CESC Ltd – ADD

CESC IN	Rs380	Utilities	19 November 2009	Company update

Changing gears

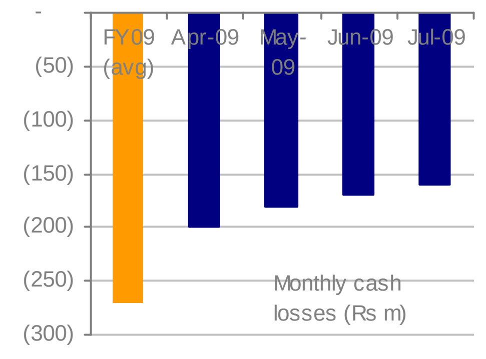
CESC is keen to shrug off its "local utility" profile, and aims to grow its business through organic and inorganic routes. This is manifested in its recent acquisition of a 600MW under-development project in Maharashtra (Rs3bn, 100% stake) and L1 bid for a distribution franchise in Bihar. Cash losses per month in its retail arm have dropped to Rs160-180m compared to Rs270m (FY09 average), indicating that the worst is over. Change in management's stance and declining retail losses bode well for the stock's performance hereon. At 1.4x consolidated FY10ii BV, valuations are attractive. We maintain ADD with a target price of Rs450/share.

BB-III construction complete, capacity up 25%: Construction of CESC's 250MW unit at Budge Budge is complete, and the company's aggregate generation capacity now stands at 1.2GW (up 25%). Currently, CESC is operating this unit at 25-30% PLF, and expects to ramp up PLF by 4QFY10. We estimate the unit will earn RoE of ~20% in steady state and contribute Rs600m-650m to CESC's power profits (15-18% of FY09 PAT). The profit contribution could be higher if CESC is able to export surplus power at attractive rates.

Changing gears—tapping inorganic growth options: CESC has acquired a 600MW under-development power project in Maharashtra. Furthermore, it has ventured outside Kolkata and participated in bidding called by Bihar State Electricity Board for appointing "distribution franchisee" in Muzaffarpur (it has been short-listed as L1 bidder). We view this change positively, and believe it would act as catalyst for a re-rating.

Organised retail—the worst seems to be over: Over the past 6-8 months, management has focussed on cost control, store closures (area down by 25%) and focussed growth from large-format stores. As a result, monthly cash losses are down to Rs160m-180m from the FY09 average of Rs270m. Hereon, reduction in losses would be driven by margin expansion and growth in revenues per sq ft. We reckon a complete turnaround is at least a year away, but loss reduction in the retail business is a key trigger for the stock's outperformance hereon.

Retail: worst seems to be over



Source: Company, IIFL Research

Financial Summary

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	28,452	30,911	33,552	34,535	36,263
EBITDA Margins (%)	23	23	27	29	29
Pre-Exceptional PAT (Rs m)	3,285	3,985	4,441	4,791	5,162
Reported PAT (Rs m)	3,554	4,100	4,441	4,791	5,162
EPS (Rs)	26.2	31.7	35.4	38.1	41.1
Consol EPS (Rs)	21.3	6.2	17.2	29.7	38.1
PER (x)	14.5	12.0	10.7	10.0	9.2
Consol PER (x)	17.8	61.6	22.1	12.8	10.0
EV/EBITDA (x)	9.2	9.3	8.3	7.9	7.7
Standalone Price/Book (x)	1.5	1.3	1.2	1.1	1.0
Consolidated Price/Book (x)	1.6	1.5	1.4	1.3	1.2

Price as at close of business on 17 November 2009

12-mth TP	***(Rs) 450 (19%)***
Market cap (US$ m)	**1,024**
52Wk High/Low (Rs)	412/171
Diluted o/s shares (m)	125
Daily volume (US$ m)	3
Dividend yield FY10ii (%)	1.6
Free float (%)	47.5

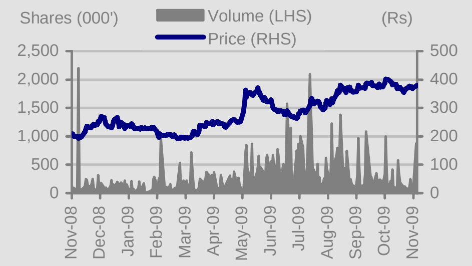
Shareholding pattern (%)

