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PGCIL

Core ROE of 22.5% offered at 1.5x; No brainer; subscribe

FPO Note

November 9, 2010

Reco

Subscribe

CMP	Price Band
Rs 98	Rs 85-90

Nifty	20,853
Sensex	6,273

Stock Details

Sector	Power
Bloomberg	PWGR@IN
Issue Size (Rs bn)	71.6 -75.8
Equity Capital Post FPO (Rs mn)	46,297
Face Value(Rs)	10
No of shares o/s Post FPO (mn)	4,630
Market Cap (Rs bn/USD bn)	454/10.2
Issue Date	Nov 09-Nov12

Shareholding Pattern (%)

	Pre-Issue	Post-Issue
Promoters	86.4	69.4
Institutions	7.3	15.7
Others	6.3	14.9

Source: Company

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- **FY10 actual core ROE of 21.3% - (1)18.9% from regulated business, (2) 1.1% from STOA, (3) 1.3% from consultancy and (4) -1.7% reduced by deferred tax accounting**
- **Core ROE to increase by 1% to about 22.5% in next two years led by Short Term Open Access volumes; Potential of further 1% ROE upside if assume likely numbers on volumes**
- **FPO at 1.5xFY13E Book, cheap on absolute basis with core ROE of 22.5% and relative basis – NTPC core ROE at 24% (including 3% from UI) and P/BV at 2.1x**
- **Operating cash flow yield of 16% in FY12E; November 11 target of Rs128/Share; Sure Shot returns; Subscribe**

Core ROE of 21.3% in FY10, helped by regulated equity calculations on gross block and negative working capital

PGCIL's core ROE jumped from 17.5% in FY09 to 21.3% in FY10. This was mainly because of (1) change in regulated ROE from 14% to 15.5%/16.0%, (2) change in other norms, (3) 0.7% increase due to STOA and (4) 0.3% increase due to consultancy. The core ROE (21.3%) is higher than regulated ROE (17.0%) in case of PGCIL due to (1) regulated equity calculations on gross block and actual equity calculations on net block and (2) negative working capital. Further on reported basis the core ROE appears lower because of deferred tax accounting eating away 1.7%. Seeing the capex quantum, we believe that PGCIL is likely to remain under MAT for the foreseeable future and the deferred tax liabilities created, practically are not likely to result in actual tax payments.

Assuming half of the volumes expected in short term market - core ROE to further increase by 1% led by STOA

PGCIL has earned its share of gross income of Rs1.2bn from STOA in FY10. This resulted in ROE upside of about 1.1%. Based on our analysis of upcoming short term capacities and assuming only half of the volumes, this income would increase significantly. We expect a ROE contribution of 2.1% from this source in FY13E. Again highlight that if we consider all the likely volumes, the ROE upside would be further 1%.

FPO at 1.5x FY13E book; cheap on absolute as well as relative basis

At higher band of Rs90/Share, the PGCIL FPO is valued at 1.5x FY13E Book. This is cheap looking at core ROE of ~22.5% in FY13E. Also PGCIL FPO is significantly undervalued compared with the current valuations of other regulated utilities like NTPC. NTPC is trading at 2.1xFY13E Book value with core ROE of 24%. However we highlight that 3% of NTPC's core ROE is from UI which is linked to short term prices. Whereas in case of power grid, the core ROE of 22.5% is totally dependent on volumes and not on prices.

With (1) Operating cash flow yield of 16% in FY12E, (2) regulated monopoly business with certainty of numbers, (3) execution track record of nearly 100% and (4) further potential of 1% REO upside from STOA - we see PGCIL as a much better investment option.

We have valued PGCIL on SoTP of its core Book and cash and investments. The (1) regulated equity of Rs182bn at the end of FY13E is valued at 2.5x and (2) equity funded cash and investments are valued at 1x (no option value considered). We recommend subscribe to the FPO with November 11 price target of Rs128/Share. We even remain positive on the stock at CMP of Rs98/Share at which the stock trades at 1.7x FY13E Book.

