

2Q earnings in-line; Maintain Buy and PO on risk-return

2Q: REC earnings in-line; Topline and margins surprise

REC reported earnings of Rs6.2bn, flat yoy growth (in-line) driven by topline, including REC taking a FX borrowing MTM hit of Rs1.3bn. Topline grew 22% yoy (5% beat) driven by strong 25% yoy loan growth and margins expanding 8bps yoy (13bps qoq). Disbursement growth weak at 10% yoy, as REC has reduced its lending of lower yielding short-term loans. Asset quality remains stable, with gross at 30bps and net at 25bps. Total CAR stands at 18.1%.

Tweak earnings by <2% for FY12; buffers built-in

While REC surprised on topline, we have cut our earnings by ~2% for FY12 to factor in a moderation in loan growth (~21%) owing to slowing macro. Moreover, our earnings for FY12/13 built in ~25-30bps of loans for FY12/13 factoring in higher NPLs. Margins are likely to hold-up, as REC has ability to raise low-cost resources via ECB / tax-free bonds, that can cushion margins.

Maintain Buy and PO on attractive risk-return

We estimate earnings growth at ~9/20% for FY12/13. Our PO is now at a target PB of 1.6x one-year fwd. (FY13), which is also an average of REC's trading history. We maintain Buy, as risk-return is still attractive, with stock trading at 1.3x FY13 book and RoEs of +21% (RoAs of ~3.0%) and dividend yield of ~5.0%. More importantly, REC has U/p (vs. Sensex) by ~15-16% YTD owing to concerns on asset quality. But Discom's, which are a bone of contention owing to accumulated loss have started raising tariffs for their consumers, which will ease their burden and REC's exp. is more to govt. sponsored co's (90% of loans) where in risk of default remains low, as State govt. will likely bail SEB's out.

Estimates (Mar)

(Rs)	2010A	2011A	2012E	2013E	2014E
Net Income (Adjusted - mn)	20,014	25,699	27,942	33,486	39,775
EPS	23.06	26.03	28.30	33.91	40.28
EPS Change (YoY)	43.0%	12.9%	8.7%	19.8%	18.8%
Dividend / Share	6.11	7.50	8.00	9.50	11.00
Pre-exceptional EPS	23.06	26.03	28.30	33.91	40.28
Pre-exceptional EPS Change (YoY)	43.0%	12.9%	8.7%	19.8%	18.8%
Book Value / Share	122.48	123.48	142.78	166.00	193.91

Valuation (Mar)

	2010A	2011A	2012E	2013E	2014E
P/E	8.5x	7.6x	7.0x	5.8x	4.9x
Dividend Yield	3.11%	3.81%	4.07%	4.83%	5.59%
Pre-exceptional PE	8.53x	7.56x	6.95x	5.80x	4.88x
Price / Book	1.75x	1.52x	1.32x	1.14x	0.984x
RoE / PB	12.50x	14.18x	15.38x	18.49x	22.01x
Price / Pre-Provision Profit	6.44x	5.58x	4.77x	3.88x	3.27x

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Stock Data

Price	Rs196.70
Price Objective	Rs240.00
Date Established	11-Aug-2011
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs155.00-Rs371.95
Mrkt Val / Shares Out (mn)	US\$3,871 / 987.5
Market Value (mn)	Rs194,233
Average Daily Volume	317,304
BofAML Ticker / Exchange	XULEF / BSE
Bloomberg / Reuters	RECL IB / RURL.BO
ROE (2012E)	20.3%
Total Dbt to Cap (Mar-2009A)	NA
Est. 5-Yr EPS / DPS Growth	15.7% / 13.6%
Free Float	33.2%

Key Changes

(Rs)	Previous	Current
2012E EPS	28.75	28.30
2013E EPS	34.06	33.91
2014E EPS	NA	40.28

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Refer to important disclosures on page 7 to 9. Analyst Certification on Page 4. Price Objective Basis/Risk on page 4. Link to Definitions on page 4. 11109297

iQprofileSM Rural Electrification Corporation Ltd

Key Income Statement Data (Mar)

