Initiating Coverage

SECTOR: BANKING & FINANCE

Rural Electrification Corp

Money power

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Contents

Rural Electrification Corporation

STOCK INFO.	BLOOMBERG
BSE Sensex: 15,629	RECL IN
	REUTERS CODE
S&P CNX: 4,643	RURL.BO

24 August 2009

Buy

Initiating Coverage

Rs204

Y/E MARCH	2008	2009	2010E	2011E
Net Fin. Inc.(Rs m)	12,969	17,776	23,051	28,651
OI (Rs m)	13,530	19,231	24,210	29,932
NP (Rs m)	9,376	14,117	17,878	22,113
EPS (Rs)	10.9	16.4	20.8	25.8
EPS Growth (%)	9.8	50.6	26.6	23.7
BV/Share (Rs)	72.0	83.2	96.7	113.1
P/E (x)	18.7	12.4	9.8	7.9
P/BV (x)	2.8	2.5	2.1	1.8
RoE (%)	17.1	21.2	23.1	24.5
RoA (%)	2.4	2.9	2.8	2.7

KEY FINANCIALS	
Shares Outstanding (m)	858.7
Market Cap. (Rs b)	175.2
Market Cap. (US$ b)	3.6
Past 3 yrs. Sales Growth (%)	32.3
Past 3 yrs. NP Growth (%)	31.3
Dividend Payout (%)	30.4
Dividend Yield (%)	3.1

STOCK DATA	
52-Week Range	208/54
Major Shareholders (as of June 2009)	%
Promoter	81.8
Domestic Inst	8.0
Foreign	4.6
Others	5.6
Average Daily Turnover	
Volume ('000 shares)	1,195.8
Value (Rs million)	140.2
1/6/12 Month Rel. Performance (%)	15/86/131
1/6/12 Month Abs. Performance (%)	17/164/140

REC a beneficiary of buoyancy in the power sector: The power sector is expected to see generation capacity addition of 120GW during FY08-12, including 80GW targeted during Eleventh Five-Year Plan. This, along with transmission and distribution, will entail investment of Rs10.3t. REC is dedicated to power-sector financing. It enjoys strong relationships with Central and state government utilities, which account for 94% of its loan book. With over 78% of the total investment pipeline expected from government utilities, we see REC to be a major beneficiary of the buoyancy in the power sector.

Strong earnings growth visibility: With cumulative sanctions of ~Rs1.2t over the past three years (double the existing loan book), REC's loan pipeline remains strong. Being a government-promoted AAA-rated organization, REC's borrowing cost is the lowest among peers. Its reported spreads will remain high at 2.75%+ (vs 3.5% reported in 1QFY10) as it enjoys lower funding cost due to bonds under Sec 54EC of the Income Tax Act. Going forward, the share of 54EC bonds is likely to come down which will increase the cost of funds. However, large upward resets in low-yielding loans should partly offset the pressure on spreads. We expect FY09-12E disbursement CAGR of 25% and loan book CAGR of 27% translating into PAT CAGR of 23%. We expect REC to report RoA of 2.5%+ and RoE of 23%+ over FY09-12E.

Capital raising will enhance lending capacity: Like most financing companies, REC's current exposure norms are linked to its net worth. To effectively tap the huge opportunity through FY12, and enable itself to take larger exposures to single projects, group SEBs and private companies, REC plans to increase its capitalization. Assuming a 15% dilution (128.8m shares) at Rs180/share (10% discount to the CMP), REC's BV would increase to Rs108 by FY10 (v/s Rs97) and Rs124 by FY11 (v/s Rs113).

Initiate coverage with a Buy: REC is a long-term play on India's power-sector growth. We believe the stock offers both earnings growth visibility (23% PAT CAGR through FY12E) and value (FY11E P/BV of 1.8x against a healthy RoE of 24%+). Our target price for REC is Rs250 (2.2x FY11E BV). We initiate coverage with a **Buy**.

REC a beneficiary of buoyancy in the power sector

The power sector is expected to see generation capacity addition of 120GW during FY08-12, including 80GW targeted during Eleventh Five-Year Plan. This, along with transmission and distribution, will entail investment of Rs10.3t. REC is dedicated to power-sector financing. It enjoys strong relationships with Central and state government utilities, which account for 94% of its loan book. With over 78% of the total investment pipeline expected from government utilities, we see REC to be a major beneficiary of the buoyancy in the power sector.

120GW power generation capacity addition during FY08-12

"Power for all by 2012" entails 80GW capacity addition in Eleventh Plan

India's National Electricity Policy envisages "Power for all by 2012" with per capita availability of power to be increased to over 1,000 units by 2011-12. This would entail generation capacity addition of 100GW during the Tenth and Eleventh Five-Year Plans (FY03-07 and FY08-12). However, the actual achievement during the Tenth Plan was only 21.2GW. Accordingly, the tentative capacity addition for the Eleventh Plan has been envisaged at 80GW. Further, 40GW is expected to be added by way of captive power plants, merchant power plants and others, taking the total capacity addition during FY08-12 to 120GW.

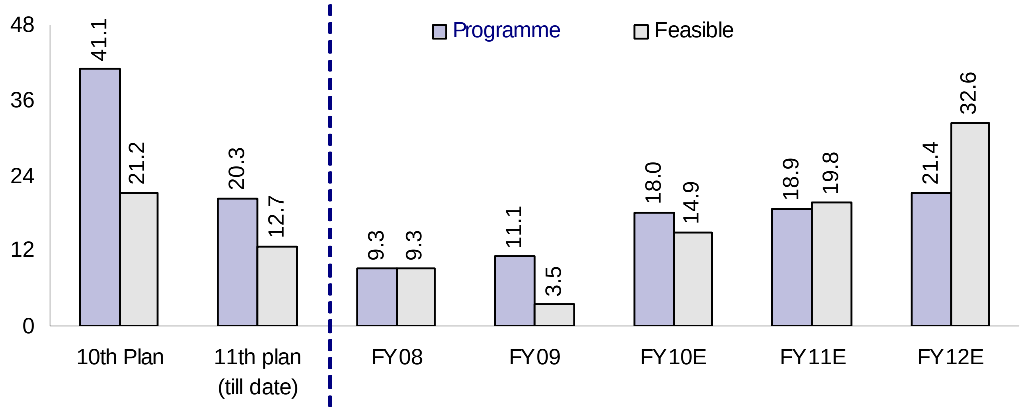
CAPACITY ADDITION IN ELEVENTH PLAN - YEAR BY YEAR

MWS	FY08	FY09	FY10E	FY11E	FY12E	TOTAL
Thermal						
Programme	6,620	9,304	14,229	16,555	12,885	59,593
Feasible	6,620	5,786	11,653	16,572	20,492	61,123
Hydro						
Programme	2,423	1,097	1,805	1,741	8,561	15,627
Feasible	2,423	1,097	1,805	1,741	8,441	15,507
Nuclear						
Programme	220	660	2,000	500	0	3,380
Feasible	220	220	1,440	1,500	0	3,380
Total						
Programme	9,263	11,061	18,034	18,896	21,446	78,700
Feasible	9,263	3,454	14,898	19,813	32,582	80,010

Source: Central Electricity Authority

Under the Eleventh Plan large part of capacity additions would be back-ended

TOTAL GENERATION CAPACITY ADDITIONS (GW)



Source: Central Electricity Authority

Total capacity additions is expected to be 120GW from FY08-12E

PLANNED CAPACITY ADDITION FY08-12MW

	THERMAL	HYDRO	NUCLEAR	TOTAL
Central	26,800	9,685	3,380	39,865
State	24,347	3,605	0	27,952
Private	7,497	3,263	0	10,760
Sub-Total	58,644	27,952	10,760	78,577
Captive Power Plants				12,000
NCES				13,500
Merchant Power Plants				10,000
Decentralized Distribution Generation				5,000
Total				**119,077**

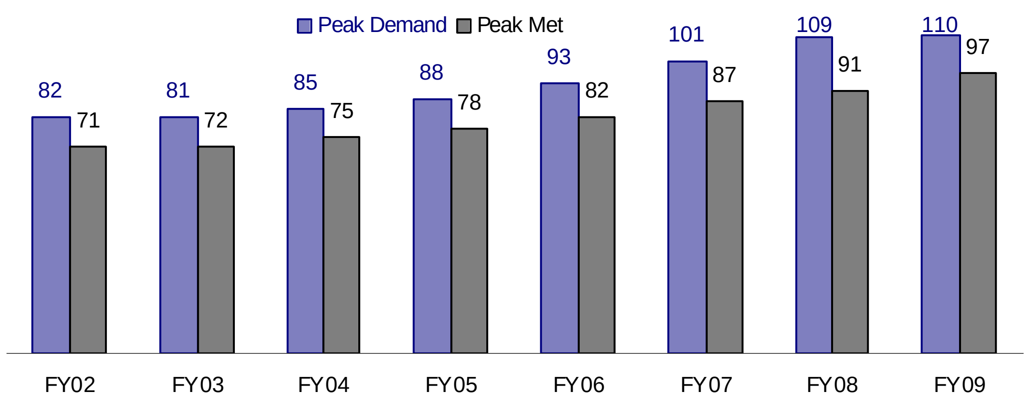
Source: Company/MOSL

Power shortage and lower per capita consumption to drive capacity addition

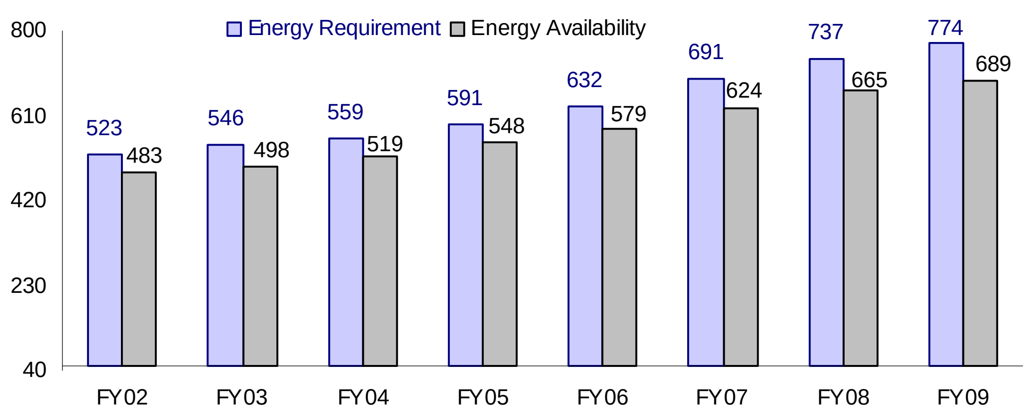
India's large capacity addition in the power sector is driven by: (1) acute power shortage (FY09 peak deficit of 12%), and (2) low per capita power consumption of (700 units v/s global average of 2,500 units).