Assuming 70% of the net block has been funded by debt, the core equity would be lower than regulated equity. As per our estimates the core equity was Rs96bn at the end of FY10 versus regulated equity of Rs110bn. This is resulting in 2.5% additional core ROE for PGCIL.

This is the result of calculating regulated equity on gross block and core equity on net block

Also negative working capital is helping the core ROE.

Rate of STOA charges were revised by CERC with effect from June 15, 2009 from 03 to 09 Paise per unit to 08 - 24 Paise per unit. This along with increasing volumes in the short term market going forward to result in significant growth in STOA income.

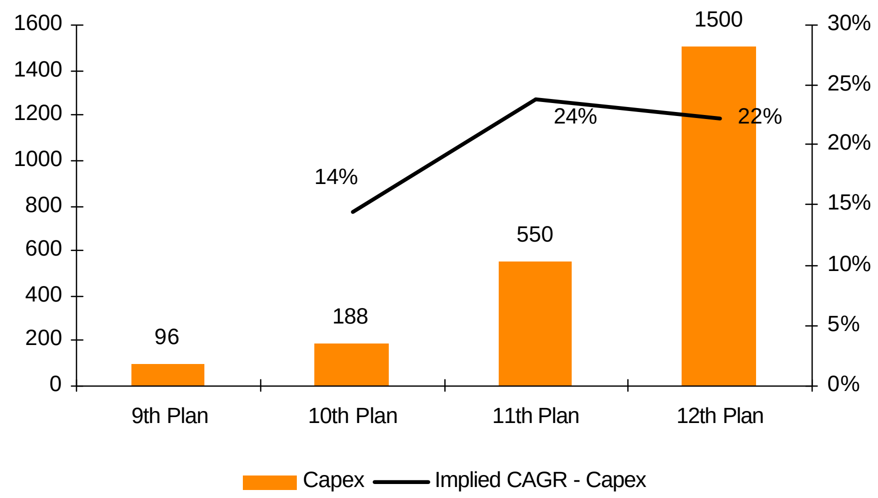
	FY09	FY10	FY11	FY12	FY13
Net Worth	148489	161407	221370	244302	272135
Debt	284654	344168	435168	553010	721010
Net Block	311284	320612	390216	502799	607878
Assuming 70% of Net Block Financed by Debt	217899	224428	273151	351959	425515
CWIP	132860	204222	241629	268512	367512
Capital WIP funded by Debt	66755	119740	162017	201051	295496
Capital WIP Funded by WC and Advance against depreciation	45887	59568	51691	56893	71579
Capital WIP Funded by Equity	20218	24914	27921	10567	437
Cash & Inv - Equity Funded	34886	40309	76384	82896	89335
Effective Regulated Equity	93385	96184	117065	150840	182363
Total Adjusted PAT	17492	21208	27230	35252	42785
Less Tax adjusted Investment Income	2587	2312	2902	3928	4353
Core PAT	14905	18850	23159	30235	37366
Core ROE	16.2%	19.6%	19.8%	20.0%	20.5%
Deferred Tax charged and not recovered	-	1650	2301	2864	3476
Core ROE reduced by deferred tax and telecom	-0.8%	-1.7%	-2.0%	-1.9%	-1.9%
Effective Core ROE	**17.0%**	**21.3%**	**21.8%**	**21.9%**	**22.4%**
Break Up of Core ROE					
Core Transmission profits	15.7%	18.9%	18.9%	18.9%	18.9%
STOA	0.4%	1.1%	1.5%	1.7%	2.1%
Consultancy	1.0%	1.3%	1.3%	1.3%	1.3%
Telecom	-0.3%	0.1%	0.0%	0.0%	0.0%
Deferred Tax	-0.5%	-1.7%	-2.0%	-1.9%	-1.9%

Earnings growth momentum clearly picking up

The company is on the path to step up its earnings growth for next 4-5years to 25% from 19% during FY06-FY10. During Q2FY11 and H1FY11, it has commissioned projects of whopping Rs39bn (Rs10bn in Q2FY10) and Rs51bn (Rs24bn in H1FY10). This has reflected in 35% (after one time adjustment - 25%) earnings growth in H1FY11.

