

CESC

STOCK INFO. BLOOMBERG
BSE Sensex: 10,007 CESC IN
REUTERS CODE
S&P CNX: 2,933 CESC.BO

19 July 2006

Buy

Rs257

Previous Recommendation: Buy

Equity Shares (m)	84.3
52-Week Range	370/178
1,6,12 Rel. Perf.(%)	14/-5/-23
M.Cap. (Rs b)	21.7
M.Cap. (US\$ b)	0.5

YEAR	NET SALES	PAT	EPS*	EPS*	P/E*	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/06A	25,159	1,853	21.0	13.0	12.2	1.4	10.8	10.4	1.5	6.2
03/07E	24,002	2,154	25.5	21.4	10.1	1.2	11.5	10.6	1.4	6.6
03/08E	25,070	2,426	28.8	12.6	8.9	1.1	11.6	10.9	1.4	6.4

* Excl impact of Budge Budge plant capital account adjustment; fully diluted

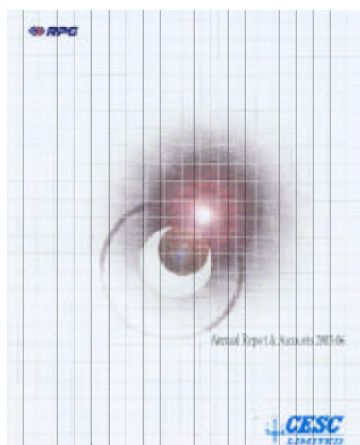
FY07 Tariff Order provides earnings visibility: FY07 Tariff Order has increased equity base (as per regulatory accounts) to Rs13.3b, up from Rs8.7b (FY06 Tariff Order). Further, WBERC has incentivized CESC by permitting to retain 40% of gains from power exports and two-thirds of the non-electricity income. The Commission has also set up an Expert committee to formulate norms for efficiency incentives which we expect to contribute to earnings from FY08 onwards. We expect CESC to report incentives of Rs136m during FY07 and Rs285m in FY08, v/s nil in FY06.

Progress towards monetizing the real estate portfolio: CESC FY06 Annual Report states "the company has a number of large properties as part of its business requirements. An in-principle decision has been taken to try and explore unlocking the value of the investments in some such properties. Considerable progress has already been made in planning the commercial development of a property at Park Circus in the heart of Kolkatta. There is another proposal for constructing residential units at the company's Mulajore property following closure of the generation station".

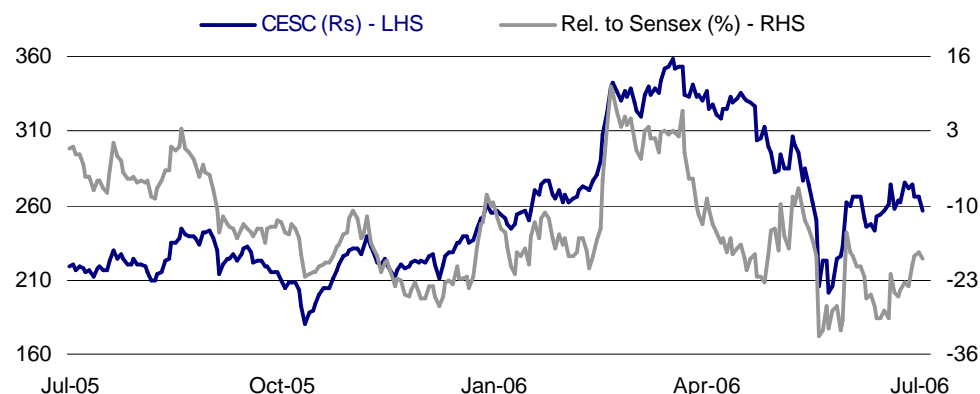
Growth opportunities: FY06 Annual Report states that for Budge Budge expansion (250MW), environment clearance has been received and equipment orders would be placed in FY07. The plant is likely to be commissioned by September 2009. Further, management meeting indicated that CESC has formulated two strategies (1) bid for ultra mega power projects (2) Undertake two of the following three projects: Haldia (1,000MW), Jharkhand and Orissa (2,000MW each).

Maintain Buy with PT of Rs332/share: CESC quotes at PER of 10.1x FY07E and 8.9x FY08E on reported basis. We value core business at Rs288/share (10x FY08E) and real estate at Rs3.7b, Rs44/share (Retail mall: Rs1.5b and Mulajore plant: Rs2.2b). We maintain **Buy** with price target of Rs332/share.

