

# RURAL ELECTRIFICATION CORPORATION

## NIMs rise further; no incremental slippages

India Equity Research | Banking and Financial Services



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Ideas create, values protect

Rural Electrification Corp's (REC) Q2FY13 PAT of INR9.54bn (up 53% YoY), was ahead of Street's expectation primarily due to a beat at NIM level (up 24bps QoQ to 4.76% - against Street's estimate of 4.5-4.6%). While the loan book sustains a 24% YoY growth, share of short term loans in Q2FY13 disbursement was hardly 5% (vis-à-vis 28% in Q1FY13). After remaining muted in FY12 (at INR 508 bn), sanctions showed signs of a strong revival (INR 483 bn in H1FY13). No slippages/credit cost incurred in Q2FY13. Raising our estimate for loan growth and NIMs, earnings are being revised up by 8-10% for FY13-14E. Though asset quality poses risk to earnings, we believe macro developments in power sector will be key driver of stock performance. Trading at 1.2x adj. book (1-year forward) generating >20% RoEs, we maintain 'BUY'.

### NIMs rise further by ~24bps to 4.8%

NIMs improved 24bps QoQ to 4.76% (as against Street's expectation of 4.5-4.6%). While funding cost increased to 8.4%, it was offset by 34bps increase in lending yields. Upfront fee of INR 205 mn on ECB issuance and incremental borrowing at 9.2-9.4% (vis-à-vis book cost of 8.1%) led to an uptick in cost of funds. However, due to adequate pricing power and benefit of higher disbursements towards high yielding short-term loans (at ~13.5%) in past few quarters, yields too improved QoQ. It continued to resort to ECBs - of the RBI's approval for raising USD750mn of ECBs, it raised USD125mn in Q2FY13 (including hedging, cost was 7.5%) and will further utilize limit of another USD100mn in Q3FY13 while the balance will be raised in Q4FY13. We are building in NIMs of 4.5% for FY13-14E.

### Outlook and valuations: Surprise on NIMs; maintain 'BUY'

With structural issues surrounding the power sector, we believe higher credit cost pose risk to its earnings. Some more positive developments are in the offing in power sector (after actions in favor of SEBs - restructuring, government support etc). Revival in sanctions allays our concerns on growth and we are revising growth estimate upwards. Led by 20% CAGR in loan assets and relatively stable NIMs, we expect 20% earnings CAGR and average ROEs of >20% over FY13-14E. The stock is trading at 1.2x Adj. book and 5.7x earnings (1-year forward). We maintain 'BUY/Sector Outperformer'.

#### EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Overweight

#### MARKET DATA (R: RURL.BO, B: RECL IN)

CMP	: INR 220
Target Price	: INR 270
52-week range (INR)	: 252 / 142
Share in issue (mn)	: 987.5
M cap (INR bn/USD mn)	: 218 / 4,043
Avg. Daily Vol.BSE/NSE('000)	: 2,678.8

#### SHARE HOLDING PATTERN (%)

	Current	Q1FY13	Q4FY12
Promoters*	66.8	66.8	66.8
MF's, FI's & BK's	6.1	6.1	6.4
FII's	20.7	20.1	19.5
Others	6.4	7.1	7.3
* Promoters pledged shares (% of share in issue)	:		NIL

#### PRICE PERFORMANCE (%)

	Stock	Nifty	EW Banks and Financial Services Index
1 month	2.8	(0.4)	10.6
3 months	7.9	9.0	4.7
12 months	18.6	8.4	22.7

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#### Financials

(INR mn)

Year to March	Q2FY13	Q2FY12	Growth (%)	Q1FY13	Growth (%)	FY12	FY13E	FY14E
Net int. inc.	12,661	8,241	53.6	11,280	12.2	40,256	51,729	59,814
PAT	9,539	6,229	53.1	8,767	8.8	28,557	36,276	40,807
Diluted EPS (INR)	9.7	6.3	53.1	8.9	8.8	28.9	36.7	41.3
ABV per share (INR)						146	170	196
Price/Earnings (x)						7.6	6.0	5.3
Price/Adj. Book (x)						1.5	1.3	1.1

### Loan growth sustained at 24%; sanctions show some revival

Loan book grew 23% YoY (5% QoQ) to INR1.12 tn led by 25% disbursement growth. Share of short term (working capital) loans in disbursements in Q2FY13 was miniscule at 5% (vis-à-vis 14% in FY12 and 28% in Q1FY13). Sanctions, after remaining muted in FY12, showed signs of strong revival (as was guided by management); already sanctioned loans worth INR 483 bn in H1FY13 vis-à-vis INR 508 bn in full year FY12. What provided a big delta in sanctions and loan growth was incremental funding requirement in T&D segment (particularly transmission segment). Management is guiding for sanctions of INR550bn and disbursements of INR300bn in FY13. We are building in a disbursement growth of 12% and loan growth of 20% over FY12-14.