A look at its plan wise Capex and profits reveal very interesting trends:

- 10th plan capex doubled (implied CAGR of 14%) from 9th plan but profits grew by 1.4x or 6% CAGR only – this is because generation capacities linked were mostly Govt. and most of it commissioned in the last year of the plan indicating recovery of transmission charges also getting delayed.
- 11th plan capex is tripling (implied CAGR of 24%) from 10th plan and PAT is also tripling – (1) partly due to new regulations, (2) partly due to huge backlog of generation capacities from 10th plan and (3) partly due to expected acceleration in generation capacities in last two years of 11th plan, also visible in commissioning pattern of PGCIL lines as highlighted above.
- 12th plan capex is again likely to triple (implied CAGR of 25%) – important to note is major capacities are coming from private players thus no bunching up in the last year of the plan – commissioning to be front loaded.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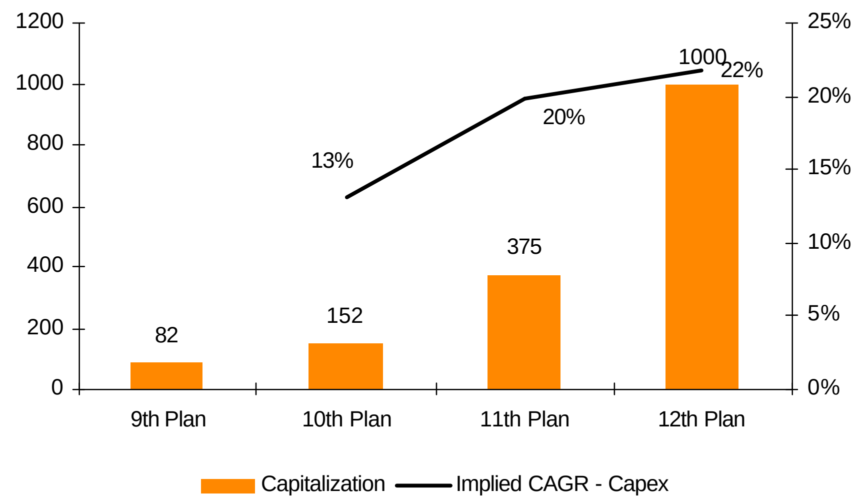
9th Plan
10th Plan
11th Plan
12th Plan
Capex
Implied CAGR - Capex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9th Plan
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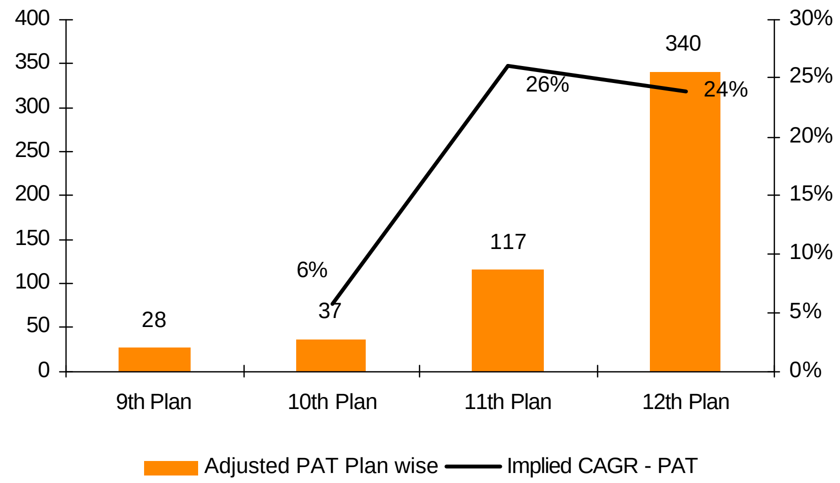
11th Plan
12th Plan
Capitalization
Implied CAGR - Capex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26%
24%
9th Plan
10th Plan
11th Plan
12th Plan
Adjusted PAT Plan wise
Implied CAGR - PAT

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