ANNUAL REPORT FY06



STOCK PERFORMANCE (1 YEAR)



FY07 Tariff Order provides earnings visibility

Increase in equity base (up 58% YoY)

As per the FY07 Tariff Order, March 2006 would be the cut off date for shifting to Return on Equity based formula, vs March 2005 earlier. Thus, West Bengal Electricity Regulatory Commission (WBERC) has included incremental net worth from recent GDR offering (Rs1.8b) and entire reasonable return during FY06 (Rs1.1b) in calculating the equity base as at March 2006. During FY06 Tariff Order, the regulator had calculated the equity base at Rs8.7b based on FY04 equity base, as audited FY05 numbers were not available. Thus, the revised mechanism has resulted in an increase in the equity base (as per regulatory accounts) to Rs13.3b, up from Rs8.7b.

CESC'S EQUITY BASE FOR ROE CALCULATION (RS M)

	FY06 TARIFF ORDER		FY07 TARIFF ORDER
	FY06	FY06	FY07
Opening Equity Base		10,018	13,343
Addition to Equity Base:			
Proceeds of GDR Offering		1,762	
Reasonable Return during FY06		1,078	
Special Appropriation		485	
Capex (financed in 70:30 DER)			716
Closing Balance	8,690	13,343	14,059
Average Equity Base			13,701
Equity Base (As per Tariff Order)	8,690		13,701
Reasonable Return (14%)	1,257		1,918

Source: Company/Motilal Oswal Securities

Grant of efficiency related incentives

The National Tariff Policy (applicable wef 1 April 2006) has incentivised all efficient generators, based on normative parameters. Based on the norms prescribed by Central Electricity Regulatory Commission (CERC), WBERC has also prescribed the following:

- ✍ **Bad debt:** 0.5% of past years revenues
- ✍ **Coal transit losses:** 1.5% of coal handled
- ✍ **T&D losses:** 15.75% of system
- ✍ **Working capital:** 12.5% of revenue
- ✍ **Interest on working capital:** at State Bank of India Prime Lending Rate
- ✍ **Generation efficiency:** Provisionally at Govt of West Bengal norm, pending finalization by WBERC Expert Committee

Thus, CESC would be eligible for efficiency related incentives. However, WBERC has not permitted the above efficiency incentives in the FY07 Tariff Order, as the regulator has set up an Expert Committee to finalize the efficiency norms. However, WBERC has permitted CESC to retain 40% of the gains on power exports and two thirds of the other non electricity income, vs nil in FY06. We expect WBERC to permit efficiency incentives from FY08 Tariff Order onwards, and factor in part of these in our earnings estimates. Thus, we expect CESC to report incentives of Rs136m during FY07 and Rs285m in FY08, vs nil in FY06.

CESC'S NET PROFIT COMPOSITION (RS M)

	FY06	FY07	FY08	FY09
Reasonable Return on Equity	1,257	1,918	2,076	2,167
Special Appropriation / Prior Period	485	-	-	-
Efficiency Incen., incl Power Exports	-	136	285	286
Interest on Cash Surplus	-	100	65	78
Rental Income from Retail Mall	-	-	-	53
Reported Net Profit	1,775	2,154	2,426	2,585

Source: Company/Motilal Oswal Securities

Key possible incentives for CESC

- ✍ Based on expected export volumes of 350MUs during FY07 (v/s 418MUs in FY06) and average rate of Rs2.25-2.4/unit, we calculate CESC's share (40%) of the gains at Rs125-150m.
- ✍ Average PLF (excl New Cossipore generation plant) during FY07 is expected at 94% and thus based on incentive of Rs0.25/unit beyond 80%, likely gains is expected at Rs181m.
- ✍ Normative interest rate for working capital is 10.5%, while for CESC, the weighted average cost is 6.5-7.5%. Thus, on working capital of Rs2.5b, the expected gains are Rs75-90m.
- ✍ CESC's operating norms pertaining to auxiliary consumption and heat rate are better than the norms prescribed by CERC, and thus the company could also gain from such incentives.

Possible increase in RoE rate

WBERC has approved permissible RoE at 14% on generation assets and 15% on distribution assets, vs 14% earlier for both generation and distribution. This is line with

CERC's order which permits 16% return on transmission and distribution and 14% return on generation. However the WBERC's Tariff Order for FY07 calculates reasonable return at 14% on the overall asset base, as the regulator has appointed Expert Committee to suggest the incremental risks involved in transmission and distribution. Going forward, we thus expect an increase in the weighted average RoE rate for CESC for calculating reasonable returns at 14.46% (as per Regulatory accounts), vs 14% in FY07. As we understand, CESC's asset base is bifurcated as 54% for generation and 46% for distribution. We do not factor in the gains in our earnings estimates.