Promoters	52.5
FIIs	16.6
Domestic MFs	19.1
Others	11.9

Price performance (%)

	1M	3M	1Y
CESC	-5.2	21.5	72.1
Rel. to Sensex	-3.6	6.2	-11.4
NTPC	0.7	5.7	42.8
Tata Power	-7.4	5.2	82.0
Reliance Infra	-8.5	7.0	146.5

Stock movement



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Budge Budge -III construction complete; capacity up by 25%

CESC is all set to commission the third unit of 250MW capacity at Budge Budge (BB-III). Construction work has been completed, the boiler has been test-fired, and following test synchronisation, the unit is generating 70-80MW daily. Peak capacity utilisation is expected by December 2009. We believe there should be no problems ramping up PLF for this unit, given CESC's track record in managing existing 975MW assets.

Figure 1: Budge Budge set to achieve peak capacity utilisation by December 2009

Source: Company, IIFL Research

Commissioning of BB-III would increase CESC's aggregate generation capacity to 1,225MW. BB-III is a part of CESC's regulated business and would supply power on a cost-plus basis (14% RoE and incentives) to power distribution companies.

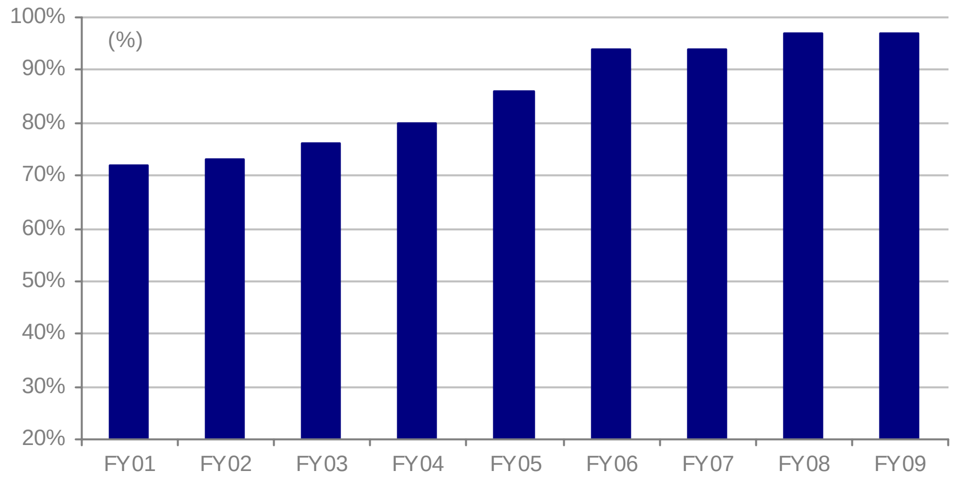
The plant is being set up with an estimated capex of Rs11.5bn, and is funded through a D:E of 70:30. Equity funding for the plant has come from internal generation. Additionally, with full capacity coming on stream, CESC would be able to earn additional incentives from efficient operations. This being a brown-field expansion, CESC would also gain from synergies with existing operations at Budge Budge station (operating at more than 95% PLF for the last six quarters). Therefore, in steady state, we estimate this unit will generate ~20% RoE and add Rs600m-650m to CESC's PAT (15-18% of FY09 PAT).

Figure 2: BB-III has increased CESC's generation capacity by 25%

Plant	Capacity (MW)
Budge Budge	500
Southern	135
Titagarh	240
New Cossipore	100
Budge Budge (expansion, unit-3)	250
Total	**1,225**

Source: Company, IIFL Research

Figure 3: Existing units are operating close to the rated capacity for past 4 years



Source: Company, IIFL Research

Changing gears: exploring inorganic growth options

Traditionally, CESC has been regarded as a utility with strong skills but little aggressiveness, as it has largely confined its business to Kolkata. However, in the current opportunity landscape, CESC has initiated several steps on business development outside Kolkata, both organically and inorganically.

While the company's plan to grow organically seems to be going rather slow (600MW capacity under development has still not achieved financial closure), its inorganic initiatives seem to be gathering momentum. It recently signed an agreement to acquire 100% stake in a 600MW under-development project for Rs3bn. Furthermore, in an attempt to grow its business beyond Kolkata, it has participated in bids invited for appointing a distribution franchisee in Patna. Also, it has expressed interest in acquiring a controlling stake in Durgapur Power project in West Bengal.