FY09 peak deficit of 12%: In FY09, India faced a 12% shortage in peak power demand. Over the years, India's power deficit has been rising as capacity addition has not kept up with demand growth. In the past five years, power requirement CAGR was 6.7% v/s availability CAGR of 5.8%.

PEAK DEMAND AND SUPPLY (GW)

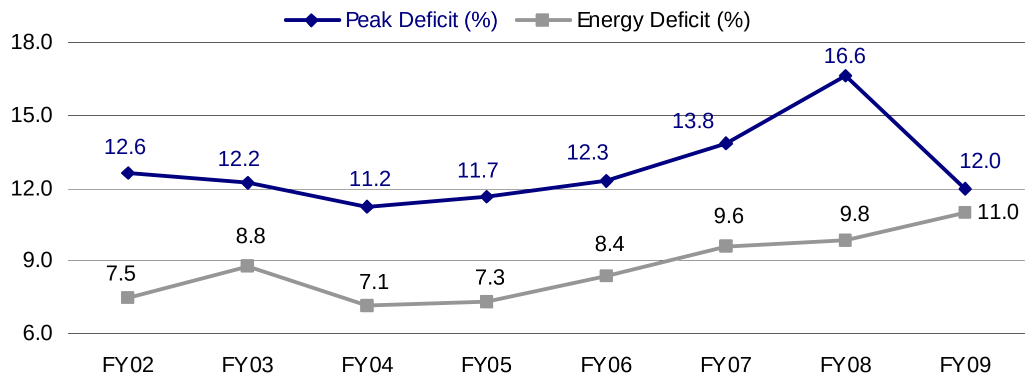


DEMAND SUPPLY GAP - BU

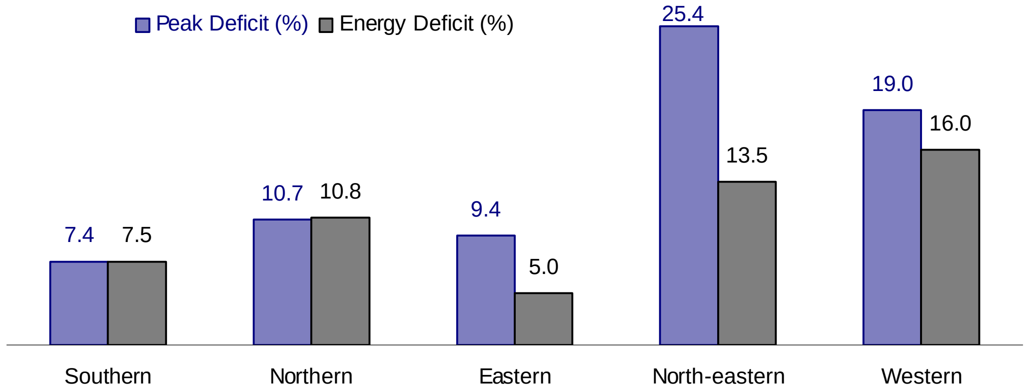


Source: Central Electricity Authority

INDIA CONTINUES TO HAVE A HIGH POWER DEFICIT



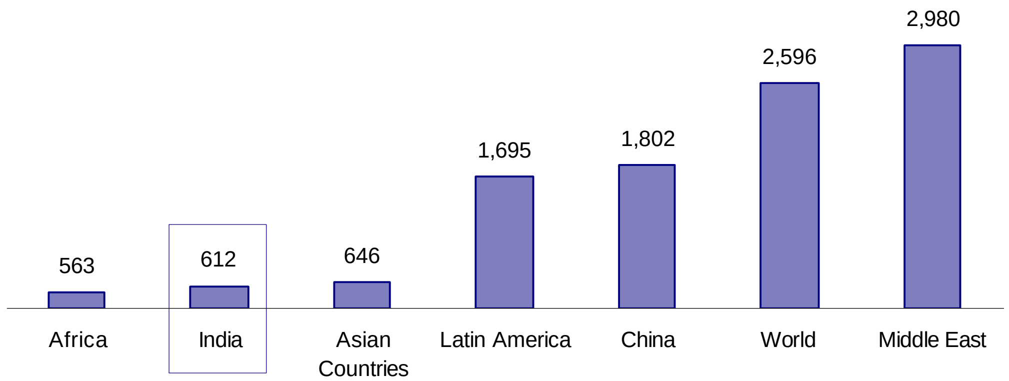
REGION-WISE ENERGY DEFICIT - FY09 (%)



Source: Company/MOSL

Low per capita consumption: India's per capita annual power consumption is less than 700 units against a global average of over 2,500 units. As India's economy grows, its energy consumption is expected to grow as well.

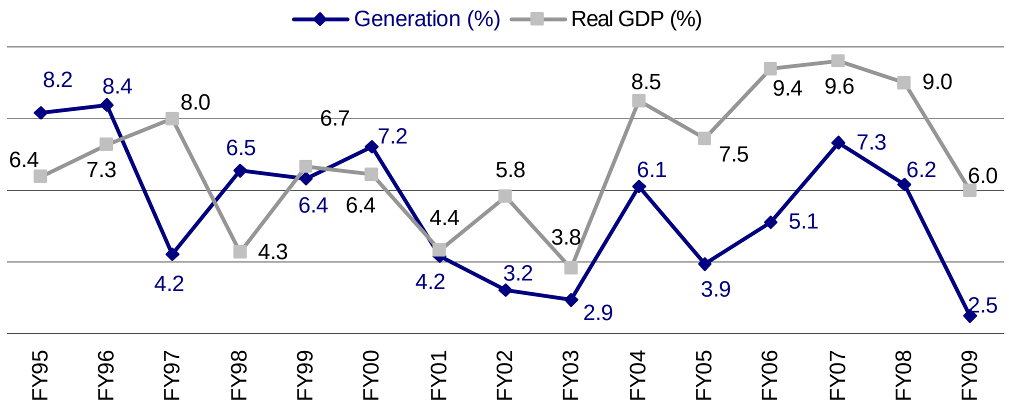
PER CAPITA ANNUAL POWER CONSUMPTION (UNITS)



Source: REC prospectus

Generation growth lags real GDP growth

REAL GDP GROWTH AND GENERATION GROWTH



Source: Company/MOSL

Investment pipeline of Rs10.3t; REC to be a major beneficiary

The 120GW of generation capacity will entail an investment of Rs6t. This will need to be supported by investment in transmission of Rs2.9t and in distribution Rs1.4t. Thus, the total investment pipeline works out to Rs10.3t. Assuming a 75:25 debt: equity ratio, this translates into a power-finance opportunity of more than Rs7.2t. Of the total investment expected, 78% is expected to be undertaken by Central and state government utilities, which currently account for 94% of REC's loan book. Thus, we see REC to be a major beneficiary of the buoyancy in power sector investment.

Rs10.3t investments in power sector expected from FY08-12E

FUNDS NEEDED (RS B)

	STATE	CENTRAL	PRIVATE	TOTAL
Generation	1,238	2,021	850	4,109
Transmission	650	750	0	1,400
Distribution	2,870	0	0	2,870
NCES and Captive	225	0	930	1,155
Merchant Power Plant	0	0	400	400
Others	159	223	0	382
Total Funds Required	**5,142**	**2,994**	**2,180**	**10,316**

Source: Report of Working Group on XIth Plan

Strong earnings growth visibility

With cumulative sanctions of ~Rs1.2t over the past three years (double the existing loan book), REC's loan pipeline remains strong. Being a government-promoted AAA-rated organization, REC's borrowing cost is the lowest among peers. Its reported spreads will remain high at 2.75%+ (vs 3.5% reported in 1QFY10) as it enjoys lower funding cost due to bonds under Sec 54EC of the Income Tax Act. Going forward, the share of 54EC bonds is likely to come down which will increase the cost of funds. However, large upward resets in low-yielding loans should partly offset the pressure on spreads. We expect FY09-12E disbursement CAGR of 25% and loan book CAGR of 27% translating into PAT CAGR of 23%. We expect REC to report RoA of 2.5%+ and RoE of 23%+ over FY09-12E.

REC will continue to have an edge in power financing

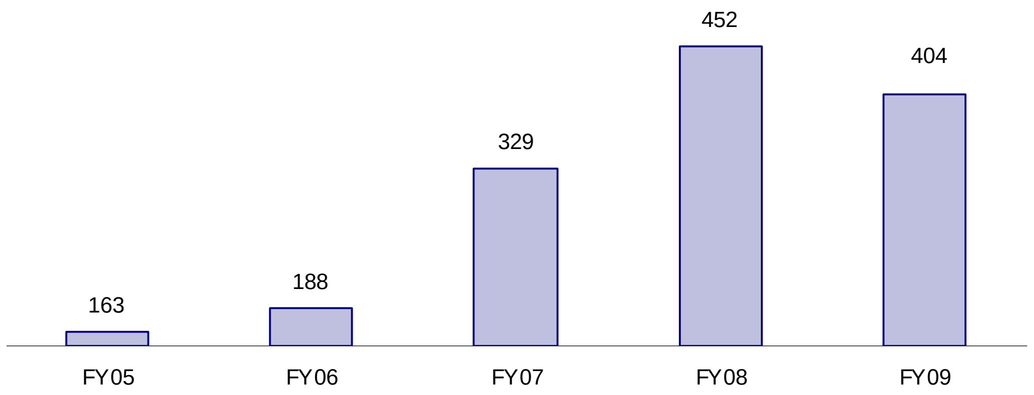
Banks have limitations in lending to SEBs because of SEBs' poor financial health and the asset-liability mismatch that lending to such borrowers would create. Power generation financing inherently has a long gestation period, which may extend to over 20 years. Bankers would be unwilling to lend beyond five to ten years as this could lead to an acute asset-liability mismatch and liquidity problems for banks. As a result, REC will continue to have an edge in power financing.