Progress towards monetizing the real estate portfolio

CESC FY06 Annual Report states that "the company has a number of large properties as part of its business requirements. An in-principle decision has been taken to try and explore unlocking the value of the investments in some such properties. Considerable progress has already been made in planning the commercial development of a property at Park Circus in the heart of Kolkatta. There is another proposal for constructing residential units at the company's Mulajore property following closure of the generation station few years back".

✍ **Development of Retail Mall (3 acres):** CESC has entered into a joint venture with Godrej Projects (CESC's share 50%) to develop a retail mall on 3 acres of land, with constructed area of 0.4m sq ft. CESC's contribution will be in the form of land, while the entire development expense would be borne by the Godrej group. The expected average rental is Rs80-125/sq ft/month, which translates into annual rental income of Rs400-600m. WBERC norms permits the company to retain two third of the non-tariff income, thus entailing CESC's share at Rs160-240m. Construction is expected to commence by September 2006 and likely to be completed by October 2008.

✍ **Mulajore plant (43 acres):** The current development plan is: Non-polluting industrial park (5 acres), housing (30 acres) and sub stations, etc of CESC (8 acres).

The site is on river Ganges and the company is also contemplating to convert the same into a tourist destination. The construction space is ~2.5m sq ft and the average value is Rs1,000/sq ft, thus entailing possible gains of Rs2.5-3b, including development. The management expects that the plans would be firmed up over the next six months and development should be completed in the next 3 years. Also, the shutting cost is expected to be minimal as the plant has already been closed, since 2004. The project also qualifies for Foreign Direct Investment.

✍ **New Cossipore (27 acres):** The plant would be shut down, post commissioning of the 250MW Budge Budge unit expected in September 2009. Currently, the plant produces just peaking power. Further, the plant is located in the city of Kolkatta, and thus the potential value unlocking could be substantial. However, given that the plans for monetizing are still 3-4 years away, we do not factor in the possible gains in our sum of the parts value estimate.

Power segment: Growth opportunities Kolkatta Centric

✍ **Budge Budge expansion (250MW):** FY06 Annual Report states that the Environment clearance has also been received and equipment orders would be placed in FY07. The plant is likely to be commissioned by September 2009. Capital cost is Rs10b, to be financed on a DER of 70:30.

✍ **Captive coal mines and pit head based mini power project:** The company has announced plans to (1) acquire another captive coal mine, which will enable CESC to meet the current gap of ~2m ton in fuel supply, out of the total requirement of 4.2m ton through Integrated Coal Mines Limited (26% holding by CESC), production will commence in 3 years post government approval (2) Increase in production by 1m ton at existing coal mine by January 2008 to meet the requirements of 250MW Budge Budge expansion (3) setting up a coal washery of 1.5m ton with capex of Rs240m, which will reduce ash content in coal from captive mines to 34% from current levels of 41%, expected commissioning

May 2008 (4) set up a mini power plant of 40MW on merchant basis to utilize the coal rejects at pitheads generated from mining operations, expected commissioning May 2008.

National opportunities

The RPG group intends to transform itself from regional to a national player. Accordingly, it has drawn up growth plans for CESC through the Special Purpose Vehicle route, with a strategic partner. To begin with, it intends to set up a pithead-based power plants, which will be linked to captive mine acquisition. CESC is also bidding for Ultra Mega power projects, with a strategic partner. The group also plans to acquire distribution circles and participate in the SEB privatization process.

To augment generation capacity, the company has outlined two possible approaches:

Strategy (1): Bid for Ultra Mega power projects, with a strategic partner

Strategy (2): Undertake two of the following three projects:

- i) Merchant based pithead power plant in Haldia (1,000MW, Phase 1: 500MW). The company is in the process of acquiring land for the project. This plant can also cater to the requirements of CESC in the Kolkatta region.
- ii) Merchant based pithead power plant in Jharkhand (2,000MW, **Phase 1:** 500MW). MoU with the State government has been signed
- iii) Merchant based pithead power plant in Orissa (2,000MW, **Phase 1:** 1,000MW). MoU with the State government is being negotiated

CESC continues to be under the MAT regime

CESC has large carry forward losses as per the Income Tax and the company will thus continue to be in a MAT regime, atleast over the next 5-7 years. Further, the company is also in a capex mode, and thus tax outgo would continue to be minimal. We have factored in the increase in MAT rate wef from FY07 in our earnings estimates.