### No incremental slippages or credit cost

GNPA/NNPA came in steady at 0.44%/0.38% as there were no incremental delinquencies in Q1FY13 and therefore no loan loss provisioning was reported during the quarter. Incremental provisioning of INR250mn (additional 10%) on Maheswar project will be required post Q3FY13 with it falling from sub-standard to doubtful category (within 18 months after having been recognized as NPL in Q1FY12). Considering structural issues in power sector, we are building in higher credit cost of 10-20bps over FY13-14E.

### Other highlights

- Due to rupee appreciation, foreign currency translation reserves which grew from INR1.8bn in FY12 to INR4.8bn in Q1FY13 once again came off to INR2.7bn. Of this, the company amortised INR140mn in Q2FY13. REC has an unhedged exposure of ~USD700mn of the total forex borrowings of USD2.5bn.

Chart 1: Sanctions show strong revival

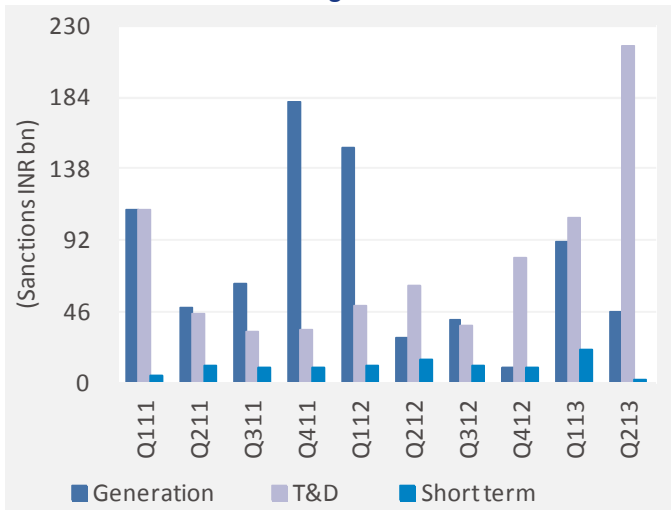
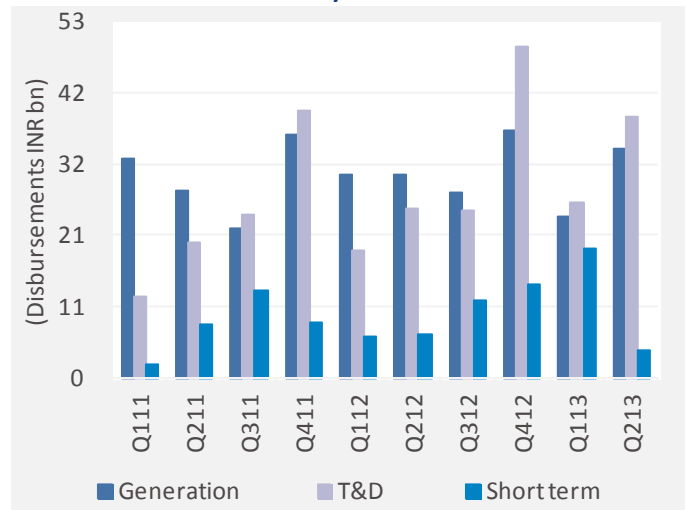
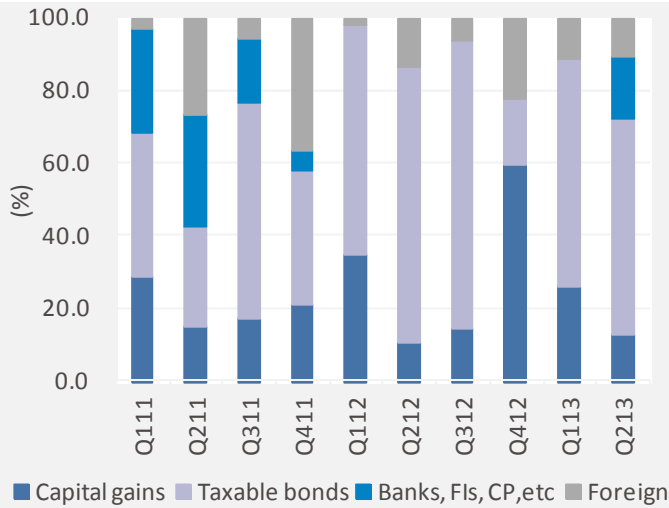