Although this initiative comes a bit late (compared to other utilities that have been more aggressive), we view it positively, and believe that they would help breach the valuation multiple gap.

- **Acquisition of 600MW under-development project would be value–accretive, in our view**

  Among its first inorganic growth initiative is CESC's acquisition of 51% stake in a 600MW power project in Chandrapur (Maharashtra), for a consideration of Rs2bn. As per the agreement, CESC would pay a further Rs1bn to acquire the remaining stake upon achievement of certain milestones.

  The plant is located 150km from Nagpur and has already achieved key milestones. For instance, the project SPV has already: 1) secured land from MIDC; 2) received water linkages; and 3) received LOA from Coal India for supply of coal.

  The plant has signed a PPA for only 50% of capacity (300MW) with MSEDCL on cost-plus basis, allowing CESC to sell the balance 300MW through case-1 bids, in which returns are usually higher than on vanilla RoE (15.5%) projects.

  The plant achieved financial closure after CESC acquired it; the company plans to place equipment orders in the next 3-5 months.

Figure 4: Chandrapur project has major clearances in place

	Unit	Value
Acquisition cost		
for initial 51%	Rs m	2,000
for remaining 49%	Rs m	1,000
Capacity	MW	600
Project capex	Rs bn	28
D/E		70:30
CoD		FY13
Current status		
Land	• 450 acres allotted from MIDC	
Fuel linkage	• Coal linkage from South Eastern Coalfields	
Water linkage	✓	
Environmental clearance	✓	
Financial closure	✓	

Source: Company, IIFL Research

- **L1 bidder for distribution franchise in Muzaffarpur**

  CESC is among select private entities that have extensive experience in power distribution (industrial as well as retail). This makes it one of the best-placed companies to benefit from opportunities emerging from distribution reforms.

  As highlighted in our note *Distribution franchising: a politically acceptable solution* (30 September 2009), some states such as Bihar are in the process of appointing distribution franchisees to improve discom operations. CESC has participated in the bids invited by Bihar State Electricity Board (BSEB) for Patna and Muzaffarpur circles. While a final decision is pending, CESC has emerged L1 bidder for the Muzaffarpur circle. In our view, CESC is well-positioned for great gains from such ventures, given its rich experience in distribution.

Organic growth initiatives promising, but little progress on the ground

Organically, CESC plans to step up its generation capacity by 1.6GW by FY15 through two new projects: 1) a 600MW power plant at Haldia; and 2) 1,000MW power plant at Dumka, Jharkhand, for which it has already been allocated a captive coal mine.

In our view, both these projects are promising, and would add value to CESC's generation portfolio. However, over the past 18 months, there has been no material progress on these projects. Management attributes the delay to land acquisition and environmental clearance issues.

Figure 5: Organic growth of 1.6GW planned

Project	Capacity (MW)	Land acquisition	Fuel linkage	Purpose	CoD	Remarks
Haldia Phase I, WB	600	80% complete	✓	WB distribution (50%) Merchant (50%)	FY13	• Environmental clearance obtained. • NOC for water drawl, chimney erection in place. • Financial closure by Feb-2010.
Dumka, Jharkhand	1,000		✓	Merchant	NA	• 110MT coal mine allocated

Source: Company, IIFL Research

Meanwhile, operating assets continues to be cash cows

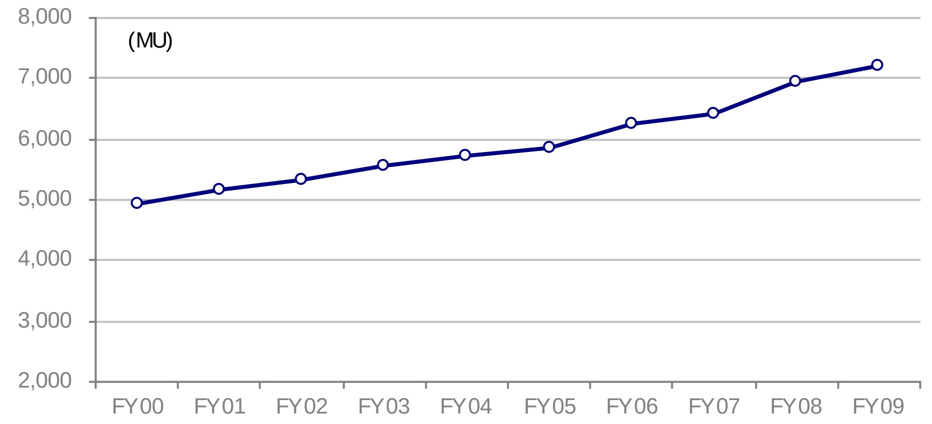
CESC's core distribution business in Kolkata continues to be a cash cow. In FY09, it earned a core RoE of 19%, and we expect these high returns to continue. We expect this business to generate cash profit of Rs7bn pa through FY10-12ii, on sustained load growth of 3-4% pa, and commissioning of 250MW capacity (BB-III).