Other takeaways from the Annual report

Continued improvement in operational performance:

Since FY02, CESC's PLF has witnessed a significant improvement from 73.4% to 94% in FY06. This led to increased generation from 6.2b units in FY02 to 7.6b units in FY06, resulting in a commensurate reduction in outside power purchases from West Bengal State Electricity Board. Lower amount of outside power purchases are cost-effective as the cost per unit for electricity purchased is Rs2.7 per unit (FY06) as compared to fuel cost of Rs1.35per unit for own power generated. CESC has been successful in reducing the AT&C losses from 21.9% in FY02 to 15.7% in FY06. Average tariff has gone down further during FY06 to Rs3.87/unit, third year in a row.

Significant addition to revaluation reserves: During FY06, CESC revalued fixed assets by Rs19b (opening gross block Rs62b), through further addition to the revaluation reserve. Post this, revaluation reserve as at March 2006 stands at Rs20.4b, as compared to Rs2.6b in March 2005. This increase has led to reported book value at Rs449/share in FY06, up from Rs207/share. Adjusted for the revaluation reserves, book value stands at Rs189/share in FY06, and Rs161/share in FY05.

TREND IN OPERATIONAL EFFICIENCY

	T&D LOSS (%)		% PLF (EXCL. PEAKING STATION)	POWER IMPORT (MU)	POWER EXPORT (MU)	SALES (EXCL. EXPORT) - MU
	TOTAL	PILFERAGE				
FY01	22.8	12.8	72	1,196		5,165
FY02	21.9	11.9	73	1,323		5,333
FY03	18.8	8.8	76	1,163		5,557
FY04	17.3	7.3	79	861	7	5,711
FY05	16.3	6.3	86	749	160	5,864
FY06	15.7	5.7	94	857	418	6,230

Source: Company/Motilal Oswal Securities

Maintain Buy with PT of Rs332/sh

CESC quotes at PER of 10.1x FY07E and 8.9x FY08E on reported basis. We value core business at Rs288/share (10x FY08E) and real estate at Rs3.7b, Rs44/share (Retail mall: Rs1.5b and Mulajore plant: Rs2.2b). We maintain **Buy** with price target of Rs332/share.

CESC: SUM OF PARTS	(RS / SH)
Core Business	288
Real Estate	44
Total Value	332

CESC: CORE BUSINESS VALUE

	FY05	FY06E	FY07E	FY08E
Net Profit (Rs m)	1,386	1,775	2,154	2,426
% YoY	68.3	28.0	21.4	12.6
Target PER (x)				10
Equity Value (Rs m)				24,263
Rs/Share				288

CESC: REAL ESTATE VALUE

Retail Mall (in JV with Godrej)	1,468
Mulajore Plant (43 acres)	2,250
Total Value	3,718
Rs/Share	44

Source: Company/ Motilal Oswal Securites

INCOME STATEMENT (RS MILLION)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Total Revenues	23,485	23,212	25,159	24,002	25,070
Cost of Energy purchased	2,913	2,257	2,518	2,678	3,250
Cost of fuel	6,638	7,605	8,396	8,816	9,037
Stores & spares	927	1,038	1,136	1,182	1,229
Employee Expenses	2,792	2,528	2,625	2,730	2,840
SG&A Expenses	3,518	3,329	4,504	3,344	3,308
EBITDA	6,697	6,454	5,979	5,252	5,407
% of Total Revenues	28.5	27.8	23.8	21.9	21.6
Depreciation	2,962	2,915	2,539	1,764	1,820
Interest	3,481	2,646	2,124	1,849	1,676
Other Income	681	659	736	809	846
Extra-ordinary Expenses	40	37	79	0	0
PBT	935	1,552	2,053	2,448	2,757
Tax	72	129	200	294	331
Rate (%)	7.6	8.3	9.7	12.0	12.0
Reported PAT	824	1,386	1,775	2,154	2,426
Adjusted PAT	863	1,423	1,853	2,154	2,426
Change (%)	1049.3	64.8	30.2	16.2	12.6
Dividend (Inc. tax)	0	212	235	240	240
Distributable Profits	498	1,178	1,359	2,154	2,426
Change (%)	-1062.0	136.5	15.3	58.6	12.6