REC's Rs1.2t sanctions to drive 27% loan book growth

During FY07-09 REC sanctioned loans worth ~Rs1.2t. These will subsequently convert into disbursements. During FY04-09 the disbursement CAGR has been 23% more towards the later years. Disbursal CAGR during FY06-09 was 32%. We expect 25% CAGR in disbursements over the next three years.

Cumulative sanctions of Rs1.2t (FY07-09) provides strong loan growth visibility

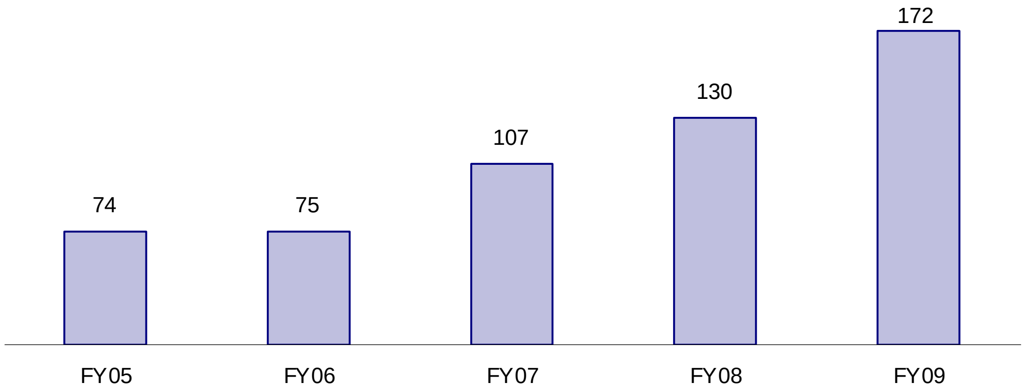
SANCTIONS IN THE PAST FIVE YEARS (RS B)



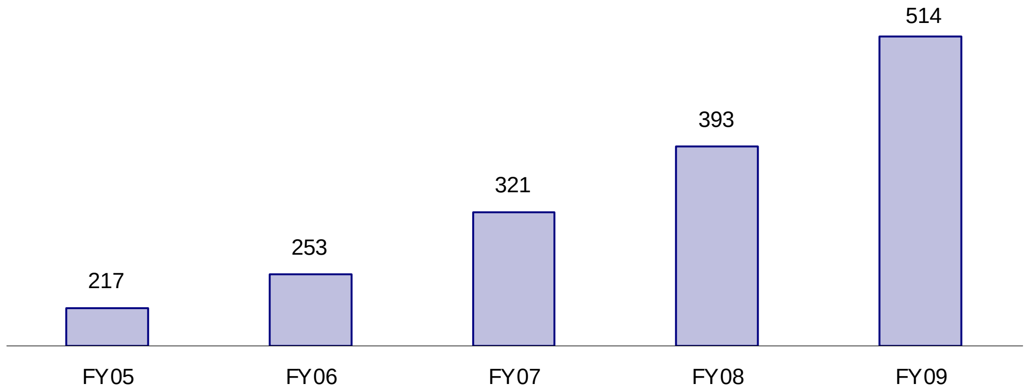
Source: Company/MOSL

Disbursements acceleration has already begun

Disbursements in the past five years (Rs b)



Loan book over last 5 years (Rs b)

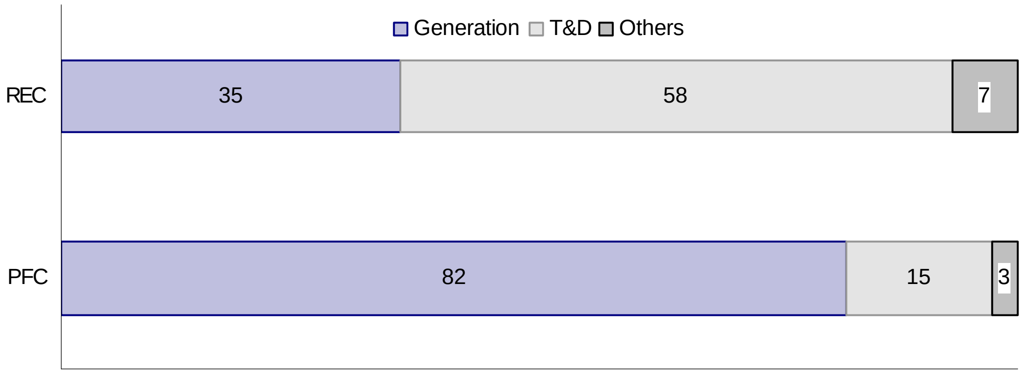


Source: Company/MOSL

REC changing business mix in favor of generation projects

While REC's exposure has historically been in favor of the T&D segment as compared with PFC, it is changing its profile in favor of generation projects as well. Sanctions and disbursement trends indicate that generation projects occupy a higher share in its incremental business. Almost 50-60% of sanctions in FY08-09 were to the generation segment against 37% in FY07. Similarly disbursements to generation projects are increasing in proportion. Of the Rs1.2t sanctions over the past three years ~50% have been for generation projects, ~40% for the T&D segment.

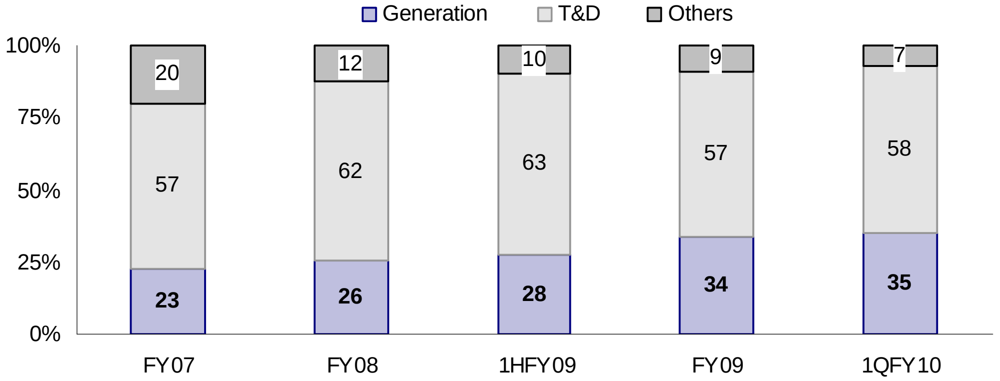
Loan-book composition (%) - PFC vs REC



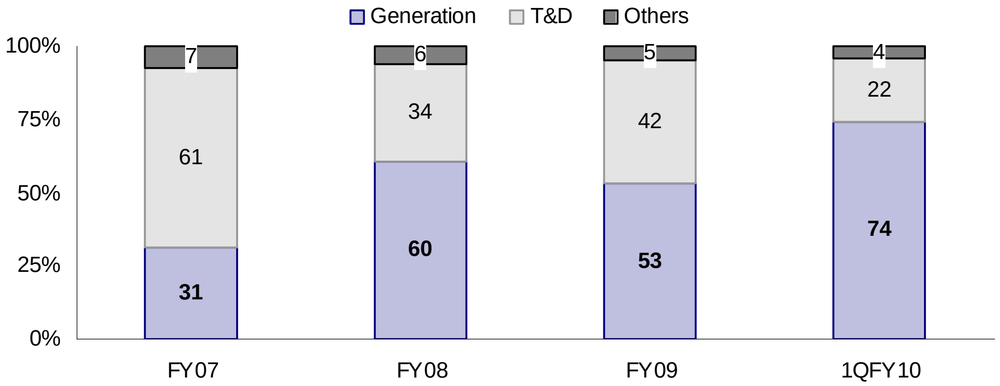
PFC: Power Finance Corporation *Source: Company/MOSL*

