Rs 124
Target Price: Rs 175
Potential Upside: 41%

COMPANY REPORT

Power Finance Corporation

Relative to sector: **Outperformer**

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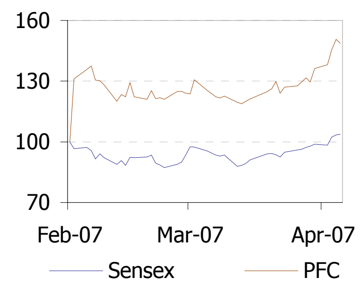
Relative Performance



Source: Bloomberg, ENAM Research

Stock data

No. of shares	: 1,148mn
Market cap	: Rs 142bn
52 week high/low	: Rs 131/ Rs 85
Avg. daily vol. (1mth)	: 2.8mn shares
Bloomberg code	: POWF IN
Reuters code	: PWFC.BO

Shareholding (%)		**Mar-07**
Promoters	:	89.8
FIIs	:	3.9
MFs / UTI	:	2.3
Banks / FIs	:	0.5
Others	:	3.6

Feel the Strength!

- PFC is one of the best plays on Power Financing in India with a projected funding requirement of ~USD 250bn in the eleventh five-year plan. Taking advantage of the huge funding potential, PFC managed to almost double its market share to >20% from the ninth to the tenth five-year plan.
- Around 81% of the lending exposure of PFC is to State Power Sector Utilities (SPSUs). However, PFC enjoys a healthy asset quality due to the effectiveness of the escrow mechanism. PFC's funding to SPSUs is on a balance sheet basis and not on a project basis, which makes the lending safer. PFC's Gross NPAs stood at 0.1% and net NPAs at 0.06% in FY07.
- Both loan disbursements and outstanding loan portfolio have grown at 22% CAGR for last 5 years. We expect loan portfolio to grow at a CAGR of 24% for the next three years, due to huge demand for funds in the power sector.
- As per our estimates, PFC has the ability to generate 2%+ interest spread and ~3.5% NIM for next 2-3 years. We believe that interest spread has bottomed out and are set to improve.
- PFC enjoys a special status as a Government Owned Public Finance Institution (PFI) and the new guidelines announced by the RBI (in Dec 2006 & Feb 2007) for Non-Banking Finance Corporations (NBFCs), are not applicable to it.
- Despite making 3.5% NIM and 2.6% ROA in FY07, PFC's ROE is relatively low due to low leveraging of ~5x. However, with a Tier-I capital of 18.5%, PFC has enough room to leverage more and improve its ROE. Valuations at 1.3x FY09E BV and 8.3x FY09E earnings are very attractive. We initiate coverage with a sector **Outperformer** rating.

Financial Summary

Y/E Mar	PAT (Rs mn)	EPS (Rs)	Change YoY (%)	P/E (x)	BV (Rs)	P/B (x)	GNPAs (%)	Cost/ Asset (%)	RoA (x)	RoE (%)	Tier-I (%)
2007	9,833	10.0	(1.2)	12.4	80.4	1.5	0.1	0.12	2.6	12.5	18.5
2008E	12,430	12.0	19.2	10.4	88.1	1.4	0.2	0.11	2.7	14.7	16.2
2009E	15,454	14.9	24.3	8.3	97.6	1.3	0.2	0.10	2.7	16.0	14.4
2010E	18,770	18.1	21.5	6.9	109.0	1.1	0.3	0.09	2.6	17.5	12.8

Source: Company, ENAM estimates

Contents

Investment Highlights

A 'SPECIAL' STATUS COMPANY

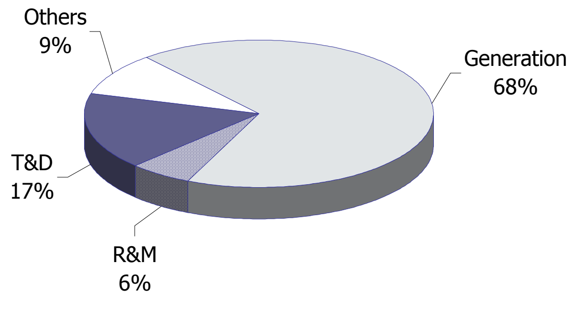
Incorporated in 1986, Power Finance Corporation (PFC) has emerged as a leading government owned power finance company, with 90% equity held by the central government. Being a 'Mini Ratna' company, it enjoys higher levels of operational freedom and autonomy in decision-making. Although registered as an NBFC with the RBI, it enjoys the status of a Public Financial Institution (PFI) and a government company under section 617. It also enjoys considerable freedom from RBI in framing its own prudential norms and policies.

PFC also enjoys ratings that are at par with sovereign ratings and hence has the ability to borrow funds at very competitive rates. It attracts only 20% risk weight in a bank's book, as a borrower, against 100% for most top-rated corporates. While PFC has significant exposure to SPSUs, its asset quality is among the best in the Indian financial sector. Lately, there has been an enhanced focus on lending to Private Sector Utility companies as well.

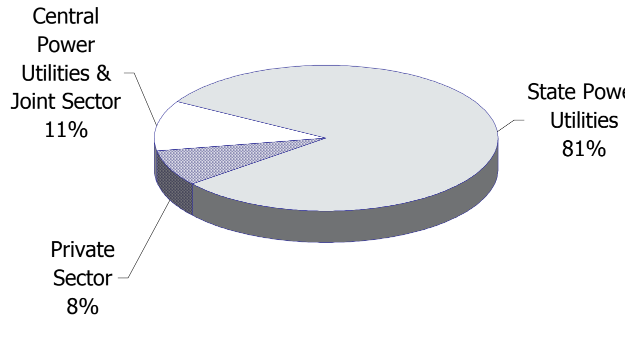
State Power Utilities have been a key focus so far

Almost 81% of the outstanding credit portfolio of PFC is with SPSUs companies, and is largely used for Power Generation Projects. Total disbursements in FY07 amounted to Rs 140.5bn (USD 3.3bn), a growth of 20% over FY06. A significant portion of term loans goes to thermal power generation projects.

PFC: Lending profile - Operational



PFC: Lending Profile - Sectoral



Source: Company. As on Mar-07.

Lending to the Private Sector has also gained momentum in the last few years and the sector formed 8% of the total credit portfolio in FY07.

Disbursements can potentially grow at a 5-year CAGR of 27%

Total installed capacity in the power sector stood at 1,27,753MW as on Dec 2006. As per the eleventh five-year plan, starting April 2007, total capacity addition through Power Utilities (including State, Central & Power) is targeted at 68,869MW for next five years. In addition, another 40,500MW of capacity is likely to be added through other sources like Captive Power, NCES & DDG etc. Taking into account these capacity additions, the Ministry of Power has estimated a total funding requirement of Rs 10.3trillion (USD 250bn) in the eleventh five-year plan. Based on the calculations shown below, we expect, PFC to finance almost Rs 1.54trillion (USD 38bn) of funds in eleventh five-year plan – leading to a 5 year projected CAGR in disbursements of ~28%.

PFC - 5 year projected CAGR in disbursements

Total Funding Requirement in Power Sector for XI 5-year plan (Rs bn)	State	Central	Private	Total	Total (USD)
Generation including nuclear power	1,238	2,021	850	4,109	100
DDG	-	200	-	200	5
R&M	159	-	-	159	4
Transmission	650	750	-	1,400	34
Distribution including rural electrification	2,870	-	-	2,870	70
HRD	-	5	-	5	0.1
R&D outlay	-	12	-	12	0.3
DSM	-	7	-	7	0.2
Total Power	**4,917**	**2,994**	**850**	**8,761**	**214**
NCES and captive power	225	-	930	1,155	28
Merchant plants	-	-	400	400	10
Total Funds Requirement	**5,142**	**2,994**	**2,180**	**10,316**	**252**
Less: funding required where PFC is unlikely to participate much (e.g. NCES and DDG etc)	-	-	-	4,000	98
Balance funding requirement (main target area for PFC)	-	-	-	6,316	154
Long term debt funding potential for PFC (assuming 70:30 debt/equity ratio)	-	-	-	4,421	108
Long term funding likely to be done by PFC assuming 24% market share	**-**	**-**	**-**	**1,061**	**26**
Add: Market share of 5% in the non-focus area (NCES & DDG) (70:30 debt ratio)	-	-	-	140	3.4
Projected long term funding (disbursements) for PFC in the eleventh year plan	-	-	-	1,201	29
Total Projected disbursements for PFC in the eleventh year plan (assuming 20% short term disbursements)	**-**	**-**	**-**	**1,501**	**37**
Disbursements in FY07	-	-	-	141	3.4
5 Year projected CAGR in disbursements for PFC in eleventh year plan	**-**	**-**	**-**	**27.0%**	**-**

Source: Ministry of Power, ENAM Research

Upcoming UMPPs can significantly boost PFC lending

PFC has been designated as the nodal agency for the development of seven Ultra Mega Power Projects (UMPP), each with a capacity of 4000MW plus. These projects have already been identified in various states. PFC has formed seven wholly owned subsidiaries for each of these UMPPs to act as SPVs for the projects. These SPVs will ultimately be transferred to successful bidders selected through a tariff-based international competitive bidding process and the bidders will then implement the project. PFC has already awarded two such UMPP projects to bidders in FY07 viz. Sasan in Madhya Pradesh and Mundra in Gujarat. While there are some uncertainties on Sasan, Mundra has already been passed to Tata Power. PFC intends to charge Rs 150mn per UMPP as consultancy fees going ahead.

