

**Nat Resources & Energy**  
**Electric Utilities**  
 Equity – India

# Power Grid Corp Of India (PWGR IN)

## Overweight

Target price (INR)	130.00
Share price (INR)	99.00
Forecast dividend yield (%)	1.8
Potential return (%)	33.1

Note: Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield

Performance	1M	3M	12M
Absolute (%)	3.1	-9.6	-7.4
Relative <sup>A</sup> (%)	-0.8	0.8	11.3

Index<sup>A</sup> BOMBAY SE SENSITIVE INDEX

RIC PGRD.BO  
 Bloomberg PWGR IN

Market cap (USDm) 8,376  
 Market cap (INRm) 416,675

Enterprise value (INRm) 753153  
 Free float (%) 31

Note: (V) = volatile (please see disclosure appendix)

25 October 2011

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

OW: On track for strong growth

- ▶ **Capacity addition in 1H is higher than expected and would be a key factor over the next two to three years**
- ▶ **Capex moderated in 1H, but we expect it to meet our FY12-13 estimates given the level of ordering in 1H**
- ▶ **Growing short-term open access income provides long-term earnings potential. Power Grid is our best pick among utilities; maintain OW rating and TP of INR130**

**Capacity addition higher than expected – a key driver for the stock:** Powergrid increased capacity by INR41bn in 1H, ahead of our expectations of INR38bn, with an additional INR10bn in October 2011. We expect this to continue over the next two to three years, given the large capital work in progress, at INR275bn, and meet our capacity expansion estimates of INR300bn for 2HFY12-FY14.

**Capex moderated in 1H, we expect the company to meet our FY12-13 estimates:** In 1H capex incurred was lower at INR46bn vs our estimate of INR60bn-65bn. However, we expect the company to meet our annual capex estimate of INR135bn in FY12-13, given that the company has already invited tenders for INR138bn in 1H and awarded contracts worth INR53bn. We expect the remainder to be done over next two to three months.

**2Q results in line:** 2Q adjusted net profit at INR7.58bn (up 20% yoy) was in line with our estimate of INR7.52bn, while ahead of consensus by 5%. Transmission income (up 5% y-o-y) was slightly lower than our forecast (by 4%), which we see as more of timing issue.

**Growing short-term open access income to provide long-term earnings potential:** Open access income grew to 3.6% of revenue in 1H (up 47% y-o-y) from c2.5% in FY11. As large capacities coming in India are near fuel centres, this income may grow quickly if open access in India takes off. This should boost earnings in the long term as it directly contributes to the bottom line with no significant cost.

**Best pick among utilities:** We expect the regulated equity base to grow at 22% CAGR from cINR141bn in 1H to cINR232bn by end-FY14, which drives our expectation of net profit growth of 15.5% CAGR over FY12-14 from a high base in FY11. We do not see any significant downside risks to these earnings estimates, given the assured return model (15.5% post-tax ROE) once the asset is operational. Also there is no fuel risk, unlike generation companies.

**Maintain OW and TP of INR130** using a DCF valuation (assuming COE of 11.8% and terminal growth of 3%). Our target price implies a FY13e PB of 2.3x versus the current FY12e PB of 2.0x, and an FY13e PE of 17.2x versus the current FY12e PE of 15.0x. **Key downside risk** includes longer-than-expected delays in project commissioning impacting earnings.

## Financials & valuation

### Financial statements

Year to	03/2010a	03/2011e	03/2012e	03/2013e
<b>Profit &amp; loss summary (INRm)</b>				
Revenue	71,275	84,143	99,497	117,374
EBITDA	57,731	69,466	81,755	96,342
Depreciation & amortisation	-19,797	-22,255	-26,396	-31,523
Operating profit/EBIT	37,934	47,211	55,360	64,819
Net interest	-15,432	-17,118	-18,916	-20,983
PBT	26,263	37,126	41,251	47,521
HSBC PBT	26,263	37,126	41,251	47,521
Taxation	-5,854	-10,886	-10,748	-12,449
Net profit	20,409	26,240	30,503	35,072
HSBC net profit	20,409	26,240	30,503	35,072

### Cash flow summary (INRm)

Year to	03/2010a	03/2011e	03/2012e	03/2013e
Cash flow from operations	52,853	51,981	60,261	69,506
Capex	-100,527	-120,000	-135,000	-135,000
Cash flow from investment	-98,016	-118,250	-133,250	-133,250
Dividends	-5,909	-9,480	-10,834	-12,188
Change in net debt	51,026	37,869	83,823	75,932
FCF equity	-55,685	-75,052	-79,546	-69,178