BALANCE SHEET (RS MILLION)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Share Capital	667	750	873	850	850
Reserves	13,092	14,641	36,059	38,386	40,572
Net Worth	13,759	15,392	36,932	39,236	41,422
Loans	26,093	21,672	19,100	15,406	13,964
Consumer's Security Dep't	3,732	4,410	5,596	5,875	6,169
Capital Employed	43,584	41,473	61,627	60,517	61,555
Gross Fixed Assets	60,632	62,054	82,610	85,010	87,010
Less: Depreciation	21,271	24,597	28,267	30,031	31,851
Net Fixed Assets	39,362	37,457	54,344	54,979	55,159
Capital WIP	988	970	1,314	2,314	5,814
Investments	301	314	314	314	314
Curr. Assets	11,294	10,216	13,072	10,526	8,359
Inventory	1,228	1,423	1,713	1,644	1,717
Debtors	7,489	5,692	5,224	4,477	3,918
Cash & Bank Balance	527	1,651	3,959	2,371	819
Loans & Advances	1,947	1,380	1,426	1,283	1,155
Deferred Payments	104	69	750	750	750
Current Liab. & Prov.	8,467	7,591	7,517	7,709	8,177
Other Liabilities	8,053	6,791	6,761	6,945	7,406
Provisions	414	800	756	764	771
Net Current Assets	2,827	2,625	5,555	2,817	182
Misc Expenses	106	107	100	93	86
Application of Funds	43,584	41,473	61,627	60,517	61,555

E: MOST Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Basic (Rs)					
EPS *	12.5	18.6	21.0	25.5	28.8
CEPS (Rs)	57.9	58.3	53.4	46.5	50.4
Book Value	206.7	161.0	189.2	212.4	238.4
DPS	0.0	2.5	2.5	2.5	2.5
Payout (incl. Div. Tax.)	0.0	14.9	11.1	9.8	8.7
Valuation (x)					
P/E		13.8	12.2	10.1	8.9
EV/EBITDA		6.5	6.2	6.6	6.4
EV/Sales		1.8	1.5	1.4	1.4
Price/Book Value		1.6	1.4	1.2	1.1
Dividend Yield (%)		1.0	1.0	1.0	1.0
Profitability Ratios (%)					
RoE	6.0	10.9	10.8	11.5	11.6
RoCE	9.3	9.9	10.4	10.6	10.9
Turnover Ratios					
Debtors (Days)	60	54	53	55	55
Inventory (Days)	19	21	26	25	25
Asset Turnover (x)	0.5	0.5	0.5	0.4	0.4
Leverage Ratio					
Debt/Equity (x)	2.4	1.7	0.6	0.4	0.4

CASH FLOW STATEMENT (Rs Million)					
	2004	2005	2006E	2007E	2008E
PBT before EO Items	935	1,552	2,053	2,448	2,757
Add : Depreciation	2,962	2,915	2,539	1,764	1,820
Interest	3,481	2,646	2,124	1,849	1,676
Less : Direct Taxes Paid	72	129	200	294	331
(Inc)/Dec in WC	3,417	1,327	-622	1,151	1,082
CF from operations	10,724	8,312	5,893	6,918	7,004
Extra-ordinary Items	40	37	79	0	0
CF from operations in	10,684	8,275	5,814	6,918	7,004
(Inc)/dec in FA	1,262	-992	-1,508	-3,400	-5,500
(Pur)/Sale of Investments	-191	-13	1	0	0
CF from investments	1,070	-1,006	-1,507	-3,400	-5,500
(Inc)/Dec in Network	-5,145	458	1,745	397	7
(Inc)/Dec in Debt	-3,837	-4,421	-2,572	-3,693	-1,442
(Inc)/Dec in Customer Sec	569	677	1,186	280	294
Less : Interest Paid	3,481	2,646	2,124	1,849	1,676
Dividend Paid	0	212	235	240	240
CF from Fin. Activity	-11,894	-6,144	-1,999	-5,105	-3,057
Inc/Dec of Cash	-139	1,125	2,308	-1,588	-1,553
Add: Beginning Balance	666	527	1,651	3,959	2,371
Closing Balance	527	1,651	3,959	2,371	819

* Excl impact of Budge Budge plant capital account adjustment and Fully Diluted

N O T E S



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Disclosure of Interest Statement

Disclosure of Interest Statement	CESC
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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