With more than 4000MW capacity for each project, the lending potential will be >Rs 140bn (USD 3.4bn) (assuming 70:30 debt equity structure) for each of these projects. Banks, which are the main competitors for lending to such projects, will face restrictions in terms of their overall exposure in a single sector.

Banks have limitations in terms of funding to the power sector

The power sector requires long term financing and considering that average duration of term deposits are in the region of 2-2.5 years, it becomes difficult for banks to skew a large amount of its lending book towards longer-term maturity. While there are re-set clauses available to take care of the interest rate risk, generation projects still require longer gestation periods, even for re-set clauses to work. PFC is in much better position to borrow, both from banks and through bonds & debentures, depending upon the tenor for which it has to lend.

Banks also have their own internal limits set for lending to a particular sector. In India, the limit to a single sector is generally 10-15% of the total loan book with some leeway for infrastructure sectors. Some of the large PSU Banks are already near their internal limits and private banks have not been lending to this sector in a big way.

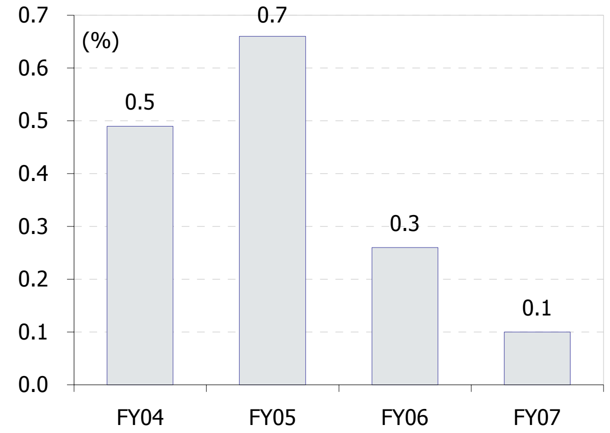
Strong Payment Mechanism: Healthy Asset Quality

PFC's asset quality has remained healthy over a long period of time. Despite significant exposure to SPSUs, which have been making cash losses, PFC has been able to receive timely interest payments from them.

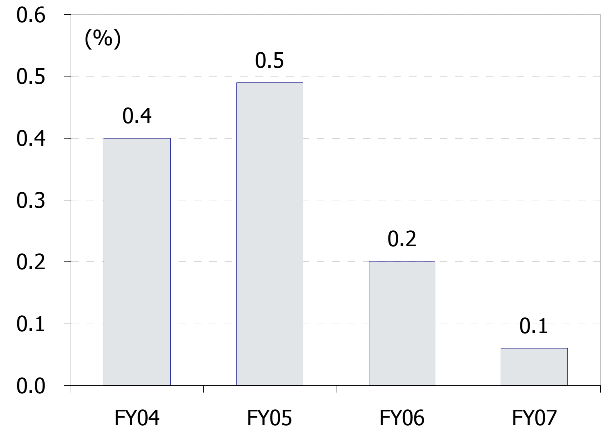
Besides primary security such as charges on assets and irrevocable state government guarantee, an escrow payment mechanism is formed in almost all loans given to SPSUs. Under this mechanism, all revenue receipts of the borrowers are routed through an escrow account with a bank. Hence, in case of a default, PFC reserves the right to direct the borrower's banker to remit the amount to PFC for clearing the dues. This mechanism helps in timely payment of the entire interest component of the loan.

PFC's financing to SEBs is on a balance sheet basis and not on a project basis, which gives it enough leeway to recover incase of any delays in project implementation.

PFC: Gross NPAs



PFC: Net NPAs



Source: Company

Despite enjoying a very healthy asset quality, PFC maintains additional Reserves For Doubtful Debt (RFDD), which stood at Rs 5.5bn in FY07. PFC gets a tax advantage of 5% on long-term income under section 36 (1) (viia) (c) and the company creates special reserves as RFDD, which are generally not a part of the net worth. In case of any slippages on loans these reserves can always be used for below the line provisioning. These reserves formed around 7% of PFC's net worth in FY07 and we have not considered them as a part of shareholder equity.

PFC is also exempt from many of the RBI prudential norms for NPA classification. PFC still follows 180-day norms for recognizing NPAs against the 90-day norm followed by banks and many financial entities. Also, NPAs are recognized on a loan-wise basis, as against the standard norm of identifying NPAs borrower-wise, which banks and most financial entities follow.

New RBI norms do not affect PFC

In Dec 2006, the RBI came out with its final guidelines on NBFCs, which stated that non deposit taking NBFCs will have to restrict single borrower exposure to 15% of its owned fund and single group of borrowers exposure at 25% of its owned fund (additional 5%-10% to be allowed for infrastructure funding). These guidelines became effective from April 1, 2007. While deposit taking government companies were not asked to follow these guidelines immediately, they were asked to prepare a roadmap for compliance to the new norms in consultation with the Government.

This caused a bit of confusion and there were fears expressed that PFC may come under this new regulation, which may restricts its capacity to lend to the power sector in a big way.

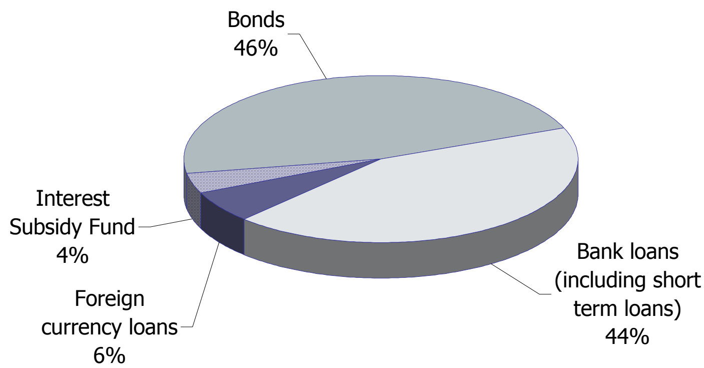
However, on 22 February 2007, in its final notification, the RBI clearly exempted government finance companies from following the new norms.

Top rating helps PFC to raise funds at very competitive rates

Rated as AAA by domestic rating agencies and on par with sovereign ratings by international rating agencies, PFC raises funds at the most competitive rates both domestically and internationally.

Despite FY07 being a tough year for financial companies, PFC managed to keep its cost of funds very much under control. Incremental cost of funds for PFC stood at 8.35% for FY07 where as outstanding cost of funds moved up only 26bps YoY to 7.33%. In FY07, at a time when borrowings from banks became much costlier, PFC focused more on borrowing through bonds. Outstanding borrowings through bonds and debentures grew 44% in FY07 against just 16% from banks.

PFC: Borrowings Profile (FY07)



Source: Company

Low operating costs keep PFC competitive vis-à-vis other banks

PFC, being a NBFC, has a higher cost of funding as compared to other banks. However, its low operating cost structure – 3.6% cost to income and 0.12% cost to asset – makes it very competitive vis-à-vis other banks. While banks have to set side 6.5% in CRR (no interest earned) and 25% SLR (~7.5% yield), PFC does not have any such requirements. The table below shows how PFC effectively competes with banks despite having higher cost of funds.

PFC's cost of borrowings vs. banks' cost of borrowings (based on current rates):

% age	PFC	Banks	Note
Average cost of incremental funds	9.5	6.2	Assumed incremental cost of term deposit at 8.5% and cost of CASA at 2%, CASA assumed at 35%
Cost of SLR/CRR	0	1.5	Calculated as an opportunity cost as a diff between yield on Loans and yield on SLR/CRR
Total cost of funds	9.5	7.7	Including the cost of CRR/SLR
Operating cost	0.15	2.0	Cost to asset of most Banks in India ranges between 2-2.5%
Total cost of borrowings	**9.65**	**9.73**	**-**

Source: ENAM Research

Against the general perception, the above table shows that PFC's cost of total borrowings (including operating and regulatory cost) will not be higher than many banks. Some banks like SBI, PNB, and HDFC bank with a higher CASA base may have a 20-30bps advantage due to higher composition of CASA (assumed around 35% for average banking sector in above calculations). However, in many banks the cost to asset ratio is 20-40bps higher than what we have assumed above. In addition, banks have to lend ~18% of incremental lending to the agriculture sector where interest rates are partly capped. This puts further pressure on banks to price other loans (including financing to power sector) at higher rates. All these factors reveal that banks do not have any significant competitive advantage against PFC in terms of overall cost of funding and pricing of loans.