### Balance sheet summary (INRm)

Year to	03/2010a	03/2011e	03/2012e	03/2013e
Intangible fixed assets	0	0	0	0
Tangible fixed assets	524,834	622,579	731,184	834,661
Current assets	96,273	124,517	113,752	106,046
Cash & others	32,776	56,487	40,256	26,336
Total assets	635,675	759,914	856,003	950,024
Operating liabilities	100,471	108,490	117,319	126,445
Gross debt	344,168	405,747	473,339	535,350
Net debt	311,392	349,260	433,083	509,014
Shareholders funds	159,419	214,059	233,728	256,612
Invested capital	487,861	582,119	687,361	787,926

### Ratio, growth and per share analysis

Year to	03/2010a	03/2011e	03/2012e	03/2013e
<b>Y-o-y % change</b>				
Revenue	25.3	18.1	18.2	18.0
EBITDA	27.8	20.3	17.7	17.8
Operating profit	10.9	24.5	17.3	17.1
PBT	17.8	41.4	11.1	15.2
HSBC EPS	20.6	22.4	11.0	15.0

### Ratios (%)

Year to	03/2010a	03/2011e	03/2012e	03/2013e
Revenue/IC (x)	0.2	0.2	0.2	0.2
ROIC	6.5	6.2	6.4	6.5
ROE	13.4	14.1	13.6	14.3
ROA	5.5	5.5	5.5	5.6
EBITDA margin	81.0	82.6	82.2	82.1
Operating profit margin	53.2	56.1	55.6	55.2
EBITDA/net interest (x)	3.7	4.1	4.3	4.6
Net debt/equity	195.3	163.2	185.3	198.4
Net debt/EBITDA (x)	5.4	5.0	5.3	5.3
CF from operations/net debt	17.0	14.9	13.9	13.7

### Per share data (INR)

Year to	03/2010a	03/2011e	03/2012e	03/2013e
EPS reported (fully diluted)	4.85	5.94	6.59	7.58
HSBC EPS (fully diluted)	4.85	5.94	6.59	7.58
DPS	1.50	1.75	2.00	2.25
Book value	37.88	46.24	50.48	55.43

### Key forecast drivers

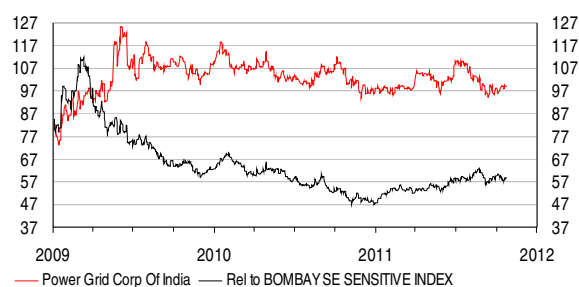
Year to	03/2010a	03/2011e	03/2012e	03/2013e
Capex (INRbn)	101	120	135	135
Capitalisation (INRbn)	29	75	100	115
Regulated Equity (INRbn)	106	129	158	193

### Valuation data

Year to	03/2010a	03/2011e	03/2012e	03/2013e
EV/sales	10.0	9.0	8.4	7.8
EV/EBITDA	12.4	10.8	10.3	9.5
EV/IC	1.5	1.3	1.2	1.2
PE*	20.4	16.7	15.0	13.1
P/Book value	2.6	2.1	2.0	1.8
FCF yield (%)	-13.8	-18.6	-19.6	-17.0
Dividend yield (%)	1.5	1.8	2.0	2.3

Note: \* = Based on HSBC EPS (fully diluted)

### Price relative



Source: HSBC

Note: price at close of 21 Oct 2011

## 2Q review: Good set of numbers

Adjusted net profit at INR7.58bn (up 20% y-o-y) was in line with our estimate of INR7.52bn and ahead of consensus by 5%. **At the operational level**, we note that the transmission income in 2Q at INR20.4bn (up 5% y-o-y) was marginally lower than our forecast (by 4%). We believe this is largely matter of timing, as assets get commissioned over a period of time and resultant income will get adjusted by the end of year.

**In terms of other operations**, consultancy income continued to fall, but short-term open access income continues to surprise on the upside. It grew to 3.6% of revenue in 1H (up 47% y-o-y) from c2.5% of revenue in FY11. This is likely to boost earnings as it directly contributes to the bottom line with no significant cost.

**Reported net profit** at INR7.1bn was lower due to accounting of forex loss of INR683m in 2Q on foreign currency loans but with no cash flow impact. Note that the company is on a cost-plus model and any actual increase in the borrowing cost, even accounting for foreign exchange variations, is passed on to customers as and when it arises.