LOAN MIX SHIFTING IN FAVOR OF GENERATION PROJECTS

Share of generation loan increased from 23% in FY07 to 35% in 1QFY10

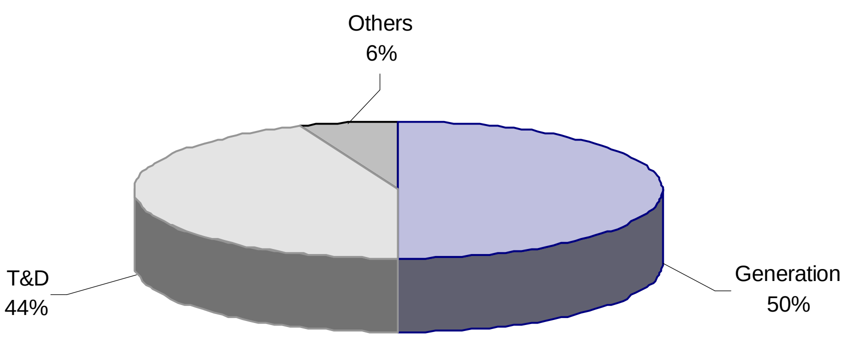


OVER THE LAST FEW YEARS SANCTIONS FOR GENERATION PROJECTS INCREASED RAPIDLY

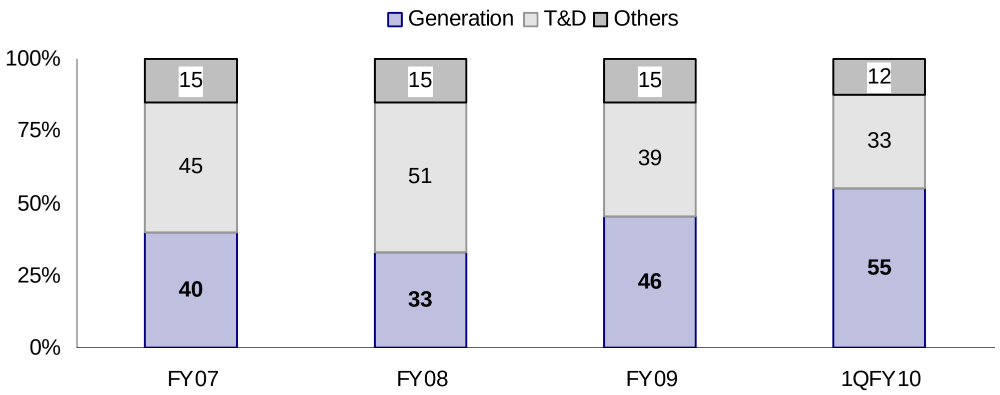


CUMULATIVE SANCTIONS COMPOSITION (%) FY07-09

50% of the sanctions during FY07-09 were towards generation



GENERATION OCCUPYING HIGHER SHARE IN DISBURSEMENTS



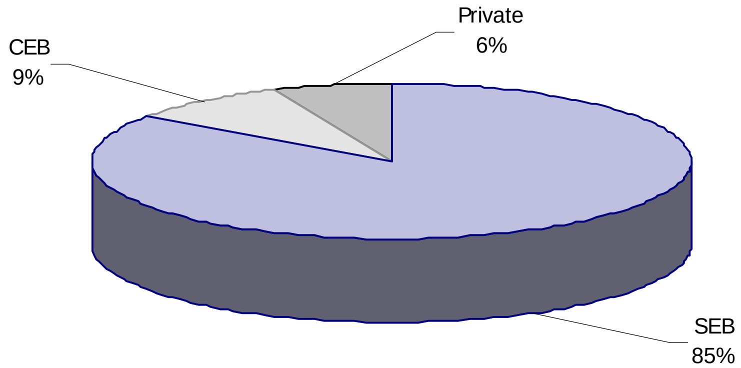
Source: Company/MOSL

State boards remain REC's mainstay

About 85% of REC's loan book comprises state boards (v/s 72% for PFC). REC plans to take higher exposure to the private sector but we believe state power bodies will continue REC's mainstay. The company's internal targets show that the private sector will constitute 15-20% of its loan book by the end of the Eleventh Five Year Plan.

REC's internal target is to increase private sector share to 15-20% by FY12

BORROWER-WISE LOAN-BOOK IN 1QFY10



Source: Company/MOSL

Spreads to moderate; however, will remain superior at 2.75%+

Low-coupon capital gains tax saver bonds keep REC's cost of funds low

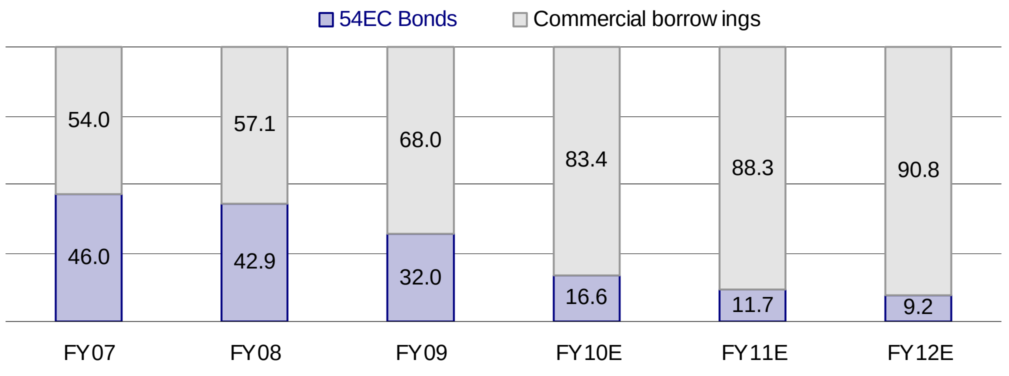
REC has reported a 3.5% spread and 4%+ NIM in 1QFY10. These higher spreads are due to favorable ALM mismatches and significant reduction in wholesale funded costs. We don't believe these are sustainable given the business profile. The management reiterates it will comfortably earn a 2.75-3% spread on an incremental basis. This is mainly because 30%+ of REC's existing borrowings is contributed by capital gains tax-saver bonds issued under Section 54EC of the Income Tax Act. These are 3-year bonds with average cost of 5.5-6% against the commercial borrowing rate of 8%+. The bonds make REC's funding costs lower and spreads higher than PFC (PFC is not eligible to issue Section 54EC bonds).

Importance of 54EC bonds to decline, to put pressure on borrowing costs

The importance of 54EC bonds is set to decline in REC's overall borrowing program. Besides REC, NHAI is eligible to issue such bonds. The incremental share for such bonds, considering REC's large borrowing programs, is low. The incremental proportion of the bonds has declined from ~80% in FY07 to 17% in FY09. Consequently, the share of these bonds in outstanding borrowings has been declining. The bonds, which raised Rs70b+ in FY07 will be repaid in FY10 reducing their proportion to less than 20% by FY10 and less than 12% by FY11. As the importance of these bonds diminishes, the cost of funds will rise, putting downward pressure on spreads.

Share of low-cost 54EC bonds to fall significantly, putting pressure on cost of funds

54EC BONDS FALLS SIGNIFICANTLY (%)



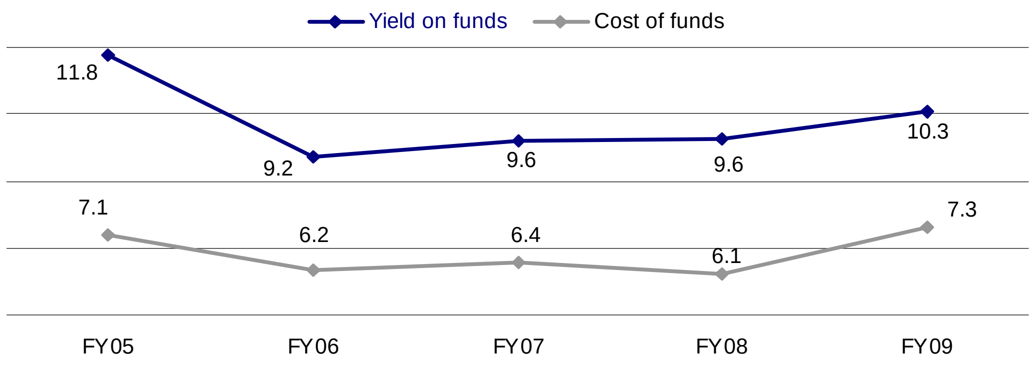
Source: Company/MOSL

Expected resets to drive yields up and offset higher borrowing costs

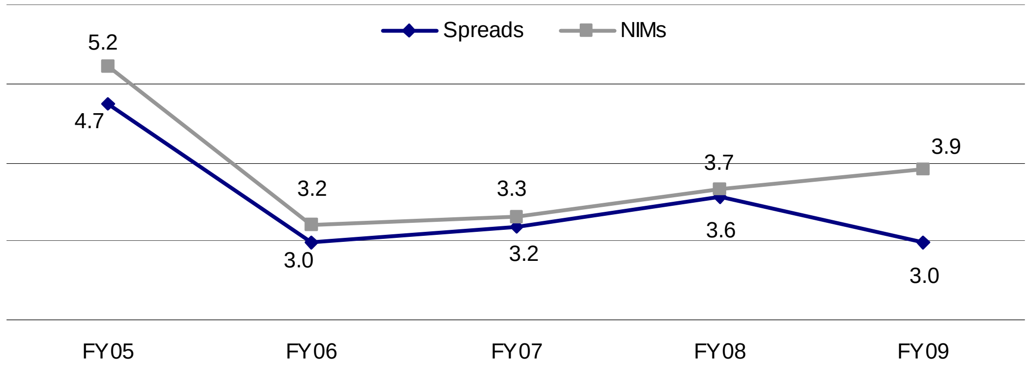
Higher cost of funds will be partly offset by upward resets of loans

About 97% of REC's loan book is covered by a 3 or 10-year reset clause. A large part of low yielding loans made in the past have come up or are expected to come up for reset in FY09-11. As these loans get reset upwards by 200-250bp, the yield on the portfolio will increase. In FY09, a loan of Rs28b got repriced upwards by ~250bp. In 2HFY10, loans of Rs78b (15% of the existing loan book) yielding less than 9% are expected to come up for reset and the management expects upward revision of at least 175bp. In FY11, Rs120b in loans (20%+ of existing loan book) are expected to be reset where upward revision can be expected. Such resets give us confidence that REC's yields can rise despite falling interest rates on incremental loans.

REC'S YIELDS AND COST OF FUNDS (REPORTED, %)



REC'S SPREADS AND NIMS (REPORTED, %)



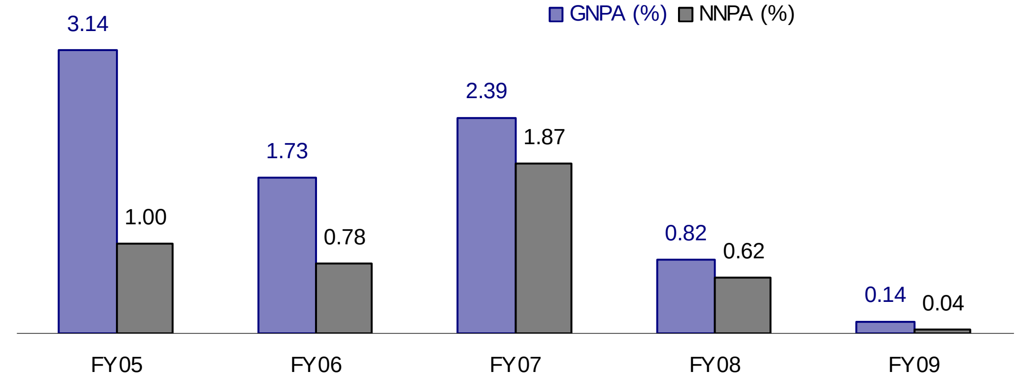
Source: Company/MOSL

Asset quality improving; remains one of the best in the sector

REC has one of the best asset quality with the GNPA level as low as 0.14% and NNPA level of 0.04% as on FY09 despite having a higher share of loans towards the loss making state utilities. About 85% of REC's loans is towards state utilities many of which are not in the best of financial health. A series of reforms have been initiated to improve the situation (see Annexure). However, REC's dues are secured by way of an escrow mechanism.