Interest spreads were earlier under pressure due to re-structuring of lending rates

During the last two years, PFC has witnessed a pressure on its interest spread, due to higher competition and the interest restructuring facility on loans that it was offering till Dec 2005. However, PFC has also been charging an interest re-structuring premium from borrowers while restructuring the loans, which was not a part of the spread (booked as an extra-ordinary item till FY06). PFC has now stopped offering this interest restructuring facility.

Interest spread on loans, which was at a high of 4% in FY04, fell to 1.83% in FY06 and further to 1.77% in H1FY07. However, since H2FY07 spreads have started improving, we believe that this is just a beginning. Interest spreads improved to 1.93% in Q4FY07 from a low of 1.77% in H1FY07.

Asset re-pricing to be faster than re-pricing of liabilities, leading us to believe that spread will expand

In our opinion, PFC is comfortably placed in a rising/higher interest rates scenario as ~87% of the total borrowings are fixed cost borrowings with an average maturity of ~4.1 years. On the asset side, while the average remaining term to maturity is 4.8 years, if we take into account the re-set clause and EQI factors, the average duration will be much lower (2-2.5 years), hence the re-pricing of assets will be much faster than re-pricing of liabilities for the next two years or so, which should help in improvement of spread for next two years**. Hence, we expect interest spread to expand to 2.2% in FY08 from 1.93% in FY07. We expect the spreads to remain high till FY09.**

However, we understand that spreads may start converging back to 2% levels, post FY09, given that PFC is making ~2% spread on incremental basis.

We are given to understand that PFC is matching its duration quite well incrementally and hence, we do not see any major duration mismatch on incremental lending. Also, in order to maintain its incremental spread, PFC is currently lending in the range of 11.5% -13.5%.

PFC: Movement of interest spread

Source: Company

We also understand that such gains are largely on account of the current asset liability structure and not due to the company's ability to make >2% incremental spreads. However, it is quite encouraging to note that PFC made an incremental spread of 1.97% in FY07 (against outstanding spread of 1.83% in FY06 and 1.93% in FY07). Hence, we do not see any sings of pressure on spreads on account of incremental lending.

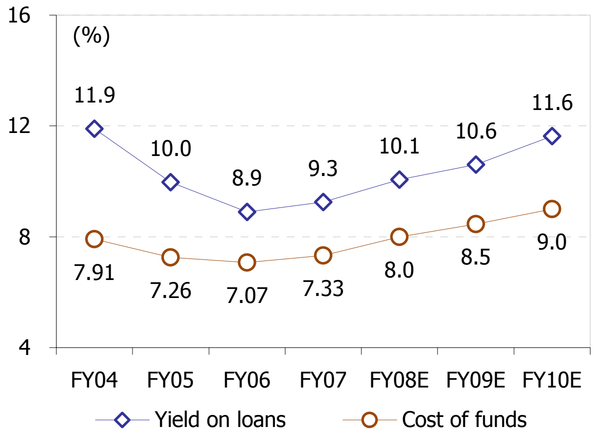
Since the current leverage is low and 20% of funding happens through net worth, PFC'S NIM at 3.5% is much higher than interest spread. While higher leveraging puts technical pressure on NIM, still, a substantial amount of the loans is expected to be re-priced upwards, which, as per our estimates, will keep NIM stable with an upward bias due to improvement in spread.

PFC: A favorable asset-liability structure in a higher interest rate regime

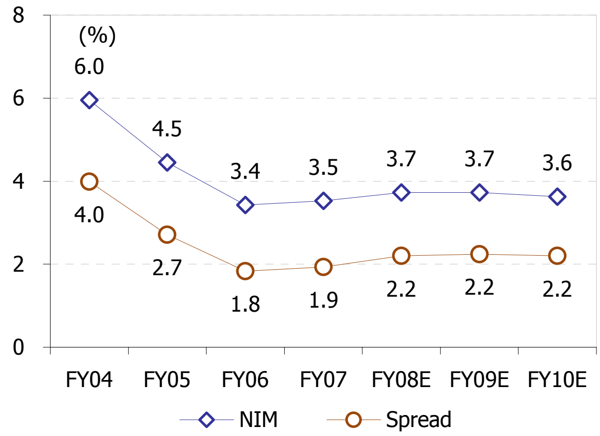
PFC: Asset - Liability Structure	Sep-06		Mar-07	
	Amount (Rs bn)	Proportion (%)	Amount (Rs bn)	Proportion (%)
PFC - Loans Outstanding				
Floating	7.0	2	6.4	1.5
With Reset Clause (3/10 years)	201.7	52	243.9	55.3
Fixed	159.0	41	171.3	38.9
Short Term Loans	17.9	5	19.3	4.4
Total	**385.6**		**441.0**	
PFC - Outstanding Borrowings				
Floating	40.0	13.7	42.6	12.7
Fixed	252.5	86.3	293.2	87.3
Total	**292.4**	**-**	**335.9**	
Avg. Maturity of Assets (based on the residual term to maturity)		-	**4.85 years**	
Average maturity of Liabilities		-	**4.09 years**	

Source: Company

PFC: Yield on Loans vs. Cost of Funds



PFC: NIM vs. Spread



Source: Company

Conservative Accounting Treatment

PFC has been following a very conservative accounting policy (as suggested by ICAI). Under the benefits of section 36(1) (viii) of the IT Act, PFC has created a deferred tax liability on it special reserves. This allowed the company to deduct up to 40% (as per the new norms, the deduction will be only 20% from FY08) of profits derived from the business of providing loans (of five years or more) and create a special reserve.

PFC debits its P&L each year to create a deferred tax liability in respect to the special reserve at the applicable tax rate. This increases the effective tax rate for PFC and reduces profitability, despite the fact that there is no cash outflow on account of such tax provisions by the company. This accounting treatment suppresses the reported net profit and hence adversely affects the ROA/ ROE.

However, in our calculations we have added back the provisions arising from DTL to the reported net profit to calculate our profitability ratios such as EPS/ROA/ROE. We believe PFC's profitability ratios will be rightly represented after adding back the provisions for DTL.

Further, the reserve for bad and doubtful debts created under section 36(1) (viia) (c) allows the company to create a reserve of 5% of taxable income. The company does not treat the reserves created under 36(1) (viia) (c) as a part of its net worth. **We have kept this amount of Rs 5.5bn out of the shareholder equity as regulation wise this can be taken back by the company in case the need arises to provide for NPAs.**

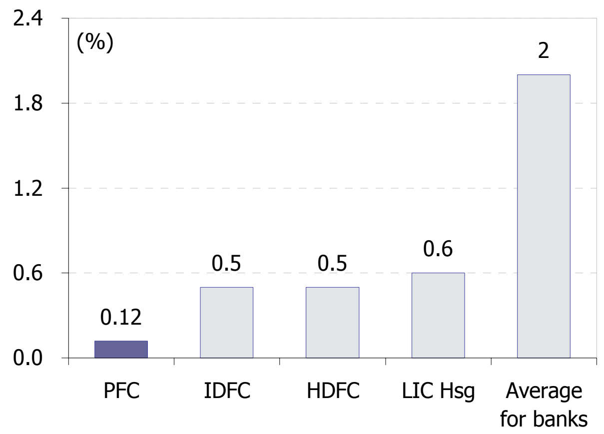
ROA High, but ROE restricted by lower leveraging

While PFC's NIM is among the highest in the financial sector (higher than HDFC & IDFC and also higher than most banks), lower fee based income makes its ROA comparatively lower when compared to IDFC, which has similar kind of leverage.