Exhibit 1: PGCIL standalone 2Q quarterly results summary

INRm	Q2FY12	y-o-y%	HSBC	Act vs HSBC	BBG Cons.	Act vs Cons.	Q2FY11
Revenue	22,644	6%	23,299	-3%	23,400	-3%	21,266
EBITDA	18,978	6%	19,623	-3%	19,585	-3%	17,858
Margin %	83.8%	(16)	84.2%	(41)	83.7%	12	84.0%
PBT (adjusted)	10,081	12%	10,298	-2%	10,110	0%	9,032
Net profit (adjusted)	7,580	20%	7,518	1%	7,229	5%	6,328
PBT (reported)	9,398	1%	10,298	-9%	10,110	-7%	9,348
Net profit (reported)	7,066	8%	7,518	-6%	7,229	-2%	6,549
<b>Segmental Revenue</b>							
Transmission	20,416	5%	21,323	-4%			19,384
Consultancy	696	-12%	829	-16%			789
Telecom	501	10%	476	5%			454
Short Term Open Access	1,031	61%	671	54%			639

Source: Company data, HSBC estimates, Consensus from Bloomberg

## Investor focus on capex and capacity addition

We expect Powergrid to complete its 11th five-year plan ending FY12 with total capex of INR520bn (versus a target of INR550bn). To date, total capex has amounted to INR430bn, and we expect the remaining INR90bn to be spent in 2H. Overall capex incurred in this plan period will represent a significant c177% increase over the last plan period.

**We do not expect any slowdown in capex** post the plan period (contrary to market concerns). We forecast PGCIL to incur capex of cINR275bn and for capacity to expand by cINR240bn in FY13-14 similar to FY12. This is likely to be driven by: a) projects under construction worth cINR452bn and b) INR580bn worth of ordering for high capacity power transmission corridors (HCPTC) projects expected to start in 2HFY12. We remain conservative, factoring capex of INR800bn for the 12th plan period (FY13-17) against the company's guidance of INR1,000bn-1,200bn. The company has already obtained investment approvals worth cINR250bn from the board relating to 12th plan projects, which will start to be awarded in next round of contract tendering.

Exhibit 2: PGCIL capex and capacity addition to continue to remain strong over next 2-3 years

INRbn	FY10	FY11	1HFY12	2HFY12e	FY13e	FY14e
Capex	101	121	46	89	135	140
Capacity addition	29	73	41	59	115	125

Source: Company data, HSBC estimates

**Exhibit 3: PCIL Operational highlights - capacity addition was strong in Q2 as well October, capex to pick up in 2H**

INRm	FY11	1HFY11	1HFY12	% yoy	YTD (upto Oct)
Capex	120,770	36,820	46,110	25%	49,000
Capacity addition*	73,130	50,890	40,570	-20%	51,000
Contracts awarded	190,560	33,500	42,240	26%	78,260
Investment approval	211,500	106,390	97,510	-8%	107,000

Source: Company data, \*Note capacity addition in Q1FY12 was mere INR8bn which picked up to INR32.6bn in Q2FY12 and another INR10bn in October 2011