(Rs Millions)	2010A	2011A	2012E	2013E	2014E
Net Interest Income	25,348	32,744	39,841	48,195	57,223
Net Fee Income	1,011	1,076	1,323	1,588	1,906
Securities Gains / (Losses)	NA	NA	NA	NA	NA
Other Income	1,757	2,789	1,649	2,630	3,023
Total Non-Interest Income	2,767	3,865	2,973	4,218	4,928
Total Operating Income	28,115	36,609	42,813	52,413	62,151
Operating Expenses	(1,620)	(1,808)	(2,055)	(2,339)	(2,674)
Pre-Provision Profit	26,495	34,801	40,758	50,075	59,477
Provisions Expense	(2.22)	(2.22)	(2.481)	(3.566)	(4.234)
Operating Profit	26,492	34,766	38,277	46,509	55,243
Non-Operating Income	NA	NA	NA	NA	NA
Pre-Tax Income	26,492	34,766	38,277	46,509	55,243
Net Income to Comm S/Hold.	20,014	25,699	27,942	33,486	39,775
Adjusted Net Income (Operating)	20,014	25,699	27,942	33,486	39,775

Key Balance Sheet Data

Total Assets	695,435	864,900	1,038,124	1,239,451	1,464,417
Average Interest Earning Assets	603,766	764,784	934,611	1,119,307	1,329,432
Weighted Risk Assets	662,105	638,713	816,002	1,031,894	1,302,597
Total Gross Customer Loans	664,526	821,321	992,428	1,188,754	1,411,286
Total Customer Deposits	NA	NA	NA	NA	NA
Tier 1 Capital	106,290	121,932	140,987	163,920	191,476
Tangible Equity	106,290	121,932	140,987	163,920	191,476
Common Shareholders' Equity	110,803	127,886	146,941	169,874	197,429

Key Metrics

Net Interest Margin	4.20%	4.28%	4.26%	4.31%	4.30%
Tier 1 Ratio	16.1%	19.1%	17.3%	15.9%	14.7%
Effective Tax Rate	24.5%	26.1%	27.0%	28.0%	28.0%
Loan / Assets Ratio	95.6%	95.0%	95.6%	95.9%	96.4%
Loan / Deposit Ratio	NA	NA	NA	NA	NA
Oper Leverage (Inc Growth - Cost Growth)	4.2%	18.6%	3.3%	8.6%	4.3%
Gearing (Assets / Equity)	6.3x	6.8x	7.1x	7.3x	7.4x
Tangible Common Equity / Assets	15.3%	14.1%	13.6%	13.2%	13.1%
Tangible Common Equity / WRAs	16.1%	19.1%	17.3%	15.9%	14.7%
Revenue Growth	38.3%	30.2%	16.9%	22.4%	18.6%
Operating Expense Growth	34.1%	11.6%	13.6%	13.8%	14.3%
Provisions Expense Growth	-93.5%	0%	111.811.2%	43.7%	18.7%
Operating Revenue / Average Assets	4.5%	4.7%	4.5%	4.6%	4.6%
Operating Expenses / Average Assets	0.3%	0.2%	0.2%	0.2%	0.2%
Pre-Provision ROA	4.2%	4.5%	4.3%	4.4%	4.4%
ROA	3.2%	3.3%	2.9%	2.9%	2.9%
Pre-Provision ROE	29.0%	29.2%	29.7%	31.6%	32.4%
ROE	21.9%	21.5%	20.3%	21.1%	21.7%
RoTE	18.8%	21.1%	19.8%	20.4%	20.8%
RoWRAs	3.0%	4.0%	3.4%	3.2%	3.1%
Dividend Payout Ratio	26.5%	28.8%	28.3%	28.0%	27.3%
Efficiency Ratio (Cost / Income Ratio)	5.8%	4.9%	4.8%	4.5%	4.3%
Total Non-Interest Inc / Operating Inc	10%	11%	7%	8%	8%
Market-Related Revenue / Total Revenues	0%	0%	0%	0%	0%
Provisioning Burden as % of PPP	0%	0%	6.1%	7.1%	7.1%
NPLs plus Foreclosed Real Estate / Loans	0%	0%	0%	0%	0%
Loan Loss Reserves / NPLs	NA	NA	NA	NA	NA
Loan Loss Reserves / Total Loans	NA	NA	NA	NA	NA
Provisions Expense / Average Loans	0%	0%	0.3%	0.3%	0.3%