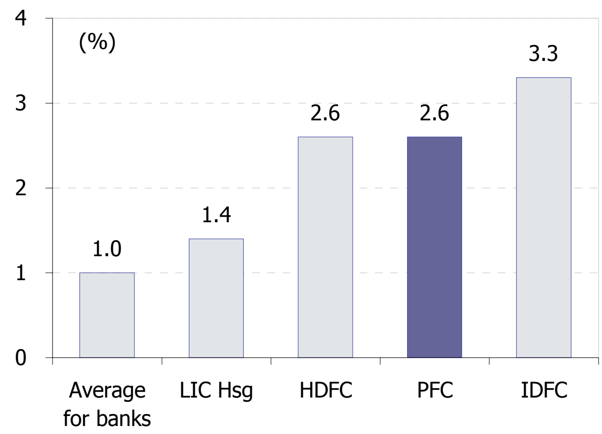
PFC's ROA stood at 2.6% in FY07 and we believe that it can sustain this ROA for next two years, despite the higher leveraging that we anticipate in this period. This will be largely be possible due to expansion in NIM in FY08 and its sustainability in FY09 and also on account of the higher fee-based income that we expect the company to earn in next two years.

Taking our assumption of loan growth at ~24% for next 2-3 years, we expect leveraging to improve to 6x in FY09 and 6.7x by FY10. Hence, the company should be able to generate an ROE of 16% by FY09 and 17.5% by FY10. Tier- I capital of PFC was already quite high at 18.5% (excluding DTL). If we include DTL in the net worth, then Tier-I capital will cross 21%.

Comparative Cost to Asset Ratio (FY07E)

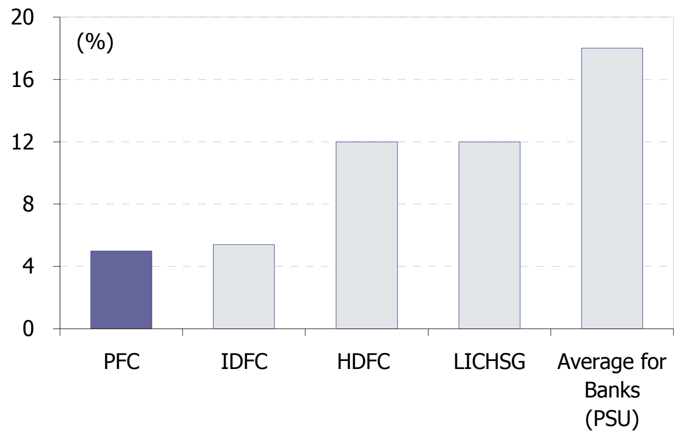


Comparative ROA (FY07E)



Source: Company, ENAM Research

Comparative Leveraging (FY07)



Source: Company, ENAM Research

HIGH VISIBILITY, ATTRACTIVE VALUATIONS

While the current ROE of PFC is relatively lower, we believe that it has one of the highest growth visibilities in the financial sector with more than USD 250bn of funding requirement in power sector in the eleventh 5-year plan and much more than that in the twelfth 5-year plan.

With Tier-I of 18.5%, (nil Tier-II and >21% Tier-I if DTL is taken into account), the bank does not need any capital dilution for next several years. While the FY09 ROE will be ~16%, its normalized ROE, in our opinion, is higher at ~17.5%, once the company starts leveraging at higher levels.

Also with leverage of just 5x, strong asset quality and high growth visibility, its cost of equity should be lower than the average cost of equity for most PSU banks. Assuming the cost of equity at 13% and normalized ROE of 17% and sustainable growth rate (g) of 8%, we believe that the stock can potentially quote at 1.8x FY09E BV, in next one year. The stock also has no FII limit, unlike all PSU Banks, which will further help the company enjoy superior valuations, going ahead**. We are initiating coverage with a sector Outperformer rating on the stock and a price target of Rs 175.**

PFC: Break-up of ROA/ROE (% of total assets)

% of total assets	FY02	FY03	FY04	FY05	FY06	FY07E	FY08E	FY09E	FY10E
Interest earned	12.7	12.5	11.0	9.4	8.5	8.9	9.7	10.3	10.8
Interest expended	6.4	5.9	5.5	5.2	5.2	5.5	6.1	6.7	7.3
Gross Interest Spread	6.4	6.6	5.5	4.2	3.3	3.4	3.6	3.6	3.5
Provisioning	0.2	(0.1)	0.0	0.1	0.0	0.0	0.1	0.1	0.1
Net Interest Spread	6.1	6.7	5.5	4.1	3.3	3.4	3.5	3.5	3.5
Operating cost	0.4	0.4	0.3	0.16	0.15	0.12	0.11	0.10	0.09
Lending spread	5.7	6.3	5.2	3.9	3.2	3.3	3.4	3.4	3.4
Fee-based income	0.4	0.3	0.2	0.1	0.1	0.1	0.2	0.2	0.2
Operating spread	6.1	6.7	5.4	4.0	3.2	3.3	3.6	3.6	3.6
Tax (including DTL)	1.8	2.1	1.7	1.3	0.8	1.2	1.2	1.2	1.2
ROA (including prov. for DTL)	**5.0**	**5.4**	**4.3**	**3.3**	**2.7**	**2.6**	**2.7**	**2.7**	**2.6**
Leveraging	4.0	4.4	4.7	5.0	5.5	5.7	6.1	6.8	7.6
Leveraging (including DTL)	3.8	4.0	4.2	4.4	4.8	5.0	5.3	6.0	6.7
ROE (Including DTL)	18.0	23.7	20.0	17.5	14.6	13.8	14.2	16.0	17.5

Source: ENAM Research

Comparative valuations

	PFC	IDFC	HDFC	SBI
Stock Price (Rs.)	**124**	**97**	**1,685**	**1,099**
P/E (x)				
FY06	12.2	27.9	20	10.5
FY07	12.4	27.9	16	9.9
FY08E	10.4	19.2	14	8.8
P/B (x)				
FY06E	1.8	3.4	5.5	1.8
FY07E	1.5	3.1	4.6	1.6
FY08E	1.4	2.7	3.9	1.4
Key Ratios (%) (FY07E)				
Gross NPAs	0.1	0.2	1.0	3.3
Net NPAs	0.06	0.0	0.1	1.5
NIM	3.5	2.7	3.0	3.2
ROA	2.6	3.3	2.6	0.8
ROE	13.8	18	30.1	15
Loan growth	23.9	37	25	26

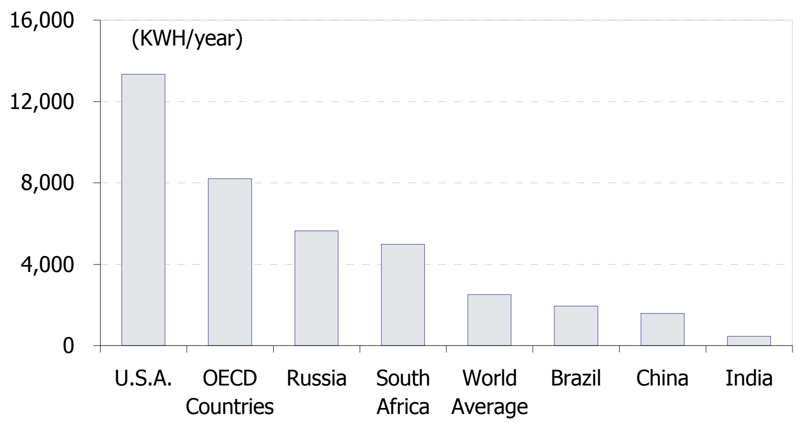
Source: Company, ENAM Research Prices as on 27–April-2007. HDFC valuations are shown after deducting the value of investments. For SBI, P/Adj. BV is taken.

Industry Evaluation

Low per capita consumption

The importance of financing the power sector cannot be underestimated in a power-starved country like India. In 2004 India's per capita consumption of electricity at 457 units compared dismally with the global average of 2,516 units. However, it also reflected the potential for growth in the country's consumption of electricity going forward. While per capital consumption rose to 600 units in 2006, it still remained much lower than the global average of 3000 units. In this regard, the eleventh plan has already targeted per capita electricity consumption of 1000 units and estimated a total energy requirement of 1038BU by 2012.

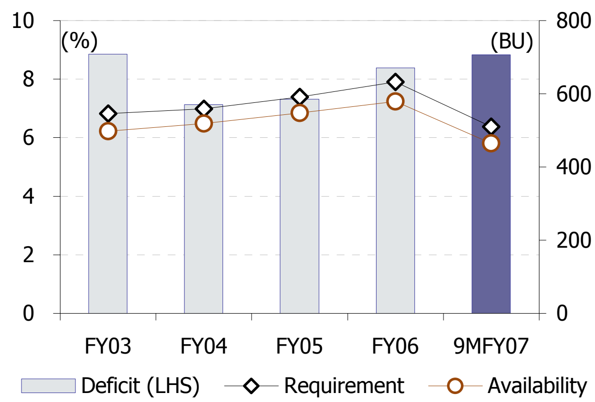
Per Capita Electricity consumption



Source: Key World Energy Statistics (2004)

Further, its has also been envisaged by the Ministry of Power that a GDP growth rate of 8% would require total energy of ~1470BU by 2016-2017 (from 741BU in FY07E and ~1000 BU in 2011-12), thus indicating the critical role the sector will play in the country's development going forward.