Figure 6: CESC earned a core RoE of 19% in FY08/09

(Rs m)	FY08	FY09
Reported profits	3,285	3,985
(-) Treasury income	583	970
Core Profits	2,702	3,015
Regulated equity	14,165	15,836
Core RoE (%)	19%	19%

Source: Company, IIFL Research

Figure 7: CESC's distribution business has seen steady growth



Source: Company, IIFL Research

Organised retail: the worst is over

CESC's subsidiary Spencer's Retail incurred adjusted loss of Rs2.5bn in FY09, the highest ever since incorporation. CESC initiated several cost control initiatives since 2HFY09. Its focus has been on: 1) closure of unviable small-format stores; 2) reduction in corporate overheads; and 3) an increased focus on large-format stores.

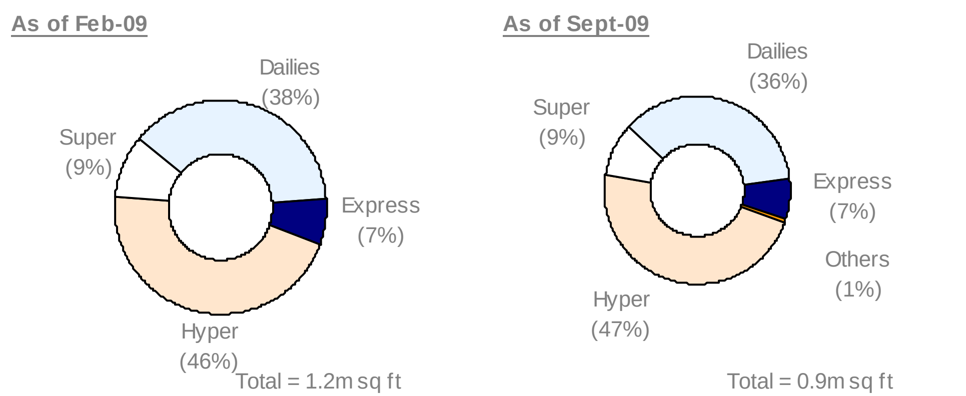
As a result of this restructuring, over the past 6-8 months, SRL's retail area stands reduced by almost 25% to 0.9m sq ft. Since store closure has primarily been in the small-format stores category, share of hyperstores and other large-format stores has increased in the overall area under operation.

Figure 8: More than 20% of the stores closed since February 2009

Number of stores closed	Feb 2009	Sep 2009
Hyper	21	17
Super	15	13
Dailies	176	132
Express	64	49
Others	0	5
Total	**276**	**216**

Source: Company, IIFL Research

Figure 9: Retail area down almost 25% from Feb 2009 to 0.89m sq ft at present

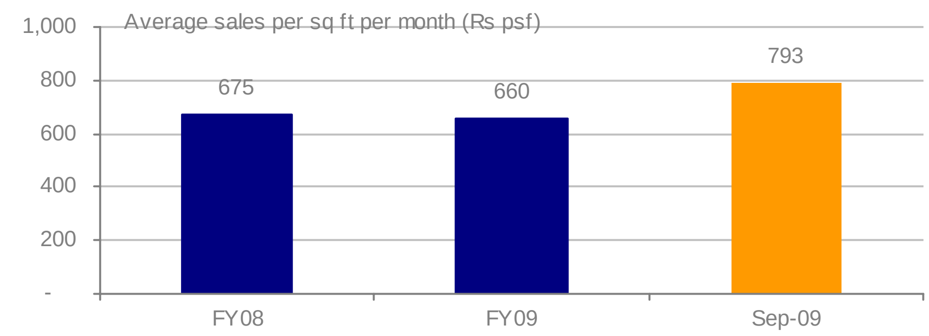


Source: Company, IIFL Research

Simultaneously, SRL is increasing its focus on the apparel segment, which fetches higher gross margins. It has entered into exclusive tie-ups with international apparel majors such as Mark Ecko, Beverly Hills Polo Club and Ladybird. Currently, this line of merchandise accounts for less than 15% of the retail business's total revenues, so its contribution to gross margin remains small.