**Exhibit 4: PGCIL: some of the large expansion projects under construction**

Project	Nature of the project	Target COD	Project cost (INRm)	Cost incurred as at 1HFY11	% spent
Transmission System for development of pooling station in Northern Part of West Bengal and transfer of power from Bhutan to Northern Region / Western Region North East / Northern Western Interconnector – I Project	Generation-linked	January, 2015	44,046	0	0%
Northern Region System Strengthening – XXI	Generation-linked	August, 2013	111,302	14,355	13%
Transmission System associated with Sasan UMPP	Grid-strengthening	April, 2013	16,776	11	0%
Transmission System associated with Pallatana and Bongaigaon power station	Generation-linked	December, 2012	58,850	13,283	23%
Transmission System associated with Vindhychal – IV and Rihand – III Projects	Generation-linked	December, 2012	21,440	853	4%
Eastern Region Scheme – III Strengthening	Generation-linked	November, 2012	46,730	120	0%
Transmission System associated with Mundra UMPP	Grid-strengthening	November, 2012	12,728	318	2%
Common Scheme for 765 kV Pooling Station with DVC and Maithon RB Project	Generation-linked	October, 2012	46,820	9,208	20%
Supplementary Transmission System associated with DVC and Maithon Project	Generation-linked	August, 2012	70,753	25,018	35%
System Strengthening in Northern Region for Sasan and Mundra UMPPs	Generation-linked	August, 2012	23,610	12,991	55%
765 kV System for Central Part of Northern Grid – PART – III	Grid strengthening	August, 2012	10,850	1,101	10%
Transmission System associated with Kundankulam – Atomic Power Project	Grid-strengthening	May, 2012	10,751	1,142	11%
Transmission System associated with Kaiga 3 and 4	Generation-linked	March, 2012	21,591	16,140	75%
765 kV System for Central Part of Northern Grid – PART – I	Generation-linked	March, 2012	10,072	7,603	75%
765 kV System for Central Part of Northern Grid – PART – II	Grid-strengthening	February, 2012	13,473	4,468	33%
Western Region Strengthening Scheme – II	Grid-strengthening	January, 2012	17,364	1,509	9%
Strengthening of East-West Transmission corridor	Grid-strengthening	March, 2011	35,690	26,465	74%
Western Region Strengthening Scheme – IX	Grid-strengthening	Dec, 2010	7,409	6,207	84%
Southern Region Strengthening Scheme – X	Grid-strengthening	March, 2011	1,410	522	37%
Western Region Strengthening Scheme – X	Grid-strengthening	April, 2012	2,240	317	14%
Northern Region Strengthening Scheme – XIII	Grid-strengthening	Feb, 2012	7,130	688	10%
Transmission System associated with Korba III generation project	Grid-strengthening	Nov, 2011	3,240	173	5%
Transmission System associated for Parbati III Hydro project	Generation-linked	March, 2011	2,763	1,581	57%
Transmission System associated for Mouda generation project	Generation-linked	Jun, 2011	6,163	4,019	65%
<b>Sub Total</b>			<b>605,999</b>	<b>148,190</b>	<b>24%</b>
Others			211,513	87,825	42%
Add: Capex incurred in 2HFY11 (Oct 2010-March 2011)				83,175	
Add: Capex incurred in 1HFY12 (April 2011- Sep 2011)				46,110	
<b>Grand Total</b>			<b>817,512</b>	<b>365,300</b>	<b>45%</b>
<b>Balance capex to be incurred</b>			<b>452,212</b>		

Source: Company data

**Exhibit 5: Summary of high-capacity transmission systems to be built for various independent power producers by PGCIL**

Project - Transmission system associated with	Capacity (MW)	LTOA (MW) - Total	Project Cost (INRbn)
Phase - I generation projects in Orissa	10,090	6,080	87,520
IPP projects in Jharkhand	4,540	4,084	57,090
IPP projects in Sikkim	2,358	2,358	13,040
IPP projects in Bilaspur complex, Chhattisgarh and IPPs in Madhya Pradesh	4,370	4,160	12,430
IPP projects in Chhattisgarh	15,485	15,185	288,240
IPP projects in Krishnapatnam area, AP	4,600	3,072	20,650
IPP projects in Tuticorin area, Tamil Nadu	2,600	2,045	23,570
IPP projects in Srikakulam area, AP	3,960	3,760	29,860
IPP projects in southern region for transfer of power to other regions	11,526	9,182	48,210
<b>Total</b>	<b>59,529</b>	<b>49,926</b>	<b>580,610</b>

Source: Company data, Note: As per company, estimated cost of corridors is expected to be INR750bn which includes transmission system for Ultra Mega power projects not included in the table above

## Reiterate Overweight rating with a TP of INR130

We use DCF to value Power Grid and apply a cost of equity of 11.8% and terminal growth rate of 3% to derive our target price of INR130 per share.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppts above and below the hurdle rate for Indian stocks of 11%. Our target price implies a potential return of 33.1%, above the Neutral band; therefore, we are reiterating our Overweight rating. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Our target price implies a FY13e PB of 2.3x versus the current FY12e PB of 2.0x, and an FY13e PE of 17.2x versus the current FY12e PE of 15.0x.

### Risks

**Key downside risks** include longer-than-expected delays in commissioning of projects. Other risks include a potential default by SEB and a reduction in regulated returns, although both look highly improbable in the immediate future.

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#### Exhibit 6: PGCL: Valuation summary

Particulars	INRm	INR/Share
Equity value - Core	550,937	119
Add: Cash & bank	40,256	9
Add: Investments	11,032	2
<b>Equity value - Total</b>	<b>602,225</b>	<b>130</b>

Source: HSBC estimates

# Disclosure appendix

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This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at [www.hsbcnet.com/research](http://www.hsbcnet.com/research). Details of these short-term investment opportunities can be found under the Reports section of this website.

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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<b>Overweight (Buy)</b>	55%	(26% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	35%	(21% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	10%	(13% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities

Power Grid Corp Of India (PGRD.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

### Recommendation & price target history

From	To	Date
N/A	Overweight	14 January 2011
Target Price	Value	Date
Price 1	130.00	14 January 2011

Source: HSBC

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- 2 All market data included in this report are dated as at close 23 October 2011, unless otherwise indicated in the report.
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