

## CESC

Rs369

NEUTRAL

Event Update: Merger negative for shareholders; downgrade to NEUTRAL Mkt Cap: Rs42.8bn; US\$1bn

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CESC is merging RPG group's retail business, Spencer Retail's holding company Pathik Retail with itself. The management believes the merger is on the lines of its strategy of converting CESC into conglomerate with different streams of revenues, not linked with each other. Consequently, CESC has issued 31mn shares (37% dilution) to promoters implying a valuation of Rs12.4bn for the retail business. However, our retail analyst has valued the retail business at Rs7.6bn (94% stake) at 20-25% discount to peer valuation. We believe the merger is negative for the CESC shareholders primarily due to the poor operating performance (huge operating losses) and fund infusion for expansion plans of the retail business. Moreover, the higher implied valuation of the retail business does not negate the 37% dilution for CESC's shareholders. Factoring in the dilution from the merger and our retail business valuation, our CESC's sum of parts valuation is Rs383/share, leaving limited upside for shareholders. Consequently we are downgrading our rating on the stock to Neutral.

## Key Financials

As on 31 March	FY05	FY06	FY07E	FY08E	FY09E
Net sales	23,212	25,159	25,451	27,719	30,362
Shares in issue (m)	74.4	82.3	83.0	116.0	116.0
Adj. EPS (Rs)	21.9	23.5	28.9	21.7	23.7
% growth	68.8	7.6	22.8	(25.0)	9.3
PER (x)	16.9	15.7	12.8	17.0	15.6
Price/Book (x)	2.0	1.8	1.6	2.0	1.8
EV/EBITDA (x)	8.0	8.6	9.6	12.4	12.7
ROE (%)	12.8	12.6	13.5	12.3	12.1
ROCE (%)	8.9	8.6	8.69	8.2	7.7

## CESC MERGER DETAILS

### □ CESC to merge the holding company of Spencer retail with itself – 36.5% dilution

CESC has decided to merge Pathik Retail Ltd (PRL), the holding company of Spencer retail (retail arm of RPG group) with itself. PRL holds 94% in Spencer retail, while the balance 6% is held by HNI's (high networth individuals).

As per the merger scheme, PRL shareholders will be issued 1 share of CESC for every 1.98 share held in PRL. Consequently, CESC's equity would be diluted from the current outstanding shares of 85mn shares (inclusive of 2mn warrants to promoters pending conversion) to 116mn shares, resulting in a dilution of 36.5%. As, PRL is 100% held by promoters, the merger will lead to promoter's stake rising from 40% to 56% in CESC.

### □ Valuation of 2.3x market cap/sales for Spencer Retail based on merger ratio

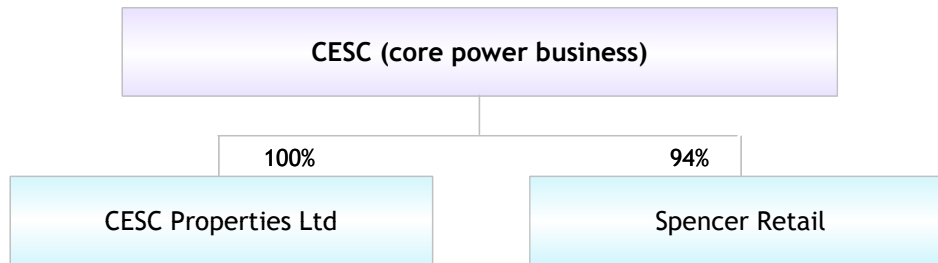
At the closing price of the announcement of merger of Rs400/share, the Spencer business has been valued at Rs12.4bn. Spencer is likely to report revenues of ~Rs5.4bn in FY07 (inclusive of revenues of Rs850mn for Music World), implying a valuation of 2.3x market capitalization / sales or 2.4x FY07 EV/sales. The Spencer retail is a loss making entity with significant losses at the operating level and a debt of Rs900mn.

### ❑ CESC – transforming itself into a conglomerate through merger with retail business

The power business mainly delivers steady growth with regulated returns along with long gestation periods. CESC management's rationale for the merger is transform CESC from a power utility where returns are regulated into a conglomerate having different businesses which can grow rapidly and are totally delinked from each other. As a first step, CESC has created a 100% subsidiary CESC Properties Ltd. to develop its real estate in central Kolkatta and Mulajore in West Bengal. Further in its efforts of transforming CESC into a conglomerate, CESC is merging the group's holding company (PRL) for its retail business with itself. As a result of the merger, CESC has taken a large step towards transforming itself into a conglomerate, with a fast growing retail and real estate businesses.