Chart 2: Disbursements led by T&D

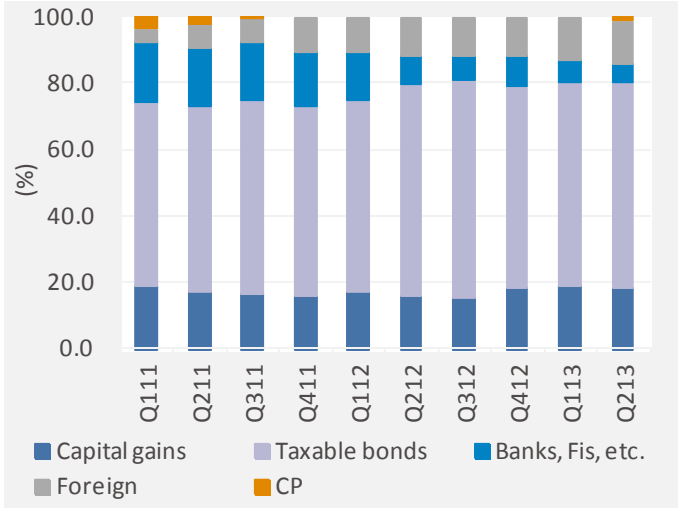


Source: Company

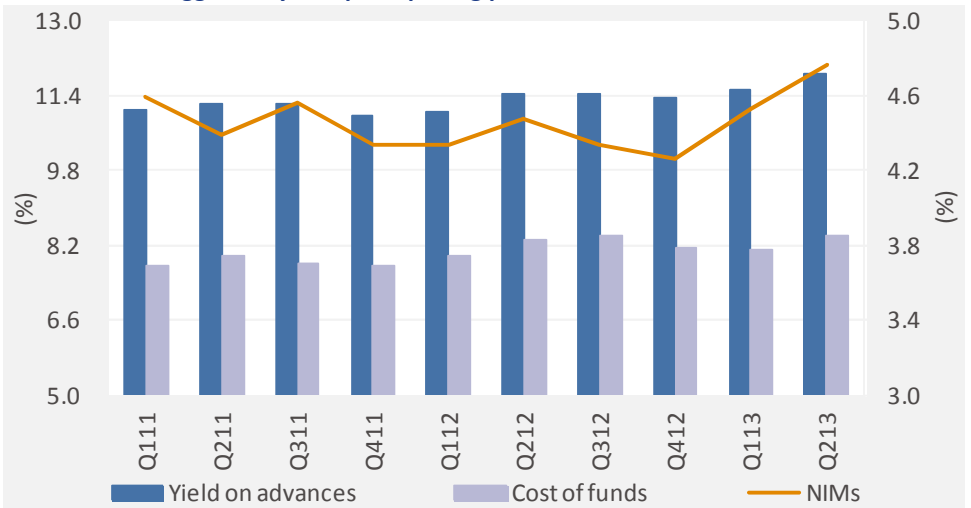
**Chart 3: Stayed away from bank borrowings completely**