REC's asset quality is consistently improving

ASSET QUALITY IMPROVING AND ONE OF THE BEST IN THE INDUSTRY



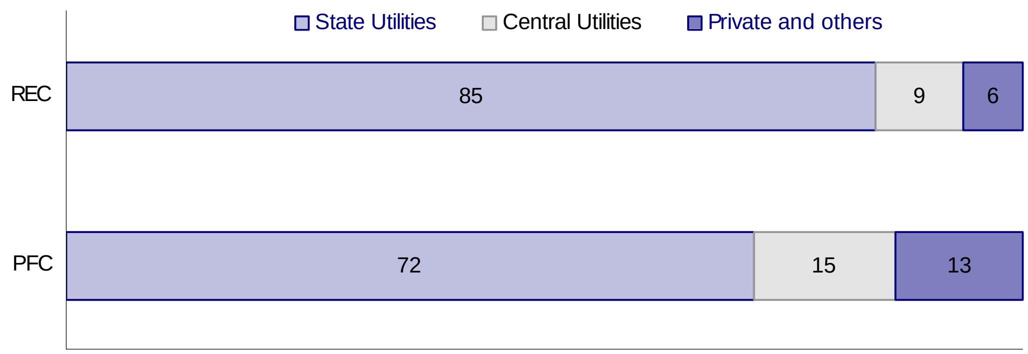
Source: Company/MOSL

Escrow mechanism ensures strong recoveries

Escrow mechanism ensures 98%+ recovery for REC

Most of the loans to SEBs are backed by default escrow accounts as a credit enhancement mechanism. Under this mechanism, certain predetermined amounts from the payments received by SEBs from their respective customers are deposited in an escrow account pursuant to a tripartite escrow agreement between REC, the SEBs and an escrow agent (the bank). The deposited amount is available to the SEBs except in case of a default due to non-payment of dues. In such cases, the escrow agent makes the default amount available to PFC/REC on demand. Thus, while balance sheets of SEBs are in bad shape, REC and PFC lend based on the security of the cash flows from the operations of the utilities. PFC and REC have enjoyed 98%+ recovery from SEBs during past few years.

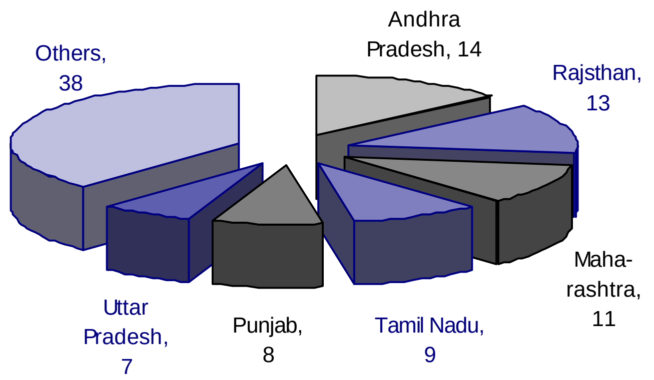
SHARE OF LOAN BOOK (PFC V/S REC)



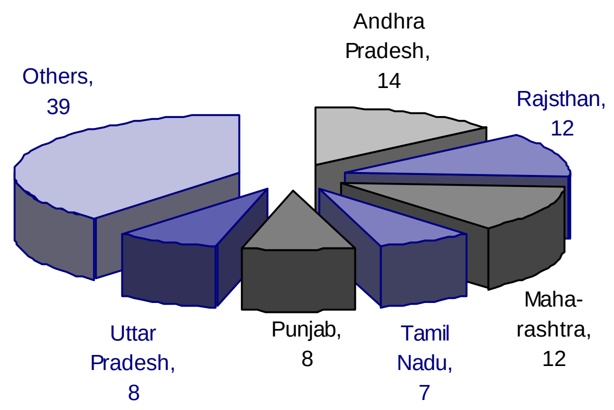
Source: Company/MOSL

REC's overall exposure is concentrated with state boards like AP, Punjab, Rajsthan, Maharshatra, Tamil Nadu etc. Also ~40% of current loan book is guaranteed by state governments.

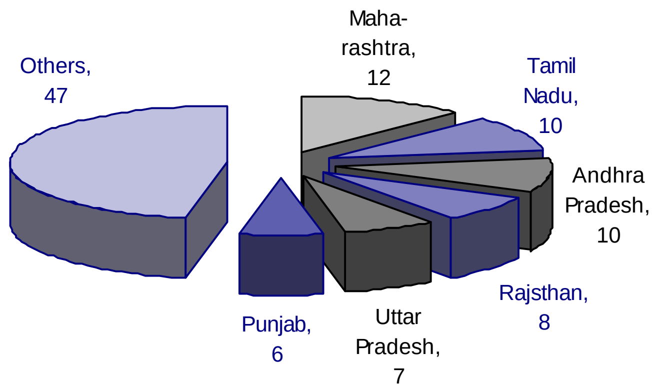
REC'S LOAN BOOK EXPOSURE AS OF MARCH 2009 (%)



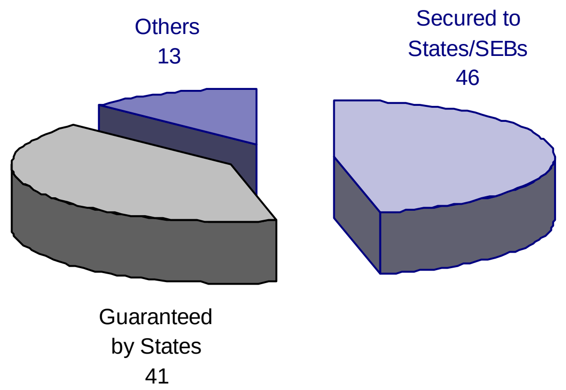
DISBURSEMENTS TILL MARCH 2009 (%)



SANCTIONS TILL MARCH 2009 (%)



LOAN BREAK UP AS OF MARCH 2009 (%)



Source: Company/MOSL

FY09-12E PAT CAGR of 23%, RoA of 2.5%+, RoE of 23%+

REC's FY09-12 loan book CAGR of 27% coupled with slightly moderated spreads translates into a healthy PAT CAGR of 23%. Return ratios also remain robust - RoA of 2.5%+ and RoE of 23%+ over FY09-12.

Capital raising will enhance lending capacity

Like most financing companies, REC's current exposure norms are linked to its net worth. To effectively tap the huge opportunity through FY12, and enable itself to take larger exposures to single projects, group SEBs and private companies, REC plans to increase its capitalization. Assuming a 15% dilution (128.8m shares) at Rs180/share (10% discount to the CMP), REC's BV would increase to Rs108 by FY10 (v/s Rs97) and Rs124 by FY11 (v/s Rs113).

REC's exposure limits linked to net worth

Like any financier, REC's single and group borrower exposure limit is linked to its net worth. Exposure limits specify that REC can lend 100% of its net worth to a single SEB in which three separate companies have not been formed, 250% of its net worth for the group of companies under one state, 25% of net worth to a single private company and 55% of net worth for a group private company.

REC planning to increase capitalization

To support its asset growth and enable itself to take larger exposures to single projects, group SEBs and private companies, REC plans to increase its capitalization. REC's capital raising plan is awaiting government approval and the management is confident of raising funds in FY10. We present below the impact of various dilution levels at various prices on REC's EPS, BV and RoE for FY10 and FY11.

SENSITIVITY ANALYSIS

	Issue Price (Rs)			DILUTION		
			NO DILUTION	10%	15%	20%
		No. of new shares (m)	**-**	**85.9**	**128.8**	**171.7**
FY10	**160**	Amount Raised (Rs b)	-	13.7	20.6	27.5
		EPS (Rs)	20.8	18.9	18.1	17.4
		BV (Rs)	96.7	102.5	105.0	107.3
		RoE (%)	23.1	21.2	20.4	19.6
	180	Amount Raised (Rs b)	-	15.5	23.2	30.9
		EPS (Rs)	20.8	18.9	18.1	17.4
		BV (Rs)	96.7	104.3	107.6	110.6
		RoE (%)	23.1	21.0	20.1	19.3
	200	Amount Raised (Rs b)	-	17.2	25.8	34.3
		EPS (Rs)	20.8	18.9	18.1	17.4
		BV (Rs)	96.7	106.1	110.2	114.0
		RoE (%)	23.1	20.8	19.8	18.9
FY11	**160**	EPS (Rs)	25.8	24.7	24.2	23.8
		BV (Rs)	113.1	118.7	121.1	123.3
		RoE (%)	24.5	22.3	21.4	20.7
	180	EPS (Rs)	25.8	24.9	24.5	24.1
		BV (Rs)	113.1	120.7	123.9	126.9
		RoE (%)	24.5	22.1	21.1	20.3
	200	EPS (Rs)	25.8	25.0	24.7	24.4
		BV (Rs)	113.1	122.6	126.8	130.6
		RoE (%)	24.5	21.9	20.9	20.0

Source: MOSL

Initiate coverage with a Buy

REC is a long-term play on India's power-sector growth. We believe the stock offers earnings growth visibility (23% PAT CAGR through FY12E) and is reasonably valued (FY11E P/BV of 1.8x against a healthy RoE of 24%+). Our target price for REC is Rs250 (2.2x FY11E BV). We initiate coverage with a **Buy**.

