fin-sight
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Sameer Kamath, Chief Financial Officer

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- MOFSL conducted its 18th Annual Wealth Creation Study in December, 2013

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Affordable housing finance in India – The emerging opportunity and its critical elements…

Current 'iceberg' nature of this segment…

Not only is housing an indicator of social wellbeing, but it is also a key multiplier in the nation's economic growth, given its linkages with numerous ancillaries. However, most of the housing development so far has largely targeted the high/mid-income population, and there remains a glaring gap between supply and demand for the mid/low-income and informal sector population – the affordable home segment. This is the population group within which most of India resides and where housing needs remain largely unmet. In terms of housing finance, majority of the loans disbursed have naturally been to the high/mid-income groups due to easier availability of proofs for credit assessment. Conversely, the ability to raise finance has been tough for the mid/low-income and informal population. Affordable housing finance is a focus area of the Government now, given its objective of financial inclusion. Recent Budgets stress this commitment, with measures including ECBs for affordable housing projects, special refinancing schemes of NHB, interest deduction of Rs 0.1mn on loans up to Rs 2.5mn, credit risk guarantee fund scheme and Rajiv Awas Yojna subsidies. While the Government estimates the national housing shortage at ~19mn, Monitor Inclusive Markets pegs the shortage at ~22mn for budget homes priced between Rs 0.3-1mn and ~5mn for homes priced between Rs 1-2.5mn. This spells a potential home loan opportunity of ~Rs 8-22tn across the entire spectrum (assuming a lower LTV of 65-70% since HFCs in this segment might be comfortable with a higher commitment from the borrower, given the perceived risks). While this is a long term estimate, even if an inventory of 1mn out of this actually hits the market in the next few years, it means a potential loan opportunity of ~Rs 300-800bn. NHB statistics show that the growth in HFCs' housing loans in recent years have largely been a result of the larger-sized loan segments rather than the smaller-sized loan segments. Given that the smaller-sized segments have lagged, it indicates potential headroom for growth. Moreover, the sizable inventory that is expected to come up in coming years in this segment indicates a significant opportunity exists in this space for HFCs. With only the surface of this segment being scratched by financiers so far, we refer to this as an 'iceberg' scenario.

Identifying this target borrower…

Affordable housing roughly refers to dwellings of 250-800 sq ft area and below a price level of Rs 2.5mn or thereabouts. Assuming housing costs to be typically ~33% of household income and average tenure of 20 years, it indicates households with monthly income within Rs 12,000-60,000. This includes mid/low-income population earning from salary and self-employment. At the other extreme of this population group are people employed in the informal sector, who earn in cash with uneven frequency and often don't possess documentary proofs.

Most are first-time home buyers with numerous queries related to purchasing/financing process, which the HFC should be equipped to handle. There are perceived risks associated with lending to these people, nevertheless, most are genuine home-buyers and committed to repaying their loans, since they would gladly exit their current housing options – which are poorly constructed, with poor sanitation/support-infrastructure and poor social environment for children. Due to these factors, there is already an available buyer base and HFCs do not have to create demand. They just need to ensure their appraisal/collection process function optimally, without slippages.

To ensure that the actual home-buyers benefit, some developers are trying not to sell more than 1 flat per buyer and try to reserve some flats for low-income buyers who often borrow from NBFCs, due to the easier documentation process of NBFCs for low-income buyers

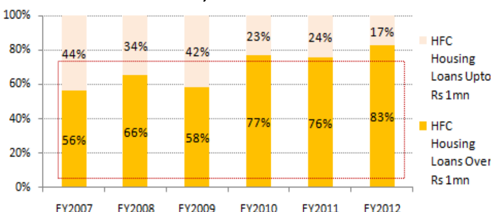
Where are the potential markets…

In terms of markets, the opportunity exists in large cities like Mumbai, Bangalore, Delhi NCR given their high existent demand. Ahmedabad, Indore, Chennai, and even Jaipur, Nagpur, Baroda are evincing interest, which is encouraging. Projects are coming along the Industrial-Corridors like Delhi-Jaipur and Kalyan-Karjat. Over 30,000 units have already been constructed between Jun 2011 and Jan 2013. Of this, ~30% are priced below Rs 0.6mn. With developers like VBHC planning to build 1mn homes in the next 10 years and TATA's Shubh Griha etc announcing projects, the supply run-rate can be expected to pick up going forward.