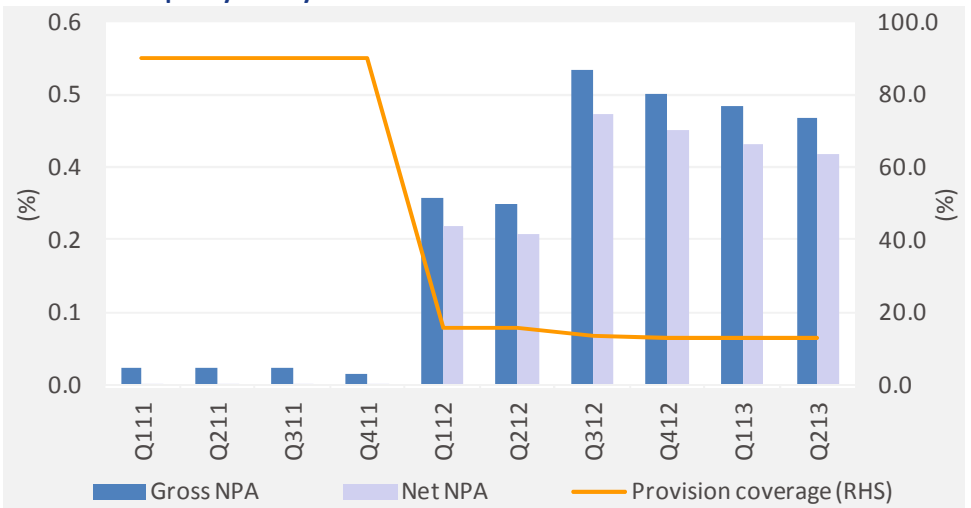
**Chart 4: Borrowings skew in favor of forex and bonds**



**Chart 5: NIMs triggered by adequate pricing power**



**Chart 6: Asset quality steady**



Source: Company

## Financial snapshot

(INR mn)

Year to March	Q2FY13	Q2FY12	% Change	Q1FY13	% Change	FY12	FY13E	FY14E
Interest income	32,405	25,145	28.9	29,968	8.1	104,044	129,656	151,467
Interest exp	19,743	16,904	16.8	18,688	5.6	63,788	77,926	91,653
Net income from ops	12,661	8,241	53.6	11,280	12.2	40,256	51,729	59,814
Net operating income	514	176	191.9	717	(28.3)	736	999	1,048
Other income	219	379	(42.4)	241	(9.4)	330	363	399
Net revenues	13,394	8,796	52.3	12,239	9.4	41,322	53,091	61,261
Staff costs	436	302	44.1	354	23.0	1,710	1,823	1,972
Other expenses	141	145	(2.8)	92	52.9	584	654	732
Depreciation	9	9	(2.3)	9	(9.6)	33	31	31
Pre prov op profit (ppop)	12,809	8,341	53.6	11,784	8.7	38,996	50,583	58,526
Provisions	-	-	-	-	-	523	1,375	2,855
Profit before tax	12,809	8,341	53.6	11,784	8.7	38,473	49,208	55,671
Tax	3,270	2,112	54.8	3,016	8.4	9,916	12,932	14,864
PAT	9,539	6,229	53.1	8,767	8.8	28,557	36,276	40,807
Diluted EPS (INR)	9.7	6.3	53.1	8.9	8.8	28.9	36.7	41.3
Cost to income (%)	4.4	5.2		3.7		5.6	4.7	4.5
Tax Rate	25.5	25.3		25.6		25.8	26.3	26.7
Price/ Earnings						7.6	6.0	5.3

## Change in Estimates

	FY13E			FY14E			% change Comments
	New	Old	% change	New	Old	% change	
NII	51,729	48,741	6.1	59,814	55,217	8.3	Loan growth revised upwards following strong revival in sanctions
PPOP	50,583	47,473	6.6	58,526	53,782	8.8	
Provisions	1,375	1,952	(29.6)	2,855	3,002	(4.9)	Zero slippages/credit cost in H1FY13
PAT	36,276	33,617	8.0	40,807	37,037	10.2	
NIMs	4.5	4.2		4.4	4.2		Outperformance in NIMs in H1FY13; benefit to flow from lower wholesale/base rates

## Company Description

Rural Electrification Corporation (REC), incorporated in 1969, is a leading public institution primarily involved in the financing of T&D and generation projects across India. It was established by GoI for the purpose of developing the T&D infrastructure in rural India and currently acts as a nodal agency for RGGVY, a GoI initiative for rural electrification. Over the last decade, the company has diversified into urban areas and it plays a strategic role in GoI plan to improve the transmission and distribution infrastructure of India. REC, along with Power Finance Corporation (PFC), is the nodal agency for APDRP, a GoI initiative to improve the financial viability of state power utilities. Loans to T&D projects constituted ~50% to the total loan book as on March 31, 2012.