COMPARATIVE VALUATION

		REC	PFC	IDFC
P/RBV (x)	FY10E	2.4	2.2	2.5
	FY11E	2.0	2.0	2.3
P/ABV (x)	FY10E	2.1	2.0	2.5
	FY11E	1.8	1.8	2.3
RoE (%)	FY10E	23.1	15.8	14.3
	FY11E	24.5	16.8	14.9
RoA (%)	FY10E	2.8	2.6	2.9
	FY11E	2.7	2.6	3.0

For REC and PFC, RBV means BV excluding DTL and ABV means BV including DTL *Source: MOSL*

Deferred tax liability a part of net worth

REC is eligible for partial tax exemption on profits under section 36(1)(viii) of the Income Tax Act. If REC transfers 20% of its profits earned from long-term infrastructure lending to a special reserve (from which dividend cannot be distributed), then the amount transferred is tax exempt. Thus REC's current tax rate is ~25%. It makes additional provisions for deferred-tax liability with a view that this is a temporary-tax difference. Thus REC's effective tax rate is 33%.We understand PFC has received approval from the ICAI to do away with this deferred tax provisioning policy. Accordingly PFC changed its accounting stance and the accumulated DTL is part of its net worth. REC will follow the same accounting practice in subsequent quarters. REC's accumulated DTL is Rs9.6b or 14% of its net worth. We include this DTL as part of net worth and we provide tax at the rate of only 26% in earnings estimates.

Risks and concerns

Delays in power project execution (Annexure 1)

India's track record of executing power projects has been dismal till the Tenth Five-Year Plan. If this persists going forward, REC's loan sanctions will not translate into disbursements, adversely impacting growth in loan book and earnings.

Mitigant: The execution in Eleventh Plan seems to be much better than earlier with a large chunk of critical equipment orders placed in Year 1 itself. Also, capacity added in Year 1 is 50% of the total capacity added in Tenth Plan.

Poor track record of state utilities (Annexure 2)

A high proportion of REC's loan book is exposed to state utilities (especially in the T&D segment), which have a poor financial track record.

Mitigant: The ongoing reforms (see Annexure) are improving the health of state utilities. In any case, REC's dues are covered by an escrow mechanism. So far, its recovery rate is 98%. Further, REC expects share of private sector to increase from 4% currently to 15-20% by FY12.

ALM mismatch

On the assets side, REC typically funds power companies with duration of 10 years or more, whereas its liabilities have duration of much lower than 10 years. Banks do not provide loans over 10 years duration due to ALM mismatch. Capital-gains bonds have duration of 3-5 years and other bonds have duration of 7-10 years. Thus, REC is always exposed to ALM mismatches.

Annexure 1: India's power project execution expected to improve

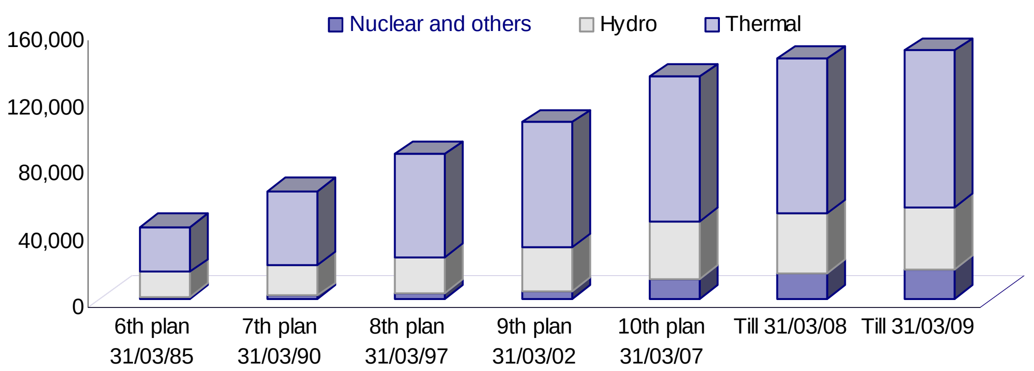
Project execution critical to translate sanctions into disbursements

In power financing, the conversion of sanctions into disbursals and loan book is directly linked to the execution of power projects. Significant disbursals (60-70% of the cost) take place during the second and third years of a power-generation project, which implies that current sanctions should convert into disbursals in FY10, FY11 and FY12. The transmission and distribution projects' execution will accelerate when new capacity addition programs near their end. T&D projects require six to 18 months for execution.

India's project execution track record is dismal

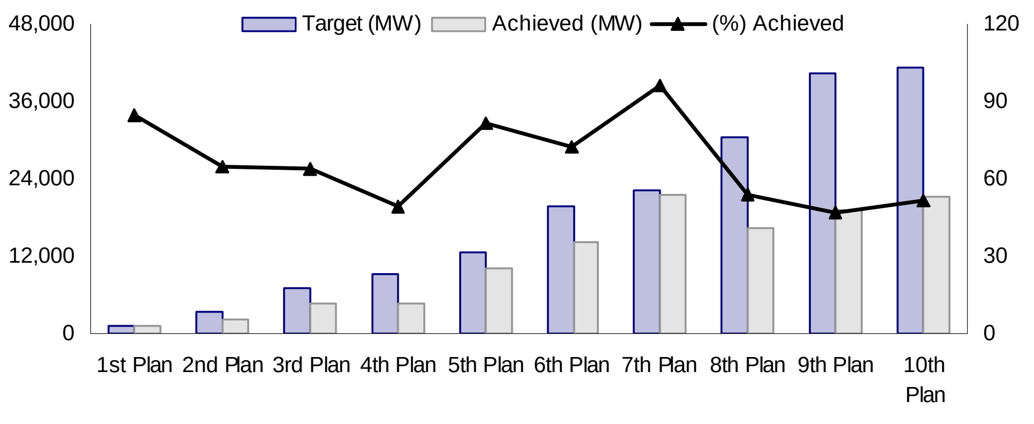
India's track record of executing power projects has been dismal so far. Installed capacity has grown at just 5-6% over the past several five-year plans. Capacity addition in the Ninth and Tenth Five Year Plans has been less than 50% of the target. Getting requisite clearances, fuel linkages and procuring critical equipment have been major hurdles to execution.

INSTALLED CAPACITY (MW)



CAPACITY ADDITION - ACHIEVEMENT LAGGING TARGETS BY HUGE MARGINS

Capacity addition in the Ninth and Tenth Five Year Plans has been less than 50% of the target



Source: Company/MOSL

Project execution expected to improve in Eleventh Plan

Orders for critical equipment for more than 65GW were placed in the first year itself

Planning and monitoring in the Eleventh Plan has been better than earlier plans. During the Tenth Plan, the placing of critical equipment orders dragged on well into the middle of the Plan period, leaving less than 36 months for project execution. The gestation period for thermal and hydro projects is four or more years and so the actual capacity additions failed to achieve targets.

In the Eleventh Plan, orders for critical equipment for more than 65GW were placed in the first year itself, leaving in hand 3-4 years of execution time. During FY08, the first year of the Eleventh Plan, 10.7GW of capacity was added, which is over 50% of the capacity added during the Tenth Plan (FY02-07). We do not expect 100% target achievement in the Eleventh Plan, given the poor execution track record of state and central government power utilities. But we believe capacity addition will be significantly higher than the past.

ELEVENTH PLAN EXECUTION STATUS AS OF MARCH 2009

	STATE	CENTRAL	PRIVATE	TOTAL
Project Commisioned	7,094	3,990	1,933	**13,017**
Projects Under Construction	18,296	29,540	19,184	**67,020**
Total	**25,390**	**33,530**	**21,117**	**80,037**
Plan Target	**26,783**	**36,874**	**15,043**	**78,700**

Source: Ministry of power, projects under construction as on 26th March 2009

Annexure 2: Reforms of State Electricity Boards

State Electricity Boards (i.e. state utilities) account for ~85% of REC's loan book. Hence, their state of affairs is critical in deciding REC's fortunes. We assess the same in this section.

State utilities will remain key players going forward

The state sector utilities will have 44% share of power generation in FY12

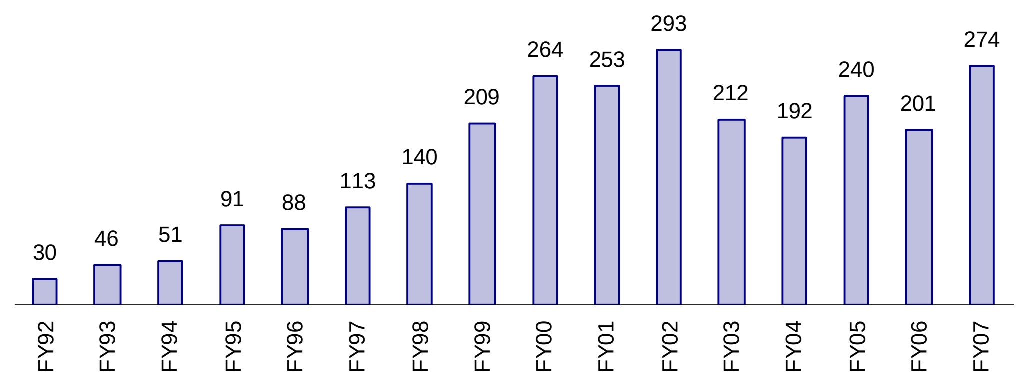
More than 50% of the installed generation capacity is under the state sector. Over 30% of the planned capacity addition in the Eleventh Plan will come from this sector. The state sector will continue to be a dominant player in India's power generation with ~44% share in FY12. All state sector entities are REC's clients with more than 80% of REC's loan book coming from state sector utilities. Out of the projected funds deployment of Rs10.3t in the Eleventh Plan, Rs5.14t is expected to be in the state sector.