Initial buyer response to the projects is encouraging. This means buyers are there. Developers just need to create the supply. Some developers are now in their 2nd or 3rd round of projects, and plan to enter Tier 2/3 markets too – a positive sign since it means the commercial viability exists

With the uptick in housing development, the momentum in affordable housing finance has also gained pace. A number of new entrants have joined the earlier incumbents. Most of the new players are regional-focused with operations centered around few states bordering each other. These are typically states with a large population base (to scale up business from fewer locations). Tamil Nadu, Gujarat, Maharashtra, Bihar, Rajasthan, Andhra, West Bengal and UP are some examples. Some micro-housing HFCs have also come up to serve the needs of the informal-low income niche specifically. In terms of home specifications, there is more demand for the 1RK format in Mumbai and Ahmedabad, while 1/2BHK formats are more popular in Indore, Jaipur etc. While the focus is on small formats for affordability (1RK, 1/2BHK), developers also see opportunity in mixed-income projects with units priced across the spectrum as they get sold faster. Given the space constraints, customers prefer the format of more rooms vs. larger rooms, as well as a balance between buildings and open spaces, to best extent possible.

So far, HFCs' housing loans to individuals have remained skewed towards the >Rs 1mn loans, as the focus has been more here…



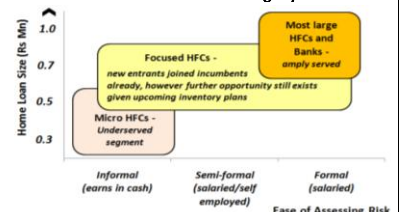
Source: NHB Annual Reports

…as a result, the CAGR in the >1mn category has also been higher

	5 Year CAGR
Upto Rs 0.5mn	-17%
Btwn Rs 0.5-1mn	14%
Over Rs 1mn	32%
Overall	**23%**

Source: NHB Annual Reports

HFC market map and opportunities, based on the loan amount and client category served