## Investment Theme

Over the Eleventh and Twelfth Five Year plans (FY07-17), India targets to add ~170 GW, creating huge investment opportunities across the power value chain. High growth, long-term visibility and sustainable returns, coupled with demand-supply gap (~12% peak deficit) and rising energy consumption, make the sector an attractive investment option. REC, being a specialised power financier, plays a strategic role in GoI's ongoing financing plans for development of the power sector. Superior domain knowledge, financing expertise and government support will enable it to leverage emerging financing opportunities.

## Key Risks

- REC's growth depends on its ability to remain effectively competitive in the power financing space and to pass the cost of funds to customers. Also, benefits under Section 54EC are being curtailed continuously and there are uncertainties surrounding the level of benefits REC will receive from these instruments, going forward.
- REC's gross NPAs are at low levels. Any major slippage or ineffective recoveries can raise NPAs significantly, adversely affecting profitability and growth.
- REC is subject to risk arising from asset-liability mismatch as majority of its loans are long-term in nature due to wholesale financing of large power projects, whereas its borrowings are relatively for shorter term.
- REC's ability to borrow from banks may be restricted with the limit on exposure of a bank in infrastructure finance companies at 10% of bank's capital funds.
- REC is exposed to project-specific and general risks inherent to the power sector. Any delay in the power sector projects due to lack of fuel supplies, supply of key equipment or delay in getting environment clearances can adversely affect the profitability of power projects, increasing the company's NPAs.

## Financial Statements

## Key Assumptions

Year to March		FY10	FY11	FY12	FY13E	FY14E
Macro -	GDP(Y-o-Y %)	8.4	8.4	6.5	5.8	6.5
	Inflation (Avg)	3.6	9.9	8.8	7.8	6.0
	Repo rate (exit rate)	5.0	6.8	8.5	7.5	6.8
	USD/INR (Avg)	47.4	45.6	47.9	53.5	52.0
Company -	Disbursement growth	23.2	16.0	13.5	15.3	9.6
	Borrowing growth	24.5	25.1	28.5	19.5	17.4
	Loan growth	29.3	23.6	23.4	21.2	18.1
	NIMs	4.4	4.5	4.3	4.5	4.4
	Gross NPL	-	-	0.5	0.8	1.3

## Income statement

(INR mn)

Year to March		FY10	FY11	FY12	FY13E	FY14E
Interest income		65,687	82,318	104,044	129,656	151,467
Interest expended		39,256	48,510	63,788	77,926	91,653
Net interest income		26,431	33,808	40,256	51,729	59,814
Non interest income		1,189	1,481	736	999	1,048
Income from operations		27,620	35,289	40,992	52,728	60,862
Other income		200	300	330	363	399
Net revenues		27,820	35,589	41,322	53,091	61,261
Operating expense		1,326	1,674	2,326	2,508	2,735
- Employee exp		1,171	1,275	1,710	1,823	1,972
- Depreciation /amortisation		22	30	33	31	31
- Other opex		133	369	584	654	732
Preprovision profit		26,494	33,915	38,996	50,583	58,526
Provisions		2	2	523	1,375	2,855
Loan loss provisions		2	2	523	1,375	2,855
Profit before tax		26,492	33,913	38,473	49,208	55,671
Provision for tax		6,478	8,847	9,916	12,932	14,864
Profit After Tax		20,014	25,066	28,557	36,276	40,807
Extraordinaries		-	633	(386)	(742)	(297)
Reported PAT		20,014	25,699	28,170	35,534	40,510
Basic EPS (INR)		20.3	25.4	28.9	36.7	41.3
Shares outstanding (mn)		987	987	987	987	987
Diluted EPS (INR)		20.3	25.4	28.9	36.7	41.3
Dividend per share (INR)		6.5	7.5	7.5	8.0	8.5
Dividend payout (%)		32.1	29.5	25.9	21.8	20.6

## Growth ratios (%)

Year to March		FY10	FY11	FY12	FY13E	FY14E
Rev. growth (%)		37.5	27.9	16.1	28.9	15.4
NII growth		39.6	27.9	19.1	28.9	15.6
Opex growth		19.4	26.3	38.9	7.8	9.1
PPP growth		38.6	28.0	15.0	30.1	15.7
Provisions growth		(93.6)	-	-	163.1	107.6
Net profit		45.2	25.2	13.9	27.6	12.5