Not in the pink of health … but improving

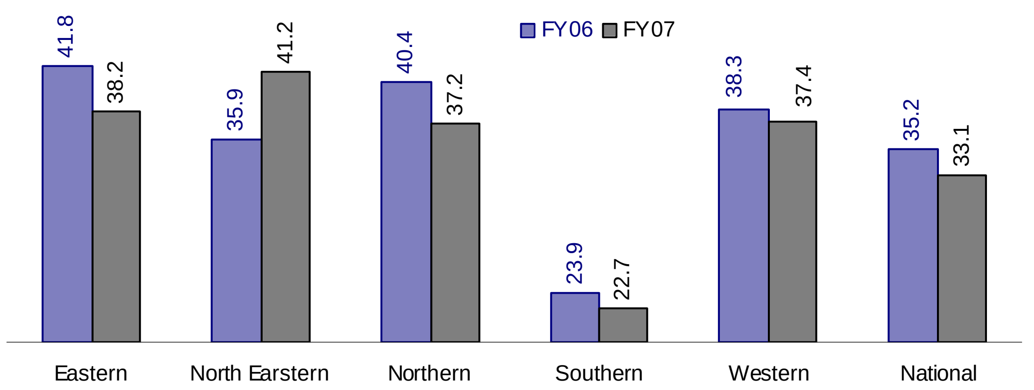
The root cause of state sector utilities is poor distribution

State Electricity Boards (SEBs) made alarming losses of Rs260b in FY00 (1.5% of GDP). Most state utilities are inefficient and incur T&D losses. Power theft, poor billing records and lower recoveries contribute to their losses. All-India AT&C (aggregate technical and commercial) losses were high at 33% in FY07. Cash losses of all utilities were ~Rs74b in FY07 and aggregate losses without accounting for subsidies were Rs274b. The root cause of the problem is poor distribution.

AGGREGATE LOSSES OF STATE UTILITIES WITHOUT SUBSIDIES (RS B)



AT&C LOSSES (%) FALL EXCEPT IN THE NORTH-EAST



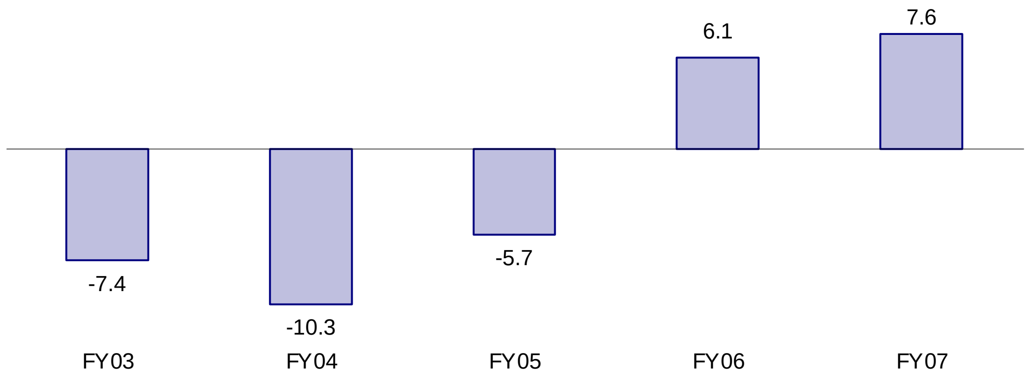
Source: ARPDP website

APDRP has been fairly successful

The grant under APDRP is incentivizing performance improvement of state utilities

The Accelerated Power Development and Reform Programme (APDRP) began from FY01 as a means to restore the commercial viability of the distribution sector. Under the program, an incentive equivalent to 50% of the actual cash loss reduction by SEBs/utilities is provided as grant. States like Andhra Pradesh (AP), Gujarat, West Bengal (WB) and Karnataka received incentives under APDRP-indicating their improving performance.

GENERATION, TRANSMISSION AND TRADING UTILITIES REPORTED PROFITS (RSB) IN FY06-07



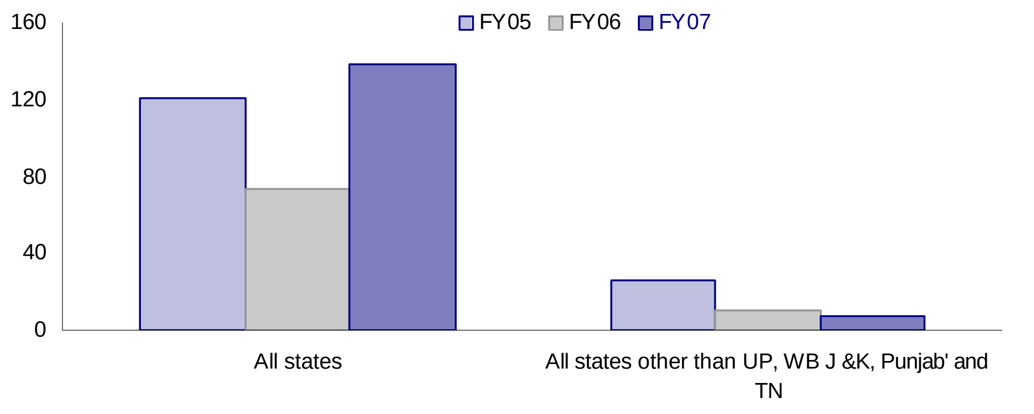
Source: Company/MOSL

KSEB, CSEB, Goa PD, Puducherry PD, Tripura PD, JSEB and all the discoms of Delhi, AP, Karnataka and Gujarat posted profit in FY07 while Bihar SEB, WBSEB, Punjab SEB, TNEB, J&KPDD and discoms in Uttar Pradesh, Madhya Pradesh, Maharashtra, Haryana & Uttarakhand posted losses in FY07.

Structural changes like the formation of SERC (State Electricity Regulatory Commission), increased accountability with a performance rating for every state, helping to cut book losses, increase cash collections and reduce AT&C losses. Power bodies in states such as Gujarat, AP, Delhi, Goa, and Karnataka improved operating performance.

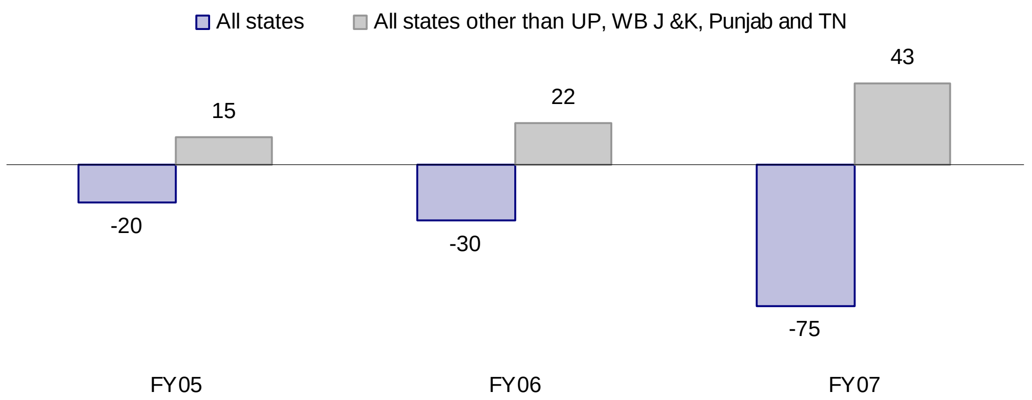
All except 5 state utilities have significantly improved performance

NET LOSSES ON ACCRUAL BASIS (RS B)



Source: Company/MOSL

... CASH LOSSES (RS B)



Source: Company/MOSL

STATUS OF THE REFORMS AT THE STATE LEVEL

	MOU	MOA	TRIPATRITE AGMT.	SEB UNBUNDLING	SERC CONSTITUTION	DISTBN. PRIVATIZATION
North						
Delhi	Y	Y	Y	Y	Y	Y
Haryana	Y	Y	Y	Y	Y	N
HP	Y	Y	Y	Y	Y	N
Jammu & Kashmir	Y	Y	Y	N	Y	N
Punjab	Y	Y	Y	N	Y	N
Rajasthan	Y	Y	Y	Y	Y	N
UP	Y	Y	Y	Y	Y	Agra & Kanpur Franchised
West						
Uttaranachal	Y	Y	Y	Y	Y	N
Chhattisgarh	Y	Y	Y	Y	N	N
Gujarat	Y	Y	Y	Y	Y	N
Goa	Y	Y	Y	N	Y	N
MP	Y	Y	Y	Y	Y	N
Maharashtra	Y	Y	Y	Y	Y	Bhiwandi Franchised
South						
Andhra Pradesh	Y	Y	Y	Y	Y	N
Karnataka	Y	Y	Y	Y	Y	N
Kerala	Y	Y	Y	N	Y	N
TN	Y	Y	Y	Y	Y	N
East						
Bihar	Y	Y	Y*	Y	Y	N
Jharkhand	Y	Y	Y	Y	Y	N
Orissa	Y	Y	Y	Y	Y	Y
West Bengal	Y	Y	Y	Y	Y	N
North-East						
Assam	Y	Y	Y	Y	Y	N
Meghalaya	Y	Y	Y	Y	Y	N
Arunachal Pradesh	Y	Y	Y	N	Y	N
Mizoram	Y	Y	Y	N	#JERC Notified	N
Manipur	Y	Y	Y	N	#JERC Notified	N
Nagaland	Y	Y	Y	N	N	N
Tripura	Y	Y	Y	Y	Y	N
Sikkim	Y	Y	Y	Y	Y	N
Total	**29**	**29**	**29**	**21**	**25**	**2**

** Steps have been initiated towards corporatisation/unbundling;*
 # Joint Electricity Regulatory Commission

Source: CEA

Reforms at the SEB level have been very encouraging

21 out of the 29 states have unbundled / in the process of unbundling SEBs into separate companies for Generation, Tranmission and Distribution

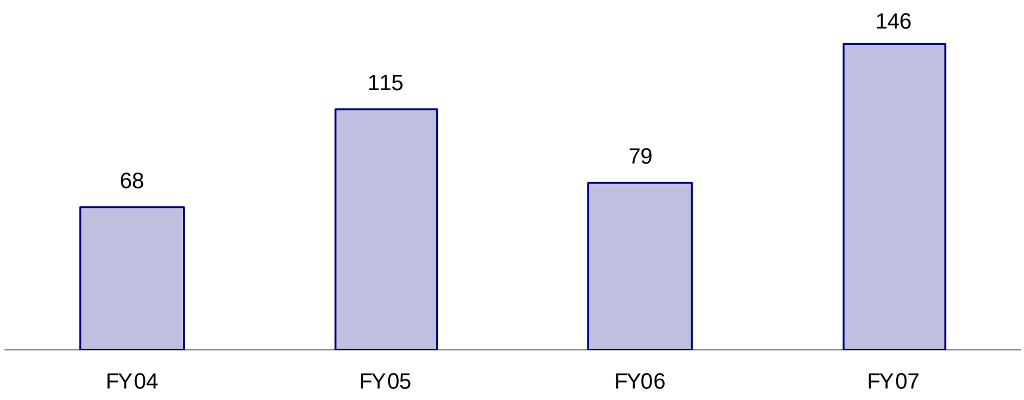
The SEBs has been reorganized into three separate divisions, generation, transmission and distribution, to make each operation accountable and efficient.