Other Metrics

Income / Employee	41.29	54.40	62.23	69.26	74.66
(Operating Expenses) / Employee	2.38	2.69	2.99	3.09	3.21
Pre-Provision Profit / Employee	38.91	51.71	59.24	66.17	71.45
Net Profit / Employee	29.39	38.19	40.61	44.25	47.78

Company Description

REC commenced operations in 1969 for the purpose of developing the power infrastructure in rural areas. It is one of 18 PSUs which have been granted Navratna status. The Company has a consistent earnings growth at 20% CAGR for last 5 years led by volume growth at 25% CAGR. REC holds the highest long-term borrowing domestic credit rating (AAA) from each of CRISIL Limited, ICRA Limited, Fitch and CARE Limited.

Investment Thesis

We have a Buy rating on REC because we believe REC is in a sweet spot owing to: 1) Strong volume growth expected in FY11/12, 2) Exposure limits addressed by applying to IFC status, 3) ALM mismatch sharply lower - positive gap from FY11 onward, 4) High comfort on asset quality, and 5) Well-capitalized with CAR at 20%.

Stock Data

Price to Book Value 1.3x

2QFY12 Results Summary

Table 1: 2QFY12 Results Summary

In Rs mn	2QFY12	2QFY11	yoy growth	Remarks
Income from Operations	25,145	19,877	27%	Led by volume growth of 24% yoy. Disbursement growth at 10% yoy
Interest expenses	15,649	12,076	30%	Led by 25% yoy increase in borrowed funds and cost increasing by 25bps yoy. Includes Rs3.4bn as one time fee on raising \$300mn ECB Loan.
Net Interest income	9,497	7,801	22%	5% above expectations, Margins expanding 8bps yoy and 13bps qoq
Other income	(700)	945	-174%	Fx borrowing MTM hit of Rs1.3bn
Operating income	8,796	8,746	1%	
Operating expenses	456	385	18%	
Pre-provision profit	8,341	8,361	0%	
Provision & contingencies	-	1	NA	Gross NPLs at 30bps and net at 25bps
Pre tax profit	8,341	8,360	0%	
Tax expenses	2,112	2,178	-3%	
Net income	6,229	6,182	1%	Earnings exactly in-line with estimates

Source: BofA Merrill Lynch Global Research estimates

Price objective basis & risk

Rural Electrification Corporation Ltd (XULEF)

Our PO is Rs240. Our PO reflects an average of 1.6x one-year fwd multiple of RECs trading history. But, risk-return is attractive, with RoEs of +21% in FY12/13, stock trading at 1.3x FY13BV. Our PO is at a 10pct premium to Gordon multiples, as structurally power financing remains a growth story over the longer term and we believe REC remains better positioned to capitalize on the growth. REC remains a direct play on the India infra story, in our opinion. Risks are higher exposure to State Electricity Boards (SEBs) in the T&D space that may not be able to increase tariffs resulting in defaults to REC.

Link to Definitions

Financials

Click [here](#) for definitions of commonly used terms.