## Operating ratios

Year to March	FY10	FY11	FY12	FY13E	FY14E
Yield on advances	10.9	10.9	11.2	11.5	11.2
Yield on assets	11.0	11.0	11.1	11.3	11.2
Net interest margins	4.4	4.5	4.3	4.5	4.4
Cost of funds	7.8	7.7	8.0	7.9	7.8
Spread	3.3	3.3	3.1	3.4	3.3
Cost-income	4.8	4.7	5.6	4.7	4.5
Tax rate	24.5	26.1	25.8	26.2	26.6

## Balance sheet

(INR mn)

As on 31st March	FY10	FY11	FY12	FY13E	FY14E
Equity capital	9,875	9,875	9,875	9,875	9,875
Reserves & surplus	96,643	112,750	131,199	156,187	185,470
Net worth	106,518	122,624	141,073	166,062	195,345
Reserve for doubtful debts	4,282	5,263	6,376	7,659	9,066
Secured loans	462,447	462,674	594,623	710,682	834,407
Unsecured loans	97,035	237,364	305,057	364,598	428,072
Deferred tax liability	(74)	(128)	(101)	(101)	(101)
<b>Total liabilities</b>	<b>670,208</b>	<b>827,798</b>	<b>1,047,028</b>	<b>1,248,899</b>	<b>1,466,789</b>
Loans	664,520	821,321	1,013,620	1,228,631	1,451,207
Investments	9,100	8,124	7,580	7,947	8,332
Total current assets	20,837	34,447	63,388	46,801	51,134
Total current liabilities & provisions	25,149	36,976	40,160	42,538	50,486
Net current assets	(4,312)	(2,529)	23,228	4,263	648
Misc Expenses not w/o	-	-	1,820	7,280	5,824
Fixed assets	900	881	780	779	778
<b>Total assets</b>	<b>670,208</b>	<b>827,798</b>	<b>1,047,028</b>	<b>1,248,899</b>	<b>1,466,789</b>
Loan growth	29.3	23.6	23.4	21.2	18.1
Deposit growth	24.5	25.1	28.5	19.5	17.4
EA growth	28.6	23.5	26.5	19.3	17.5
Gross NPA ratio	-	-	0.5	0.8	1.3
Net NPA ratio	-	-	0.4	0.7	1.0
Provision coverage	90.0	90.0	13.0	15.0	20.0
Book value per share (INR)	112.2	129.5	149.3	175.9	207.0

## Sanctions and disbursements

Year to March	FY10	FY11	FY12	FY13E	FY14E
Sanctions (INR mn)	453,570	664,210	508,360	610,032	732,038
Disbursements (INR mn)	211,325	245,190	278,200	320,868	351,582
Disbursements to sanction ratio (%)	46.6	36.9	54.7	52.6	48.0
Disbursements growth (%)	23.2	16.0	13.5	15.3	9.6
Sanctions growth (%)	11.3	46.4	(23.5)	20.0	20.0

### RoE decomposition (%)

Year to March	FY10	FY11	FY12	FY13E	FY14E
Net interest income/assets	4.4	4.5	4.3	4.5	4.4
Non interest income/assets	0.2	0.2	0.1	0.1	0.1
Investment profits/Assets	-	-	-	-	-
Net revenues/assets	4.7	4.8	4.4	4.6	4.5
Operating expense/assets	0.2	0.2	0.2	0.2	0.2
Provisions/assets	-	-	0.1	0.1	0.2
Taxes/assets	1.1	1.2	1.1	1.1	1.1
Total costs/assets	1.3	1.4	1.4	1.5	1.5
ROA	3.4	3.4	3.0	3.2	3.0
Equity/assets	15.4	16.0	14.6	13.6	13.4
ROAE (%)	21.9	21.0	20.9	23.4	22.5

### Valuation parameters

Year to March	FY10	FY11	FY12	FY13E	FY14E
Diluted EPS (INR)	20.3	25.4	28.9	36.7	41.3
Y-o-Y growth (%)	26.2	25.2	13.9	27.0	12.5
Book value per share (INR)	112.2	129.5	149.3	175.9	207.0
Adjusted book value per share (INR)	112.2	129.5	146.3	170.0	196.3
Diluted PE (x)	10.9	8.7	7.6	6.0	5.3
Price/ Adj. BV (x)	2.0	1.7	1.5	1.3	1.1
Dividend yield (%)	2.9	3.4	3.4	3.6	3.9