Consequently, the retail business will become the 94% subsidiary of CESC. Overall, the core power business would continue as the main business of CESC, while the retail and real estate businesses would be subsidiaries of CESC

#### Holding structure of CESC



Source: Company, SSKI Research

### SPENCER RETAIL

#### ❑ Spencer has 0.56mn sq. ft. of retail area, likely to expand to 1.5mn sq.ft. by FY08 end

Spencer has 0.56mn sq.ft. of area for its various types of retail stores such as hyper markets, super stores, Daily Fresh and Express stores. These stores primarily offer an array of food items such as groceries, fresh foods, chilled and frozen products, vegetables, etc. In the hypermarkets, low priced items along with non-food items are sold under one roof, while the super stores are mini hyper stores offering products at competitive prices.

The management expects to expand the number of stores and area to 1.5mn sq.ft. by end of FY08. The management follows the rental model for setting up the stores rather than owning the real estate. Consequently, the primary capex will be towards fit out of the properties.

#### ❑ Capex of approximately Rs6bn over the next 4 years

Spencer plans to expand its retail business to 5mn sq ft over the next 4 years in order to cater to the growing retail demand. As a result, the company would incur a capex of approximately Rs6bn over the next 4 years primarily for the fit outs for the stores and back end logistics. We believe the capex will be funded primarily through CESC's cash flows in form of equity contribution (75%). CESC generates annual cash flows of about Rs4-4.5bn annually, which can easily fund the expansion plans of the retail business.

#### ❑ Break even by FY09 - value unlocking through IPO or private placement

With Spencer's expansion of its retail business and new stores sales reaching stability, the management expects the operating leverage to kick in and achieve break-even at the net profit level by FY09. Moreover, the management expects to create value for CESC shareholders through an IPO or private placement of Spencer Retail over the medium term.

## OUR VIEW AND VALUATION

### □ Fair value of retail business estimated at Rs8.1bn

Spencer Retail had revenues of Rs5.44bn with operating losses in FY07. Consequently our retail analyst, Nikhil Vora, has valued the retail business on at EV/Sales (x) multiple. The peers of the Spencer Retail trade at 1.2x to 0.9x FY08 EV/ sales. We have used a 15-20% discount to the peers multiple to arrive at a fair EV/sales multiple of 1x as Spencer has losses at the EBITDA level. Based on the multiple, he has valued the retail business at an enterprise value of Rs9bn, implying an equity valuation of Rs8.1bn. As a result, CESC's 94% stake is valued at Rs7.6bn against the merger valuation of Rs12.4bn.

### Comparative peer valuations

(Rs m)	Revenues FY08	EBITDA FY08	Mkt. Capitalization (Rs m)	Enterprise Value (Rs m)	Mkt. Cap/ Sales (x)	EV / EBITDA (x)	EV/ Sales (x)
Pantaloon Retail	54,552	3,592	57,402	65,607	1.1	18.3	1.2
Shopper's Stop	11,444	892	22,705	21,596	2.0	24.2	1.9
Piramyd Retail	2,184	(100)	1,266	1,521	0.6	n/a	0.7
Spencer's Retail*	9,000	n/a	8,100	9,000	0.9	n/a	1.0

\* Retail Analyst estimates

### □ Negative on merger of retail business on both counts - strategy as well as valuation

Although we agree with CESC management's strategy of transforming CESC into a conglomerate with different businesses, the merger of retail business is negative for shareholders in the medium term as the business requires huge cash infusion to fund its expansion plans. Moreover, the implied valuation of Rs12.4bn is also on the higher side compared to our retail analyst's fair valuation of Rs7.6bn as well as its peer valuations, considering its huge losses at the EBITDA level.

### □ Higher value for the real estate business led by 100% stake

CESC is unlocking value of its property assets by developing a commercial mall on its surplus land located in Central Kolkotta of 3 acres (0.4mn sq.ft) and 35 acre land at Mulajore. Earlier, CESC had plans to develop the land as a 50% JV partner with a real estate developer. However, CESC has now floated a 100% subsidiary to manage its real estate ventures and plans to develop the real estate business on its own. Accordingly, we have attributed higher valuation to the property value based on 100% CESC stake at Rs36/share or Rs4.2bn.