Source: Secondary research

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Operational criticalities…

- **Field-based credit assessment**: This is one of the critical elements of the entire enterprise. While risk assessment for salaried clients is a more straightforward process, the process is slightly complicated for those in the self employed and informal categories. For salaried borrowers, it is typically a 2-3 day process involving collection of income/tax proofs, CIBIL credit check, analysis of source of equity/banking behavior, preparation of CAM up to appraisal and approval. However, self employed borrowers do not have consistent monthly income as their earnings are prone to business cycles and can vary month-on-month. Similarly, those in the informal sector may not have income/tax/banking documentation. These people are working in diverse work areas and the income generation capability of each work is different. Hence, credit assessment processes needs to be dynamic. HFCs need to tweak their existing operating models and credit assessment processes to ensure business delivery yet adherence to risk management. They may use field-based credit assessment by visiting the client's place personally to understand the nature of his work, income flow patterns, monthly commitments, savings, his attitude/lifestyle/habits, understand the loan's objective and collect the available documents. The officer needs to do cross-reference checks by personally meeting self-employed applicants' customers, suppliers and competitors to gauge a reasonable profit generated by his business. This includes meeting the applicants' existing creditors - an important part of the process. It may also involve using more than one credit evaluator, if required, either for 2nd opinion or for faster turnaround. Field officers should be able to gauge the client's repayment capabilities and his genuine willingness to repay. Since this is a longer process involving multiple checks, the processing period is longer.
- **Retaining quality credit appraisal staff and training fresh recruits**: Given the relatively complicated process of establishing the viability of lending to low-income or self-employed borrowers, the credit officer's role is extremely critical. The experienced ones with good strike-rates (in terms of bringing in genuine borrowers who repaid in time) might claim a premium for their quality work, hence salary costs as a % to topline needs to be monitored. HFCs might need to benchmark/document the best-practices processes of experienced officers which can help training the newer, fresh recruits who will typically come at a lower price.
- **Early-warning systems in collection process**: After credit appraisal, collection and default monitoring are another key area in this segment from operations' perspective. In cases of borrowers in low-income/informal sector, the repayment frequency can be weekly or fortnightly, instead of monthly. Repayment frequency can be more than monthly also for cases where the income flows are such. MIS systems need to identify cases of slippages and alert the recovery team through early-warning systems. This can ensure better monitoring of the cash flows and faster turnaround for recovery initiation in case of default. During defaults, the credit officer who checked that client is typically involved in the follow-up process with that client by way of personal visits. In cases of genuine difficulty, the loan might be restructured by extending the tenure. However, in situations when no method works, HFC can repossess due to the Sarfaesi Act.
- **Marketing methods to get closer to the 'horse's mouth'**: Affordable housing companies, and in fact most HFCs for that matter, base home-loan counselors at the actual project site itself, so that prospective home buyers can enquire about documentation processes and apply for home loan products at the same time. Other marketing methods include radio/newspaper/online advertising as well as banners behind buses/autorikshaws as these are the platforms where they can best grab the eyeballs of their relevant target client group. Apart from these, many HFCs are also tying up with developers directly to get empanelled as financiers for a particular project.
- **Project risk**: HFCs need to house legal and technical officers to do checks on the property to ensure it is free of litigation, encumbrance etc. Smaller HFCs might often outsource this function to specialist providers. Not only does this help the HFCs to identify clean projects for the viability of its own business, but it also helps the potential home-buyers by giving them a comfort factor in terms of project's risks.
- **The Maths – a 'game of scale'**: Given the involvement/time required in credit appraisal processes in this segment, it can lead to higher operational cost as a percent of revenues as compared to other HFCs. Higher opex means margins might be on the lower side. Hence, this is largely a business of scale – where higher volumes would compensate for lower margins. However, the chase for volumes cannot be at the cost of asset quality, which is where the credit officers' skills holds key. Apart from the promoters' equity, the HFC can also raise funds from banks. Eventual financing from NHB helps access loans at competitive rates. Idle funds are typically kept in liquid/debt funds or bank FDs and an estimate for next month's disbursal is kept in current account. RBI recently allowed developers and HFCs to raise up to USD 1bn through ECBs to access cheaper funds overseas and reduce the overall cost for affordable housing projects. Typically, assuming HFCs to access debt from banks at rates in the range of 11-13%, it means the HFC would lend at 14-16% to earn a spread of 3% or thereabouts.
- **Operating structure – 'hub and spoke' structure might be preferred**: The corporate office divides its target geography into regional units. Each regional unit office is responsible for a number of branches under that area. Regional office will house appraisal and collection staff, as well as an operational team to process the paperwork from branches. The branches, in turn, will interact with the client directly and house credit appraisal and customer service staff. Size of branches would depend on the potential volume in the area. Smaller HFCs operating in a limited area might not need regional unit levels. This hub and spoke structure helps maintain accountability/monitoring of operations yet ensures faster turnaround as compared to structures where everything is routed centrally from the corporate office itself.
- **Guarantor**: Guarantor is important, especially while lending to the informal sector. It mirrors the rationale behind using the group concept in microfinance as a proxy for collateral, since social pressure might get customers to repay loans. An HFC is also working with reputed lenders to provide loan programs based on partial-guarantees. However, garnering a guarantor might be difficult for this target group.

Challenges…

- Access to low-cost funds and the cost of debt is a major challenge in being able to grow the book
- Demand for home finance might be impacted if there are more 'pure investors' purchasing homes rather than 'genuine home-buyers'
- Credit risk assessment, retention of quality credit staff, early warning systems for default monitoring/follow-up are operational challenges
- Higher servicing costs due to more involved nature of credit appraisal can put opex pressures
- Ability to build scale ahead of competitors to ensure profitability in a high opex/lower margin environment
- Lower asset appreciation and less liquid markets in smaller towns/rural areas can lead to difficulty in sale during cases of recoveries
- Timely completion of projects without cost escalations is a key concern facing borrowers and financiers alike.
- Ability to build an enabling environment via faster approvals, support-infrastructure, easier FDI processes, low cost funds, tax incentives etc

Conclusion…

The residential piece constitutes the bulk of the Indian real estate market and affordable housing is set to be a major driving segment in this. While the supply of affordable housing and finance has increased, the gap between supply and demand is still huge, spelling a significant opportunity. Excellence in operational processes like appraisal/collection hold key to the business' success. Access to lower-cost funding and the ability to build scale is a chicken-egg story, since money will not flow to them till they have capacity and without funding, they cannot develop. Tapping the capital markets for funding is a substitute to bank funds, however the ability to deepen the usage of capital markets for this purpose will require closer collaboration between the HFCs, government, rating agencies and investors alike.

Financial service firms who offer an entire gamut of products need to view housing as an essential credit product, as it is a long-duration relationship during which it can sell more products to that captive base, provided the client's experience during the home loan process was positive

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