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India - Financials Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
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	Federal Bank	XFDRF	FB IN	Veekesh Gandhi
	HDFC	HGDF	HDFC IN	Rajeev Varma
	HDFC Bank	XHDF	HDFCB IN	Rajeev Varma
	HDFC Bank	HDB	HDB US	Rajeev Varma
	ICICI Bank	ICIJF	ICICIB IN	Rajeev Varma
	ICICI Bank - A	IBN	IBN US	Rajeev Varma
	IndiaBulls Financial Services	IBLFF	IBULL IN	Veekesh Gandhi
	Indian Bank	INDIF	INBK IN	Rajeev Varma
	LIC Housing Finance, Ltd.	LHFLF	LICHF IN	Veekesh Gandhi
	Manappuram	XMGP	MGFL IN	Veekesh Gandhi
	Max India	XMIXF	MAX IN	Rajeev Varma
	Power finance corporation Ltd	PWFEEF	POWF IN	Veekesh Gandhi
	Punjab	PUJBF	PNB IN	Rajeev Varma
	Reliance Capital	RLCCF	RCAPT IN	Veekesh Gandhi
	Rural Electrification Corporation Ltd	XULEF	RECL IB	Veekesh Gandhi
	SBI	SBINF	SBIN IN	Rajeev Varma
	SBI -G	SBKFF	SBID LI	Rajeev Varma
	Shriram Transport Finance	SHTFF	SHTF IN	Veekesh Gandhi
	Yes Bank Ltd	YESBF	YES IN	Veekesh Gandhi
NEUTRAL				
	Axis Bank	XAXSF	AXSB IN	Rajeev Varma
	Axis Bank - GDR	XBKSF	AXB LI	Rajeev Varma
	Bank of Baroda	BKBAF	BOB IN	Rajeev Varma
UNDERPERFORM				
	Bank of India	XDIIF	BOI IN	Rajeev Varma
	Canara Bank	CNRKF	CBK IN	Rajeev Varma
	IDBI	XDBIF	IDBI IN	Veekesh Gandhi
	Infrastruct Dev	IFDFF	IDFC IN	Rajeev Varma
	Kotak Mahindra Bank	XXRVF	KMB IN	Rajeev Varma
	ORBC	ORBCF	OBC IN	Rajeev Varma
	Union Bank India	UBOIF	UNBK IN	Rajeev Varma

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

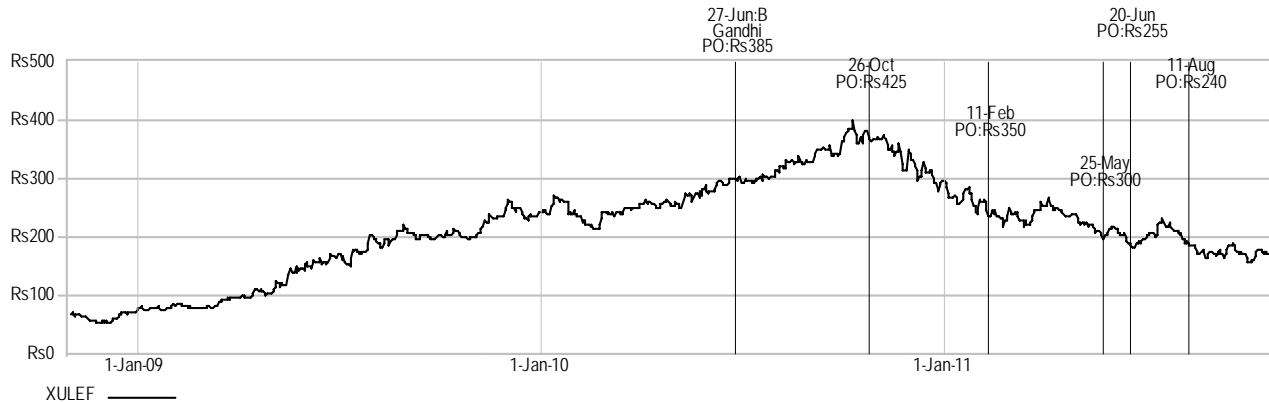
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XULEF Price Chart



B : Buy, N : Neutral, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

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Investment Rating Distribution: Financial Services Group (as of 01 Oct 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	183	54.46%	Buy	78	44.57%
Neutral	101	30.06%	Neutral	49	49.49%
Sell	52	15.48%	Sell	19	37.25%

Investment Rating Distribution: Global Group (as of 01 Oct 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2073	54.13%	Buy	923	49.12%
Neutral	961	25.09%	Neutral	460	52.57%
Sell	796	20.78%	Sell	287	38.32%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
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Underperform	N/A	≥ 20%

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