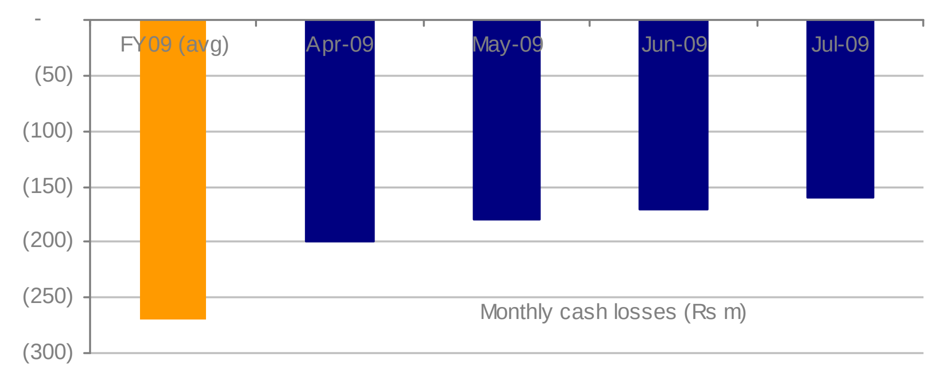
SRL's efforts to increase revenue per sq ft per month seem to be paying off. Its sales per sq ft per month rose from Rs660 in FY09 to Rs793 in September 2009. The management also mentioned that during Diwali/ Durga Pooja season, this figure was close to Rs900/sq ft. The effect of cost control measures and increasing revenue per sq ft is reflected in gradual reduction in monthly cash losses, which dropped to Rs160m in October 2009, from Rs270m (FY09 average).

Figure 10: Continued strength in psf sales would determine success of initiatives



Source: Company

Figure 11: Monthly cash losses down since March 2009, but still remain significant

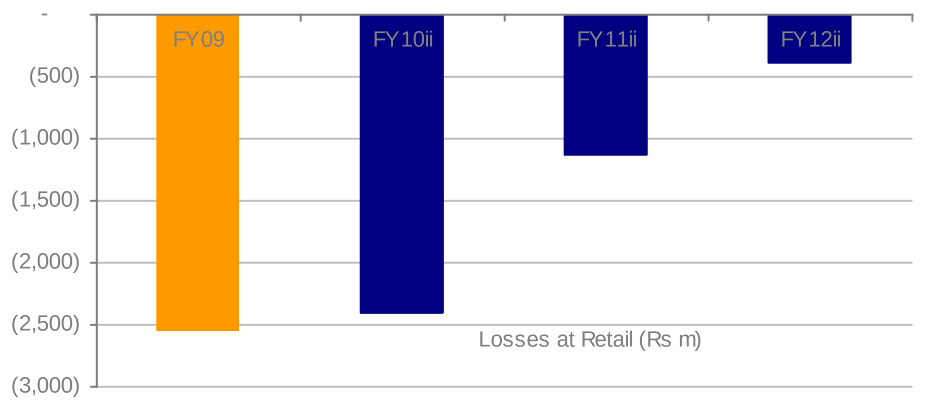


Source: Company

In our view, SRL has successfully completed initial cost control measures (store closures, manpower rationalisation, etc). The effect of these initiatives is visible in lower cash losses, which indicates that the worst is over for this venture. However, hereon, reduction in cash losses would hinge largely on SRL's ability to increase per sq ft revenue and enhance gross margins from the present 17%.

We are building in annual loss of Rs2.4bn in FY10ii and Rs1.1bn in FY11ii in our earnings model, and a marginal loss in FY12ii for the retail business.

Figure 12: We build in improvement in retail losses going forward



Source: Company, IIFL Research

Trading near book value; we maintain ADD

We forecast CESC's consolidated profits will register a CAGR of 84% through FY09-12ii. At 1.3x FY11ii consolidated BV, valuations are at 45% discount to sectoral peers.