Deficit in Electricity



Source: Ministry of Power

In this scenario the eleventh plan has conceived capacity additions in generation (68,896MW of added capacity), transmission (20,700MW additional inter-regional capacity) and distribution (15mn ckm and 292,000 MVA of additional distribution capacity). In fact, the eleventh plan aims to increase the generation capacity at a CAGR of 9% between 2007-2012, vis-à-vis a CAGR of 5.1% achieved during the tenth plan, which appears to be a tall order, but most projects are either already under construction or have been committed.

Eleventh 5-year plan: Targeted generation capacity addition (MW)

11th Plan Generation Target	Thermal	Hydro	Nuclear	Total
Central	23,810	9,685	3,160	36,655
State	20,352	2,637	-	22,989
Private	5,962	3,263	-	9,225
Total	**-**	**-**	**-**	**68,869**
Captive Power Plants	-	-	-	12,000
NCES	-	-	-	13,500
Merchant Power Plants	-	-	-	10,000
Decentralized Distribution Generation	-	-	-	5,000
Total Capacity Addition	**-**	**-**	**-**	**109,369**

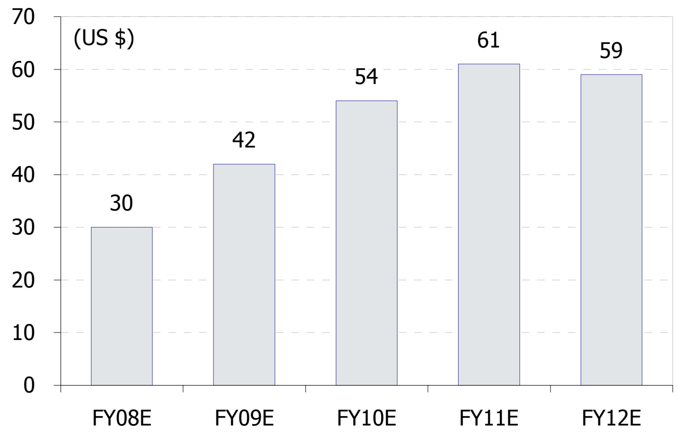
Source: Ministry of Power, Company

Generation capacity addition: progress so far (MW)

Sector (MW)	Hydro	Thermal	Nuclear	Total
Projects Under Construction	11,931	16,254	3,160	31,345
Committed Projects	3,654	33,870	-	*37,524
Total capacity	**15,585**	**50,124**	**3,160**	**68,869**

Source: Ministry of Power, * Note: Out of the projects totalling to 37,524 MW under committed category as given above, orders for Dadri Unit-6 (490 MW) & Mezia Ph-II (1000 MW) has been recently placed.

Eleventh 5-Year Plan - Amount of total funding required per year



Source: Ministry of Power

While power and other infrastructure sectors will witness a significant surge in capacities, capital investments in infrastructure hovers around 4% of GDP for India as compared to 10% for many Asian countries, indicating the funding constraints faced by the sector.

Debt funding for power companies, apart from PFC, is largely dependent on the following lenders:

Banks: Which incrementally lent Rs 191.2bn to the power sector in FY06, are restrained by single entity (individual or group) lending limits. Maximum exposure to a single borrower and to a single group is constrained at 15-20% and 25-35% respectively for infrastructure projects (including power). Since bank lending is constrained due to regulatory factors, other lenders such as PFC and REC aid in filling important funding gaps.

REC: (Rural Electrification Corporation) – which disbursed close to Rs 78.85bn in FY05, primarily focuses on financing and promoting rural electrification projects. The institution also finances SEBs and state utilities.

IIFCL: (India Infrastructure Finance Company Ltd.) – was set up in Jan 2006 with the objective of providing financial support to infrastructure projects (including power) in the country. However, IIFCL is likely to focus on central and private utility lending going forward, leaving state utility lending to PFC, REC and the banks.

Business Evaluation

BACKGROUND

PFC was set up in 1986, with the aim of providing funding to State Power Utilities. In 1997, PFC also started financing Private Sector Projects, in line with the government's initiative to re-structure the Power Sector and encourage Private Sector participation. Private Sector, however, still comprises less than 10% of PFC's lending portfolio.

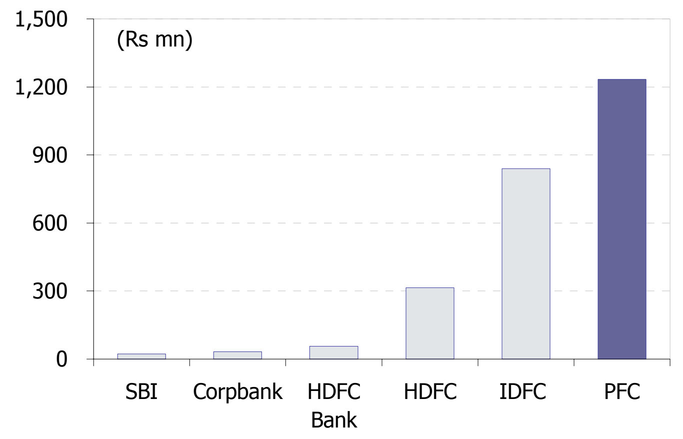
PFC is registered with RBI as an NBFC, but also enjoys the status of a Public Financial Institution. As a result, PFC also enjoys certain tax rebates. Key among them is the tax rebate available under section 36 (1) (viii). However, such benefits are increasingly reducing. The benefit earlier available under Section 10 (23G) is now withdrawn.

PFC provides both long-term and short-term financing for the power sector, though a significant portion of financing is lent for long-term (above 10 years). In 1998, the Government of India granted PFC a 'Mini Ratna' status, which gives PFC greater operational freedom and autonomy in decision-making, as compared to other PSUs.

PFC: Organizational Structure

The board of directors (currently five directors), appointed by the Ministry of Finance, has the ultimate responsibility for management and administration of the company. Below it are Executive Directors and General Managers. PFC is a lean organization with a total employee base of just 314 (a similar asset-sized Public Sector Bank will have more than 10,000 employees). This makes the organization very competitive in terms of operating cost structure. Around 60% of the employees hold professional degrees such as MBA and CA/ICWA and another 30% are engineers.

Comparative Assets Per Employee (FY06)

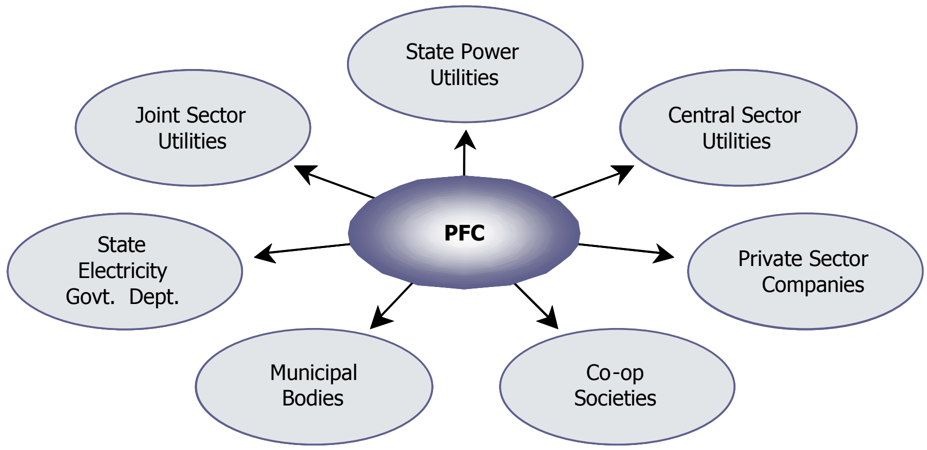


Source: Company, ENAM Research

PFC: LENDING PROFILE

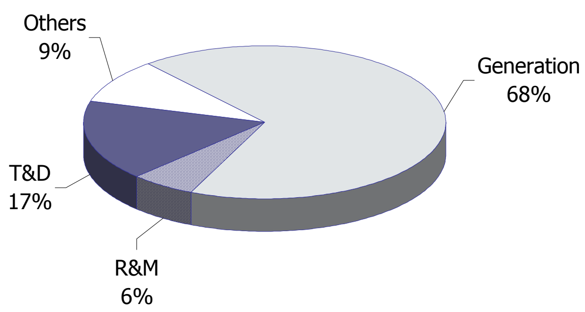
A significant portion of PFC's lending goes to the SPSUs – largely for Power Generation Projects. PFC also lends to CPSUs and Private Sector Power Projects. In addition, PFC provides consulting assingments to its clients, though the income from this is comparatively low.