### Peer comparison valuation

	Price (INR)	Mcap (INR bn)	P/ABV		ROE (%)		P/E (x)	
			FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
HDFC Ltd	766	1,181	4.8	3.9	22.4	22.5	23.9	20.0
IDFC	168	255	1.9	1.6	14.0	15.3	13.9	11.3
LIC Housing Finance	250	126	1.8	1.6	16.3	18.2	12.6	9.1
Mahindra Finance	890	93	2.7	2.3	25.3	24.3	11.2	9.7
Manappuram Finance	37	31	1.1	0.9	21.6	20.7	5.3	4.7
MCX	1,416	72	5.9	4.9	28.7	27.2	22.7	19.7
Muthoot Finance	185	69	1.8	1.4	30.6	29.2	6.7	5.5
PFC	189	249	1.2	1.0	18.5	18.9	6.3	5.3
Reliance Capital	392	96	0.8	0.7	6.4	6.9	12.5	11.0
Rural Electrification Corp	220	218	1.3	1.1	23.4	22.5	6.0	5.3
Shriram City Union Finance	821	43	2.1	1.7	23.6	23.9	9.7	7.9

Source: Bloomberg, Edelweiss research



Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Allahabad Bank	HOLD	SP	M	Axis Bank	BUY	SO	M
Bank of Baroda	BUY	SP	M	Federal Bank	BUY	SO	L
HDFC	HOLD	SU	L	HDFC Bank	HOLD	SP	L
ICICI Bank	BUY	SO	L	Indian Overseas Bank	HOLD	SU	M
IndusInd Bank	BUY	SP	L	IDFC	BUY	SO	L
ING Vysya	BUY	SO	L	Karnataka Bank	BUY	SO	M
Kotak Mahindra Bank	REDUCE	SU	M	LIC Housing Finance	BUY	SO	M
Mahindra & Mahindra Financial Services	BUY	SO	M	Manappuram General Finance	BUY	SO	M
Multi Commodity Exchange of India	BUY	SO	M	Muthoot Finance	BUY	SO	M
Oriental Bank Of Commerce	BUY	SO	L	Power Finance Corp	BUY	SO	M
Punjab National Bank	HOLD	SU	M	Reliance Capital	BUY	SO	M
Rural Electrification Corporation	BUY	SO	M	Shriram City Union Finance	BUY	SO	M
South Indian Bank	HOLD	SP	M	State Bank of India	BUY	SO	L
Union Bank Of India	BUY	SO	M	Yes Bank	BUY	SO	M

**ABSOLUTE RATING**
**Ratings**
**Expected absolute returns over 12 months**

Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

**RELATIVE RETURNS RATING**
**Ratings**
**Criteria**

Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

**RELATIVE RISK RATING**
**Ratings**
**Criteria**

Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

**SECTOR RATING**
**Ratings**
**Criteria**

Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return



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Allahabad Bank, Axis Bank, Bank of Baroda, Federal Bank, HDFC, HDFC Bank, ICICI Bank, Infrastructure Development Finance Co Ltd, IndusInd Bank, Indian Overseas Bank, Karnataka Bank, Kotak Mahindra Bank, LIC Housing Finance, Multi Commodity Exchange of India, Manappuram General Finance, Mahindra & Mahindra Financial Services, Muthoot Finance, Oriental Bank Of Commerce, Punjab National Bank, Power Finance Corp, Reliance Capital, Rural Electrification Corporation, State Bank of India, Shriram City Union Finance, South Indian Bank, Union Bank Of India, ING Vysya, Yes Bank

#### Recent Research

Date	Company	Title	Price (INR)	Recos
02-Nov-12	<b>Union Bank</b>	Performs on asset quality with controlled slippages; <i>Result Update</i>	223	Buy
01-Nov-12	<b>Shriram City Union Finance</b>	Growth buoyant; NIMs stable; <i>Result Update</i>	789	Buy
31-Oct-12	<b>Muthoot Finance</b>	Beat on earnings led by yield improvement; <i>Result Update</i>	186	Buy

#### Distribution of Ratings / Market Cap

##### Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	113	53	19	186
* 1 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	114	58	14	

#### Rating Interpretation

Rating	Expected to
<b>Buy</b>	appreciate more than 15% over a 12-month period
<b>Hold</b>	appreciate up to 15% over a 12-month period
<b>Reduce</b>	depreciate more than 5% over a 12-month period



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