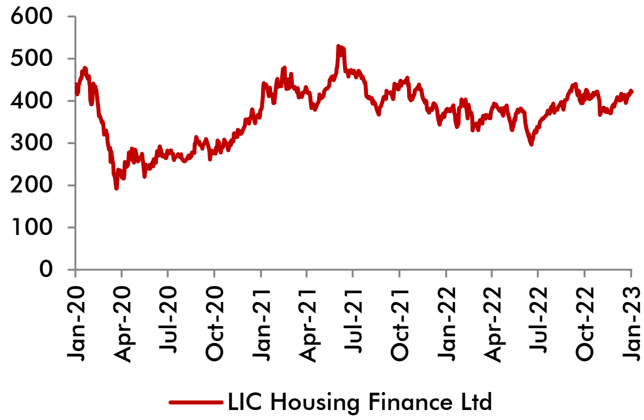
Source: Bloomberg, Ambit Capital research

Home First Finance Co India (HOMEFIRS IN, SELL)



Source: Bloomberg, Ambit Capital research

LIC Housing Finance Ltd (LICHF IN, BUY)



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