Types of Clients

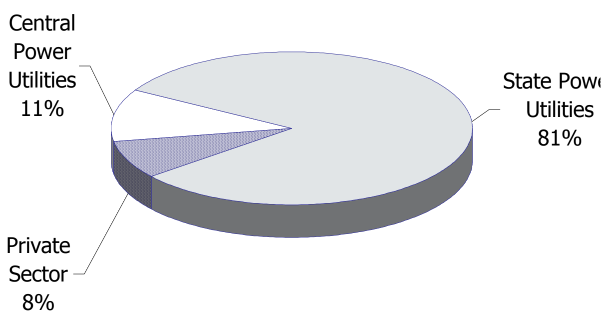


Source: Company

PFC: Lending profile - Operational



PFC: Lending Profile - Sectoral



Source: Company. Figures as on March-07

PFC: Growth Prospects

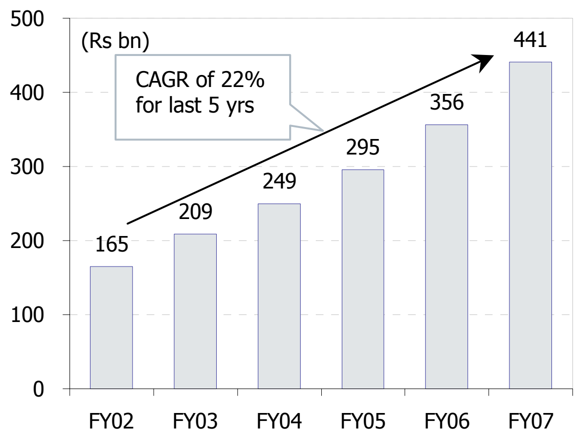
PFC disbursements have grown at a CAGR of 22% for the last 5 years and its loan book has grown at a similar CAGR in the same period. On an average, ~15% of the total loan portfolio matures in a year. **Based on the planned capacity installation in the eleventh plan, we expect PFC's disbursements to grow at a CAGR of 27% for the next 5 years.**

PFC: 5 year projected CAGR in disbursements

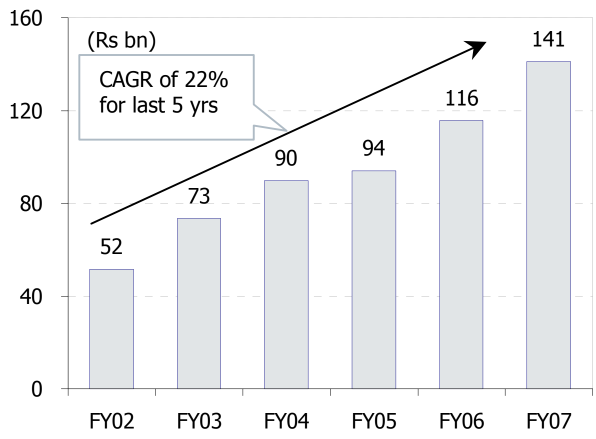
Total Funding Requirement in Power sector for XI 5-year plan (Rs bn)	State	Central	Private	Total	Total (US $)
Generation including Nuclear	1,238	2,021	850	4,109	100
DDG		200	-	200	5
R&M	159	-	-	159	4
Transmission	650	750	-	1,400	34
Distribution including Rural Electrification	2,870	-	-	2,870	70
HRD	-	5	-	5	0.1
R&D Outlay	-	12	-	12	0.3
DSM	-	7	-	7	0.2
Total Power	**4,917**	**2,994**	**850**	**8,761**	**214**
NCES and Captive power	225	-	930	1,155	28
Merchant Plants	-		400	400	10
Total Funds Requirement	**5,142**	**2,994**	**2,180**	**10,316**	**252**
Less: Funding required where PFC is unlikely to participate much (e.g. NCES and DDG)	-	-	-	4,000	98
Balance funding Requirement (main target area for PFC)	-	-	-	6,316	154
Long term Debt Funding potential for PFC (assuming 70:30 deb/equity ratio)	-	-	-	4,421	108
Long term Funding likely to be done by PFC assuming 24% market share	**-**	**-**	**-**	**1,061**	**26**
- Add: Market share of 5% in the non-focus area (NCES & DDG) (70:30 debt ratio)	-	-	-	140	3.4
Projected Long term Funding (disbursements) for PFC in the eleventh year plan	-	-	-	1,201	29
Total Projected Disbursements for PFC in the eleventh year plan (assuming 20% short term disbursements)	**-**	**-**	**-**	**1,501**	**37**
Disbursements in FY07	-	-	-	141	3.4
5 Year projected CAGR in disbursements for PFC in eleventh year plan	**-**	**-**	**-**	**27.0%**	**-**

Source: Ministry of Power, ENAM Research

PFC: Lending CAGR

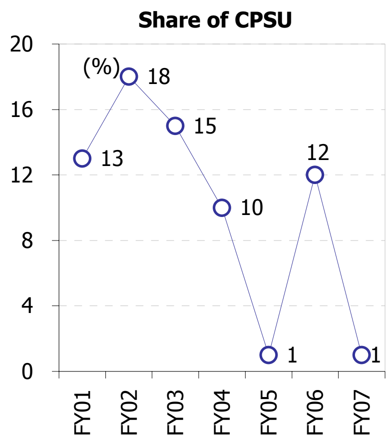


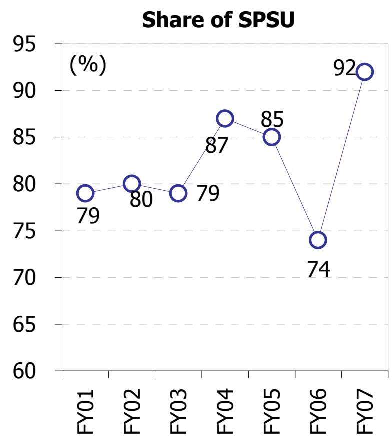
PFC: Disbursements CAGR

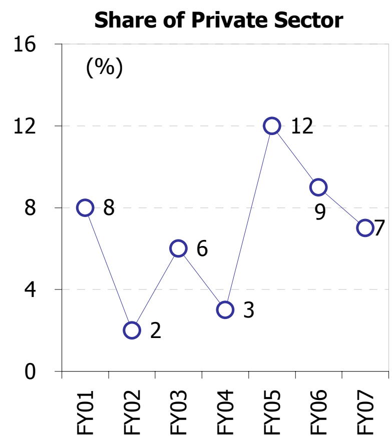


Source: Company

PFC: Share of Power Utilities in disbursements







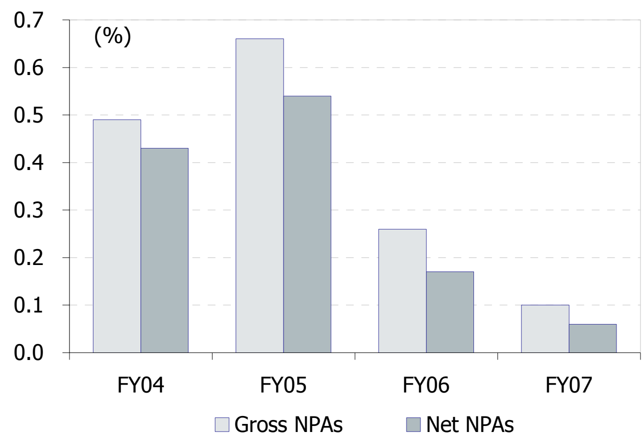
Source: Company. Note: CPSU/SPSU – Central/ State Power Sector Utilities

PFC: STRICT CONTROL ON ASSET QUALITY

Despite significant exposure to SPSUs (which have been making cash losses), PFC has been able to receive timely interest payments from them. In addition to primary securities such as charge on assets and irrevocable state government guarantee, an *escrow payment mechanism has been formed in most state sector loans.* Under this mechanism, all revenue receipts of the borrowers are routed through an escrow account with a bank. Hence, in case of a default, PFC reserves the right to direct the borrower's banker to remit the amount to PFC for clearing the dues. This mechanism helps in timely payment of the entire interest component of the loan.

PFC also enjoys a very healthy coverage ratio on its loans to SPSUs. For instance, in FY06, PFC enjoyed a coverage ratio of 17x on its top ten borrowers, which formed 45-50% of its total loan book.

PFC: Gross & Net NPAs



Source: Company

PFC is also exempt from many of the RBI prudential norms for NPA classification. PFC still follows 180-day norms for recognizing NPAs against the 90-day norm followed by banks and financial institutions. Also, NPAs are recognized on loan-wise basis as against the standard norm of identifying NPAs borrower-wise, which banks and most financial entities follow.