While CESC's retail business is likely to incur losses over the next couple of years, we think the worst is over for the business. An improved macro environment also increases possibility of a partial stake sale in the retail business to a strategic investor. This coupled with management's intent to grow the core power business organically as well as inorganically, should aid a re-rating in CESC's P/BV. We maintain ADD.

Figure 13: almost 50% discount on P/BV to peers should narrow down in our view

Company	CMP (Rs)	Mkt Cap (USm)	P/B FY10	P/B FY11	P/E FY10	P/E FY11
NTPC	215	38,311	2.8	2.5	20.6	18.9
JSPL	707	14,110	6.2	4.9	18.8	16.4
NHPC	32	8,607	1.5	1.4	28.9	20.5
Tata Power	1,319	6,307	4.2	3.5	17.0	16.1
Reliance Infra	1,189	5,804	2.1	2.0	24.9	21.1
GIPCL	118	384	1.3	1.3	14.4	10.2
CESC (consolidated)	380	1,030	1.4	1.3	22.1	12.8
Sector average			**2.8**	**2.4**	**21.0**	**16.6**
CESC's % premium/ (discount) to average			**-49%**	**-45%**	**6%**	**-23%**

Source: Bloomberg, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue	28,452	30,911	33,552	34,535	36,263
EBITDA	6,680	7,244	8,907	9,891	10,434
EBIT	**4,996**	**5,494**	**6,837**	**7,530**	**7,993**
Interest income	583	970	563	463	425
Interest expense	-1,818	-1,927	-2,133	-2,339	-2,339
Profit before tax	3,760	4,537	5,267	5,654	6,080
Tax expense	-476	-552	-826	-863	-917
Extraordinary items	269	115	0	0	0
Net Profit	**3,554**	**4,100**	**4,441**	**4,791**	**5,162**

Cashflow summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Profit before tax	3,760	4,537	5,267	5,654	6,080
Depreciation & Amortization	1,685	1,750	2,070	2,361	2,441
Tax paid	476	552	826	863	917
Working capital change	3,166	3,681	(3,392)	114	203
Operating Cash-flow	8,135	9,416	3,119	7,266	7,806
Capital expenditure	-6,453	-13,560	-7,914	-8,722	-8,882
Free cash flow	1,681	-4,144	-4,795	-1,456	-1,076
Equity raised	7,761	2,113	0	0	0
Investments	-5,783	-3,355	-1,300	-1,750	0
Debt financing/disposal	-794	8,483	4,348	2,518	1,951
Dividends paid	-585	-568	-753	-812	-875
Other items	269	115	0	0	0
Net change in Cash & cash equivalents	2,550	2,645	-2,500	-1,500	0

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Cash & cash equivalents	9,864	12,510	10,010	8,510	8,510
Sundry debtors	3,152	3,889	4,224	4,346	4,563
Trade Inventories	1,762	2,120	2,302	2,369	2,487
Other current assets	2,339	2,303	2,501	2,573	2,702
Fixed assets	42,109	53,919	59,763	66,124	72,565
Other assets	8,197	11,551	12,851	14,601	14,601
Total assets	67,422	86,290	91,651	98,523	105,429
Sundry creditors	10,931	15,645	12,969	13,344	14,012
Other current liabilities	1,206	1,231	1,231	1,231	1,231
Long-term debt/Convertibles	23,710	32,193	36,541	39,059	41,010
Networth	31,576	37,221	40,909	44,888	49,175
Total liabilities & equity	67,422	86,290	91,651	98,523	105,429

Ratio Analysis

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Sales growth (%)	11.5	8.6	8.5	2.9	5.0
Core EBITDA growth (%)	-2.0	8.4	23.0	11.1	5.5
Core EBIT growth (%)	-4.6	10.0	24.4	10.1	6.1
Core EBITDA margin (%)	23.5	23.4	26.5	28.6	28.8
Core EBIT margin (%)	17.6	17.8	20.4	21.8	22.0
Net profit margin (%)	11.5	12.9	13.2	13.9	14.2
Dividend payout ratio (%)	17.8	14.2	17.0	17.0	17.0
Tax rate (%)	11.8	11.9	15.7	15.3	15.1
Net Debt/Equity (%)	43.8	52.9	64.9	68.1	66.1
Return on Equity (%)	11.3	11.0	10.9	10.7	10.5
Return on Assets (%)	4.9	4.6	4.8	4.9	4.9

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