### □ Downgrade to NEUTRAL

As mentioned earlier, we believe the merger of the retail business is not value accretive to minority shareholders of CESC due to higher valuation of the retail business and huge cash requirement for funding its expansion plans. Based on sum of parts valuation, we have valued CESC at Rs383/share for the core power, real estate and retail businesses. As the merger valuation is at significant premium to our valuation, there is limited upside for CESC shareholders after the merger. Although we believe that the three businesses can achieve significant growth over the next 3-4 years based on their growth strategies, we believe the current valuations adequately factor in the growth. Consequently, we are downgrading the stock to NEUTRAL.

### Sum-of-part valuation - limited upside from current levels

	(Rs m)	Rs/ share
Value to Shareholders (core power business) (DCF basis)	32,661	282
Add: Real Estate Value	4,189	36
Add: Retail Value	7,614	66
Total Value to CESC shareholders	44,465	383
No. of Shares (post dilution)	116	
<b>Intrinsic Value per Share (Rs/share)</b>	<b>383</b>	<b>383</b>

## Comparative valuation – FY08

Companies	Price (Rs)	Mcap (Rs m)	Earnings growth (%)	EPS (Rs/share)	P/E (x)	EV/EBITDA (x)	P/BV (x)	ROE (%)	ROCE (%)
NTPC	160	1,319,266	6.2	8.5	18.8	14.5	2.3	12.9	8.1
REL	511	108,527	14.1	42.5	12.0	10.5	1.2	10.2	3.0
Tata Power	546	108,113	3.4	26.7	20.4	8.9	1.9	9.7	7.9
CESC	369	28,923	(25.0)	21.7	17.0	9.4	2.0	12.3	9.4

## Earnings model

Year to Mar 31 (Rs m)	FY05	FY06	FY07E	FY08E	FY09E
<b>Net sales</b>	<b>23,212</b>	<b>25,159</b>	<b>25,451</b>	<b>27,719</b>	<b>30,362</b>
% growth	(1.2)	8.4	1.2	8.9	9.5
Operating expenses	16,760	19,189	20,195	22,510	25,000
<b>EBITDA</b>	<b>6,451</b>	<b>5,970</b>	<b>5,256</b>	<b>5,209</b>	<b>5,361</b>
% growth	(3.6)	(7.5)	(11.9)	(0.9)	2.9
Other income	659	737	866	838	794
Net interest	(2,560)	(2,124)	(1,713)	(1,451)	(1,215)
Depreciation	2,915	2,539	1,652	1,694	1,781
<b>Pre-tax profit</b>	<b>1,636</b>	<b>2,044</b>	<b>2,757</b>	<b>2,901</b>	<b>3,159</b>
Deferred Tax	-	-	-	-	-
Current Tax	129	200	358	386	411
<b>Profit after tax</b>	<b>1,507</b>	<b>1,844</b>	<b>2,398</b>	<b>2,515</b>	<b>2,748</b>
Preference dividend	-	-	-	-	-
Non-recurring items	(35)	(69)	510	-	-
Net profit after non-recurring items	1,473	1,775	2,908	2,515	2,748
% growth	79.0	20.5	63.8	(13.5)	9.3

## Balance sheet

As on Mar 31 (Rs m)	FY05	FY06	FY07E	FY08E	FY09E
Paid-up capital	744	830	830	850	850
Preference share capital	7	43	43	43	43
Reserves & surplus	12,082	15,667	18,285	20,770	22,939
Total shareholders' equity	12,826	16,497	19,115	21,620	23,788
ST Debt/Lease financing	4,410	5,596	5,596	5,596	5,596
LT Debt	21,672	19,100	16,999	17,061	19,774
<b>Total liabilities</b>	<b>38,913</b>	<b>41,235</b>	<b>41,752</b>	<b>44,320</b>	<b>49,201</b>
Net fixed assets	35,867	35,267	39,719	43,070	47,334
Investments	314	314	300	1,800	3,375
Total current assets	10,177	13,072	12,209	11,278	11,704
Total current liabilities	7,552	7,517	10,575	11,928	13,312
Working capital	2,625	5,555	1,633	(650)	(1,608)
Other non-current assets	107	100	100	100	100
<b>Total assets</b>	<b>38,913</b>	<b>41,235</b>	<b>41,752</b>	<b>44,320</b>	<b>49,201</b>