PFC has a robust credit appraisal methodology for appraising loans. The eligibility criteria place an emphasis on the borrower's financial and operational strength, capability and competence. PFC does use differential lending rates to promote certain important schemes, however the eligibility criteria and funding decision are always guided by the merit of the project and no funds are pre-allocated.

PFC was awarded ISO 9001:2000 certification in June 2004 for its appraisal of loan proposal and sanction of financial assistance for projects/ schemes in power and allied sectors.

The extent of funding that PFC grants to various projects as a percentage of project costs is:

PFC: Extent of Funding (% of Project Cost)

Projects	State Sector Projects (%)	Private Sector Projects (%)
Medium and Large Hydro Generation	70	25
Thermal Generation Projects	70	20
Transmission	70	50
Captive & Co-generation Plants	70	50
R&M/R&U of Generation and Transmission	70	50
Urban Distribution System	70	50
Research & Development	90	50
Mini, Micro & Small Hydro	70	50
Capacitors, Energy Meters, Computerization	80	50
Non Conventional Energy Source	70	50
Environmental Upgradation	80	50
Studies, Consultancy and Training	100	50
Infrastructure Projects with forward/backward linkage to Power Projects	70	20

Source: Company

Repayment Period (Yrs)*

Types of projects / schemes	State Sector#	Private Sector
Hydro Generation Schemes	20	12
Thermal Generation Schemes	15	12
Studies consultancy, training. R&D, survey and investigation communication and computerization, installation of energy meters for energy audit and billing	5	5
All schemes/projects other than (1) , (2) and (3) above	15	10

Source: Company; *Excl. Construction and 6 months period after commissioning; # Projects with interest reset condition; Notes: All such loans shall also have put and call option after the end of every 12 years (for thermal & other schemes) and 15 years (for hydro schemes) from the date of commissioning of project and on subsequent reset dates

Recovery Mechanism: Keeps Delinquencies Low

PFC has an effective risk mitigation mechanism in place that has helped the company keep delinquencies in check over the years.

Advances are made to those SPSUs who provide confirmation that PFC would have a priority claim on the particular utility's surplus revenue, over the loan granted by the State Government to the SEBs. A majority of outstanding loans to State Level Utilities are backed by an irrevocable guarantee given by the relevant State Governments, and some are secured by a charge on assets. Loans are further secured through default escrow accounts as a credit enhancement mechanism. Under this arrangement, the borrowers along with the escrow bank agrees to route a specified level of cash flow through the designated account and in case of a default pays this directly to PFC.

In case of private power projects, security is obtained through non-exclusive first priority mortgages, charge on project assets. Payment security mechanism is obtained through 'Trust and Retention Account' and pledge of shares held by promoters. In certain cases, collateral securities like personal and corporate guarantees are also required.

PFC provides a rebate on timely payment of dues to borrowers but when payment on a loan is overdue for more than 90days, all additional disbursements and sanctions to that project are delayed until all dues are recovered. In case dues are not paid, recoveries are initiated through the escrow account facility for state sector borrowers and through a Trust and Retention Account in the case of private sector borrowers.

Therefore, historically the overall principal recovery rate has been a healthy 98-99%, which is evidence of the success of the recovery mechanisms put in place when structuring loan agreements with its borrowers, and shows the level of compliance that the company is able to achieve from its borrowers.

Management Evaluation

A LEAN ORGANIZATIONAL STRUCTURE

One of the biggest achievements of the management, in our opinion, has been its ability to keep a lean organizational structure, without compromising on growth. PFC's asset/ employee ratio at Rs 1.2bn is unparalleled in the Indian financial sector, with nearest competitor IDFC's ratio at Rs 840mn.

Higher Operational Freedom to Top Management

Within 10 years of operations, PFC was given a 'Mini Ratna' status, which gives the management of the company greater operational freedom in the areas of recruitment, prudential norms etc. The company has been awarded ISO 9001:2000 certification in June 2004 for its appraisal of loan proposals and sanction of financial assistance for projects/schemes in power and allied sectors. The top management is also well incentivised for its superior performance.

Asset quality among the best in the financial sector

Despite significant exposure to SPSUs, which are making cash losses, PFC has been able to maintain a fairly healthy asset quality. PFC was in fact the pioneer of escrow mechanism in the industry. Routing the interest payments through an escrow account has been fairly successful. Therefore, historically the overall principal recovery rate has been a healthy 98-99%, which is an evidence of the success of the recovery mechanisms put in place by management.

Fee-based income & higher leveraging requires more focus

Despite delivering 3.5% NIM and 2.7% ROA (backed by 0.12% cost to asset ratio), ROE is expected to remain lower, in the region of 14-16% for next two years. This is because of two reasons. First, the fee-based income is almost negligible. Second, leveraging at ~5x is on the lower side. PFC has started addressing the first issue and has started charging a higher fee-based income.

The pipeline of fee-based income is much better than earlier years (management has given the guidance that Rs 490mn of fee-based income is already secured and a large part should be booked in FY08. PFC is also planning to charge Rs 150mn per UMPP, which is lined up for next 2-3 years.

Financial Evaluation

Interest spread has bottomed out, likely to improve

In our opinion, PFC is comfortably placed in a rising/higher interest rates scenario as ~87% of the total borrowings are fixed cost borrowings with an average maturity of ~4 years. On the asset side, while the average duration is 4.8 years (in terms of remaining term to maturity), if we take into account the re-set clause and EQI (Equated Quarterly Installment) factors, the average duration will be much lower, hence the re-pricing of assets will be much faster than re-pricing of liabilities for the next two years or so, leading to improvement in spread for next two years. However, we understand that spreads may converge back to 2% levels, given that PFC is making ~2% spread on incremental basis.

Reported profits are subdued due to provisioning for DTL

Unlike, its peers like IDFC and HDFC, PFC creates Deferred Tax Liability on account of the benefits arising from section (1) (viii). Hence, a provisioning for such DTL is also created in the P&L, which subdues reported net profit, despite the fact that there is no cash outgo on such tax provisions. While calculating all our profitability ratios, we have added back such provisions in the reported profit. Also while we have shown the DTL amount separately in the balance sheet and not taken it in the shareholders equity, we believe that on economic basis, it is a part of shareholder equity. Hence our BV and ROE calculations consider DTL as a part of shareholder equity.

Reserves for Bad & Doubtful Debt provide additional safety

While PFC's asset quality is among the best in the financial sector, it takes advantage of section 36 (1) (viia) (c), which allows the company to create a reserve of 5% of taxable income. PFC has already created Rs 5.5bn of reserves for doubtful debt, which we have not taken as a part of shareholder equity (and also not in our calculations for ROE/BV. These reserves provide additional safety to the asset quality and can be used for loan specific provisioning, in case the need arises. Hence, the provisioning requirement for PFC is likely to remain very low in the coming years. However, we have still taken Rs 450-550mn as provisioning amount for NPAs in the P&L, as a measure of conservatism.

NII projected to grow at a CAGR of 25% for next three years

We expect NII to grow at a higher rate of 31% in FY08, driven by expansion in spread and 24% growth in loan book. Thereafter, we expect, NII to grow at 24% in FY09 and 21% in FY10, as we expect spreads to start converging to 2% levels from FY10 onwards.

Valuations

While the current ROE of PFC is relatively lower, we believe that it has one of the highest growth visibilities in the financial sector with more than USD 250bn of funding requirement in the eleventh 5-year plan and much more than that in the next twelfth 5-year plan.

With Tier-I of 18.5%, (nil Tier-II and >21% Tier-I if DTL is taken into account), the bank does not need any capital dilution for next several years. While the FY09 ROE will be ~16%, we believe that its normalized ROE is higher at ~17.5%, once the company starts leveraging at higher levels.

Also with leverage of just 5x, strong asset quality and high growth visibility, its cost of equity should be lower than the average cost of equity for most PSU banks. Assuming the cost of equity at 13% and normalized ROE of 17% and sustainable growth rate (g) of 8%, we believe that the stock can potentially quote at 1.8x FY09E BV, in next one year. The stock also has no FII limit, unlike all PSU Banks, which will further help the company enjoy superior valuations, going ahead**. We are initiating coverage with a sector outperformer rating on the stock and a price target of Rs 175.**

Comparative valuations

	PFC	IDFC	HDFC	SBI
Stock Price (Rs.)	**124**	**97**	**1,685**	**1,099**
P/E (x)				
FY06	12.2	27.9	20	10.5
FY07	12.4	27.9	16	9.9
FY08E	10.4	19.2	14	8.8
P/B (x)				
FY06	1.8	3.4	5.5	1.8
FY07E	1.5	3.1	4.6	1.6
FY08E	1.4	2.7	3.9	1.4
Key Ratios (%) (FY07E)				
Gross NPAs	0.1	0.2	1.0	3.3
Net NPAs	0.06	0.0	0.1	1.5
NIM	3.5	2.7	3.0	3.2
ROA	2.6	3.3	2.6	0.8
ROE	13.8	18	30.1	15
Loan growth	23.9	37	25	26

Source: Company, ENAM Research Prices as on 27–April-2007. HDFC valuations are shown after deducting the value of investments. For SBI, P/Adj. BV is taken.