## Cash flow statement

Year to Mar 31 (Rs m)	FY05	FY06	FY07E	FY08E	FY09E
Pre-tax profit	1,636	2,044	2,757	2,901	3,159
Depreciation	2,915	2,539	1,652	1,694	1,781
chg in Working capital	1,141	(664)	2,835	190	213
Total tax paid	(129)	(200)	(358)	(386)	(411)
Ext ord. Items	(35)	(69)	510	-	-
Operating cash Inflow	5,529	3,650	7,396	4,400	4,742
Capital expenditure	(1,843)	(1,893)	(6,060)	(5,000)	(6,000)
Free cash flow (a+b)	3,686	1,757	1,336	(600)	(1,258)
Chg in investments	(13)	1	14	(1,500)	(1,575)
Debt raised/(repaid)	(3,744)	(1,350)	(2,101)	62	2,712
Capital raised/(repaid)	497	1,804	-	454	-
Dividend (incl. tax)	(27)	(186)	(235)	(291)	(464)
Misc	725	281	(45)	(45)	(45)
<b>Net chg in cash</b>	<b>1,125</b>	<b>2,307</b>	<b>(1,031)</b>	<b>(1,919)</b>	<b>(629)</b>

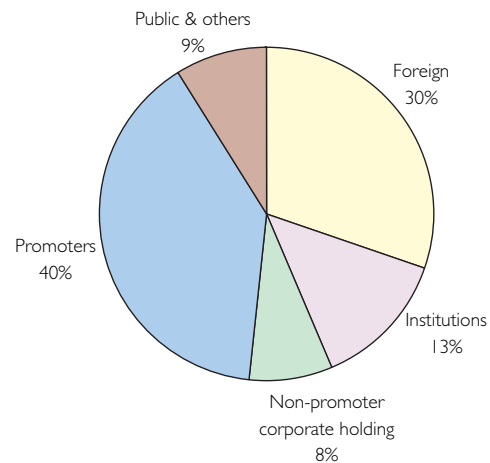
## Key ratios

Year to Mar 31	FY05	FY06	FY07E	FY08E	FY09E
EBITDA margin (%)	27.8	23.7	20.7	18.8	17.7
EBIT margin (%)	15.2	13.6	14.2	12.7	11.8
PAT margin (%)	6.3	7.1	11.4	9.1	9.1
ROE (%)	12.8	12.6	13.5	12.3	12.1
ROCE (%)	8.9	8.6	8.7	8.2	7.7
Net gearing (x)	1.9	1.3	1.0	1.0	1.1

## Valuations

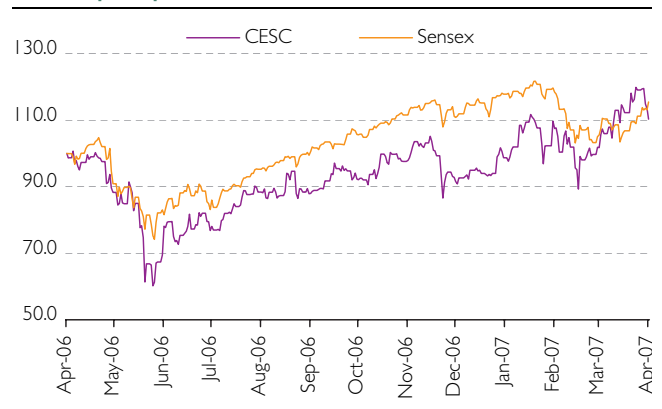
Year to Mar 31	FY05	FY06	FY07E	FY08E	FY09E
Reported EPS (Rs)	21.9	23.5	28.9	21.7	23.7
Adj. EPS (Rs)	21.9	23.5	28.9	21.7	23.7
PER (x)	16.9	15.7	12.8	17.0	15.6
Price/Book (x)	2.0	1.8	1.6	2.0	1.8
EV/Net sales (x)	2.2	2.0	2.0	2.3	2.2
EV/EBITDA (x)	8.0	8.6	9.6	12.4	12.7

## Shareholding pattern



As on December 2006

## Relative price performance



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1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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