Company Financials

Income Statement

(Rs mn)	FY05	FY06	FY07	FY08E	FY09E	FY010E
Interest Earned	27,133	29,177	37,199	50,045	65,277	85,251
Interest Expended	15,027	17,936	23,019	31,489	42,275	57,342
Net Interest Income	**12,106**	**11,241**	**14,180**	**18,556**	**23,003**	**27,910**
Non-Interest Income	**237**	**258**	**322**	**1,040**	**1,290**	**1,395**
Lease Income (net)	162	227	207	210	210	210
Income from consultancy assignments	5	11	57	800	1,050	1,155
Others	70	20	58	30	30	30
Net Income	**12,343**	**11,500**	**14,503**	**19,596**	**24,293**	**29,305**
% change	(12)	(7)	26	35	24	21
Operating Expenses	**460**	**499**	**518**	**577**	**660**	**723**
Personnel & Admin expns	446	485	480	552	635	698
-Staff cost	216	232	248	273	300	330
Depreciation	14	14	38	25	25	25
Operating Profit	**11,883**	**11,001**	**13,985**	**19,019**	**23,633**	**28,581**
Provisions for NPAs	228	(144.0)	(48)	450	550	550
Provisions for investments	3	1.81	(0.8)	2.0	2.0	2.0
Core PBT	**11,651**	**11,143**	**14,034**	**18,567**	**23,081**	**28,029**
Provision for tax	2,091	1,923	3,223	4,827	6,001	7,288
Provision for DTL	1,800	715	1,684	1,300	1,616	1,962
Provision for FBT	0.00	8	9.41	10.00	10.00	10.00
PAT before extra-ordinary	**7,760**	**8,497**	**9,118**	**12,430**	**15,454**	**18,770**
Extra-ordinaries:	**2,370**	**1,521**	**1,044**	**-**	**-**	**-**
- Interest restructuring premium	2,118	1,051	-	-	-	-
- Exchange losses or gains	252	470	1,044	-	-	-
Taxes on extra-ordinaries	425	262	329	-	-	-
Extra-ordinaries less taxes	1,945	1,258	715	-	-	-
Reported PAT	**9,705**	**9,755**	**9,833**	**12,430**	**15,454**	**18,770**

Source: Company, ENAM Research

Balance Sheet

Rs mn	FY05	FY06	FY07	FY08E	FY09E	FY010E
Capital	10,305	10,305	11,478	11,478	11,478	11,478
Free Reserves & Surplus	49,670	54,751	69,448	76,906	86,210	97,391
Net worth	**59,975**	**65,055**	**80,926**	**88,383**	**97,688**	**108,869**
Deferred Tax Liability (DTL)	8,990	9,705	11,390	12,690	14,305	16,267
Reserves for bad & doubtful debt	4,178	4,722	5,506	6,434	7,584	8,979
Borrowings	216,482	269,248	335,838	428,002	547,044	702,389
Interest Subsidy fund from GOI	11,559	12,003	12,390	12,698	12,991	13,269
Current liabilities & Provisions	10,271	14,162	17,709	20,718	24,159	30,102
Total Liabilities	**311,455**	**374,896**	**463,759**	**568,925**	**703,771**	**879,876**
Assets						
Advances	295,201	356,025	440,980	546,815	678,051	847,564
Fixed Assets	813	847	810	818	826	835
Current assets, loans & advances	15,301	17,859	21,689	21,011	24,614	31,198
Total Assets	**311,455**	**374,896**	**463,759**	**568,925**	**703,771**	**879,876**
Growth (%)						
Growth in NII	(10.2)	(7.1)	26.1	30.9	24.0	21.3
Growth in reported net profit	(4.7)	0.5	0.8	26.4	24.3	21.5
Growth in core net profit	(13.8)	9.5	7.3	36.3	24.3	21.5
Growth in Advances	18.9	20.6	23.9	24.0	24.0	25.0
Growth in balance sheet	16.8	20.4	23.7	22.7	23.7	25.0

Source: Company, ENAM Research

Key Ratios

(%)	FY05	FY06	FY07	FY08E	FY09E	FY010E
Valuations						
EPS (Rs)	11.2	10.2	10.0	12.0	14.9	18.1
ROA	3.3	2.7	2.6	2.7	2.7	2.6
ROE	17.5	14.6	13.8	14.2	16.0	17.5
BV (including DTL)	67	73	80	88	98	109
BV (including DTL & Reserves for bad & doubtful)	71	77	85	94	104	117
Yields & Margins						
Average Yield on Advances	10.1	9.0	9.5	10.2	10.7	11.2
Yield on avg. assets	10.0	8.8	9.3	10.1	10.6	11.1
Average Cost of Funds	7.3	7.0	7.3	8.0	8.4	9.0
Spread	2.7	1.8	1.9	2.2	2.2	2.2
NIM	4.4	3.4	3.5	3.7	3.7	3.6
Asset Quality						
Gross NPAs (%)	0.66	0.26	0.1	0.2	0.2	0.3
Net NPAs (%)	0.5	0.2	0.06	0.1	0.2	0.2
Capital (%)						
Tier-I (%)	20.9	18.2	18.4	16.2	14.4	12.8
Tier-II	0	0	0	0	0	0
Others						
Fee income/Total income	1.9	2.2	2.2	5.3	5.3	4.8
Leveraging	5.0	5.5	5.7	6.1	6.8	7.7
Leveraging including DTL	4.4	4.8	5.0	5.3	6.0	6.7
Operating cost as a % of average assets	0.16	0.15	0.12	0.11	0.1	0.09
Operating Cost as % of Net Income	3.7	4.3	3.5	2.9	2.7	2.47
Dividend Rate (%)	37.4	35.1	30.0	38.0	47.0	58.0
Total Payout (including tax) (%)	45	42	40	40	40	40

Source: Company, ENAM Research. Calculation of EPS, ROA & ROE includes provision for DTL.

Key Risks to our call

- Benefits given to long term financing under section 36(1) (viii) have been reduced to 20% of the profits from 40% earlier. There is a risk that even this 20% tax deduction may be removed going ahead. However, given the fact that some categories of banks have now been included in this benefit from FY08 onwards, we argue that this benefit in a reduced form is likely to continue.

- Volatility of interest rates can put pressure on incremental spreads, as PFC does not have access to low cost deposits.

Abbreviations

DDG – Decentralized Distributed Generation

NCES – Non-Conventional Energy Sources

SPSU – State Power Sector Utility

CPSU – Central Power Sector Utility

SLR – Statutory Reserves Ratio

CRR – Cash Reserve Ratio

EQI –Equated Quarterly Installment

NIM – Net Interest Margin

Ckm – Circuit Kilometer

BU – Billion Units

MW – Mega Watt

MVA – Mega Volt Ampere

R&M – Renovation & Modernization

HRD – Human Resource Development

R&D – Research & Development

DSM – Demand Side Management

DTL – Deferred Tax Liability

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CONFLICT OF INTEREST DISCLOSURE STATEMENT

We, at ENAM, are committed to providing the most honest and transparen2t advice to our clients. However, given the nature of the capital markets, from time to time we are faced with situations that could give rise to potential conflict of interest. In order to provide complete transparency to our clients, before we make any recommendations, we are committed to making a disclosure of our interest and any potential conflict IN ADVANCE so that the interests of our clients are safe- guarded at all times. In light of this policy, we have instituted what we believe to be the most comprehensive disclosure policy among leading investment banks/brokerages in the world so that our clients may make an informed judgment about our recommendations. The following disclosures are intended to keep you informed before you make any decision- in addition, we will be happy to provide information in response to specific queries that our clients may seek from us.

Disclosure of interest statement (As of April 24, 2007)

1. Analyst ownership of the stock	Yes
2. Firm ownership of the stock	No
3. Directors ownership of the stock	Yes
4. Investment Banking mandate	No
5. Broking relationship	No

We are committed to providing completely independent and transparent recommendations to help our clients reach a better decision.