Till June 2009, 21 out of the 29 states have unbundled / in the process of unbundling SEBs into separate companies for Generation, Tranmission and Distribution since the beginning of the scheme in 1999. This is the pre-requisite for possible privatization of distribution and transmission, a key catalyst for the investment in T&D sector in the country over the next 4-5 years. The performance of the privatization has been quite satisfactory particularly with respect to improvement in AT&C losses, investment in strengthening of distribution system and revenues to state government.

Commercial losses remain high

The commercial losses are at distribution level for most states as billing and recovery systems are inefficient. State governments infuse cash to make good the losses. But state governments do not usually provide security to financiers or guarantee loans availed by state power companies. However, 40% of REC's existing loans are guaranteed by state government and another 45%+ are fully secured which give us comfort on asset quality.

AGGREGATE BOOK LOSSES OF UTILITIES SELLING DIRECTLY TO CONSUMERS (RS B)



Source: Company/MOSL

Escrow mechanism ensures REC's recoveries

Escrow mechanism ensures 98%+ recovery for REC

Most of the loans to SEBs are backed by default escrow accounts as a credit enhancement mechanism. Under this mechanism, certain predetermined amounts from the payments received by SEBs from their respective customers are deposited in an escrow account pursuant to a tripartite escrow agreement between REC, the SEBs and an escrow agent (the bank). The deposited amount is available to the SEBs except in case of a default due to non-payment of dues. In such cases, the escrow agent makes the default amount available to PFC/REC on demand. Thus, while balance sheets of SEBs are in bad shape, REC and PFC lend based on the security of the cash flows from the operations of the utilities. **PFC and REC have enjoyed over 98% recovery from SEBs during past four to five years.**

INCOME STATEMENT						(RS MILLION)
Y/E MARCH	2007	2008	2009	2010E	2011E	2012E
Interest on Loans	25,512	33,605	46,649	61,932	80,152	102,156
Interest Exp and Other Charges	17,427	20,637	28,873	38,882	51,502	67,409
Net Financing Income	**8,085**	**12,969**	**17,776**	**23,051**	**28,651**	**34,747**
Change (%)	*35.8*	*60.4*	*37.1*	*29.7*	*24.3*	*21.3*
Other Operating Income	1,005	177	922	975	1,030	1,100
Other Income	2,023	1,594	1,741	1,450	1,575	1,600
Net Income	**11,113**	**14,740**	**20,439**	**25,476**	**31,256**	**37,447**
Change (%)	*22.7*	*32.6*	*38.7*	*24.6*	*22.7*	*19.8*
Employee Cost	498	923	872	916	962	1,010
Administrative Exp	144	182	224	235	247	259
Other Operating Exp.	232	105	112	115	115	115
Operating Income	**10,239**	**13,530**	**19,231**	**24,210**	**29,932**	**36,063**
Change (%)	*23.3*	*32.1*	*42.1*	*25.9*	*23.6*	*20.5*
Total Provisions	210	400	34	50	50	50
% to Operating Income	*2.1*	*3.0*	*0.2*	*0.2*	*0.2*	*0.1*
PBT	**10,029**	**13,130**	**19,197**	**24,160**	**29,882**	**36,013**
Prior Period Adjustments	33	-6	4	0	0	0
PBT (post prior period adj)	**10,062**	**13,124**	**19,201**	**24,160**	**29,882**	**36,013**
Tax (Incl Deferred tax)	3,459	4,523	6,480	6,282	7,769	9,363
Tax Rate (%)	*34.5*	*34.4*	*33.8*	*26.0*	*26.0*	*26.0*
PAT	**6,603**	**8,601**	**12,721**	**17,878**	**22,113**	**26,650**
Change (%)	*3.6*	*30.3*	*47.9*	*40.5*	*23.7*	*20.5*
PAT (Incl DTL)	**7,766**	**9,376**	**14,117**	**17,878**	**22,113**	**26,650**
Change (%)	*24.5*	*20.7*	*50.6*	*26.6*	*23.7*	*20.5*
Proposed Dividend	1,770	2,576	3,864	5,367	6,869	8,587

BALANCE SHEET						(RS MILLION)
Y/E MARCH	2007	2008	2009	2010E	2011E	2012E
Capital	7,806	8,587	8,587	8,587	8,587	8,587
Reserves & Surplus	32,321	45,090	53,314	64,913	78,989	95,592
Net Worth	**40,127**	**53,677**	**61,901**	**73,500**	**87,576**	**104,179**
Deferred Tax Liability	7,397	8,171	9,567	9,567	9,567	9,567
Net Worth (incl DTL)	**47,524**	**61,848**	**71,468**	**83,067**	**97,142**	**113,746**
Borrowings	302,810	342,828	449,360	575,489	738,121	935,376
Change (%)	*26.0*	*13.2*	*31.1*	*28.1*	*28.3*	*26.7*
Current Liabilities and Prov	11,700	24,468	38,737	50,358	65,466	85,105
Total Liabilities	**362,034**	**429,144**	**559,564**	**708,913**	**900,729**	**1,134,227**
Cash and Bank Balance	22,973	12,530	18,860	17,971	24,700	29,477
Investments	11,945	11,474	10,049	11,053	12,159	13,375
Change (%)	*-9.8*	*-3.9*	*-12.4*	*10.0*	*10.0*	*10.0*
Loans	320,991	393,165	513,814	661,481	843,567	1,069,001
Change (%)	*26.7*	*22.5*	*30.7*	*28.7*	*27.5*	*26.7*
Net Fixed Assets	**636**	**779**	**809**	**776**	**911**	**1,046**
Other Assets	5,488	11,195	16,032	17,632	19,392	21,328
Total Assets	**362,034**	**429,144**	**559,564**	**708,913**	**900,729**	**1,134,227**

ASSUMPTIONS						(%)
Disbursements Growth	43.3	20.7	32.5	25.0	25.0	25.0
Borrowings Growth	26.0	13.2	31.1	28.1	28.3	26.7
Loans Growth	26.7	22.5	30.7	28.7	27.5	26.7
Investments Growth	-9.8	-3.9	-12.4	10.0	10.0	10.0
Dividend	2.3	3.0	4.5	6.3	8.0	10.0

E: MOSL Estimates

RATIOS

Y/E MARCH	2007	2008	2009	2010E	2011E	2012E
Spreads Analysis (%)						
Avg. Yield - on Financing Portfolio	8.7	9.3	10.1	10.3	10.5	10.5
Avg Cost of Funds	6.3	6.4	7.3	7.6	7.8	8.0
Interest Spread	2.4	2.9	2.8	2.8	2.6	2.5
Net Interest Margin	2.8	3.6	3.9	3.9	3.8	3.6
Profitability Ratios (%)						
RoE	17.4	17.1	21.2	23.1	24.5	25.3
RoA	2.3	2.4	2.9	2.8	2.7	2.6
Efficiency Ratios (%)						
Int. Expended/Int.Earned	68.3	61.4	61.9	62.8	64.3	66.0
Other operating Inc./Net Income	9.0	1.2	4.5	3.8	3.3	2.9
Other Income/Net Income	18.2	10.8	8.5	5.7	5.0	4.3
Op. Exps./Net Income	7.9	8.2	5.9	5.0	4.2	3.7
Empl. Cost/Op. Exps.	57.0	76.3	72.2	72.3	72.7	73.0
Asset-Liability Profile (%)						
Loans/Borrowings Ratio	106.0	114.7	114.3	114.9	114.3	114.3
Debt/(Equity+DTL) Ratio	6.4	5.5	6.3	6.9	7.6	8.2
Debt/Equity Ratio	7.5	6.4	7.3	7.8	8.4	9.0

VALUATIONS

BV excluding DTL (Rs)	51.4	62.5	72.1	85.6	102.0	121.3
Price-BV (x)	4.0	3.3	2.8	2.4	2.0	1.7
BV including DTL (Rs)	60.9	72.0	83.2	96.7	113.1	132.5
Price-ABV (x)	3.4	2.8	2.5	2.1	1.8	1.5
EPS (Rs)	8.5	10.0	14.8	20.8	25.8	31.0
EPS Growth (%)	3.6	18.4	47.9	40.5	23.7	20.5
Price-Earnings (x)	24.1	20.4	13.8	9.8	7.9	6.6
EPS Excl DTL (Rs)	9.9	10.9	16.4	20.8	25.8	31.0
EPS Excl DTL Growth (%)	24.5	9.8	50.6	26.6	23.7	20.5
Price-Adj EPS (x)	20.5	18.7	12.4	9.8	7.9	6.6

E: MOSL Estimates

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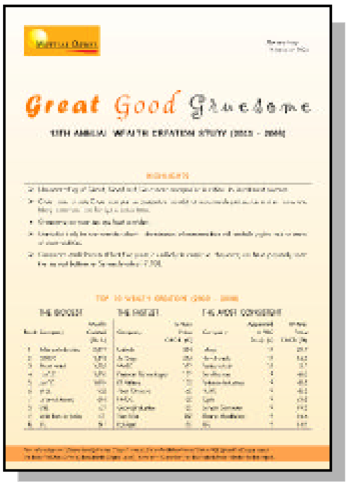
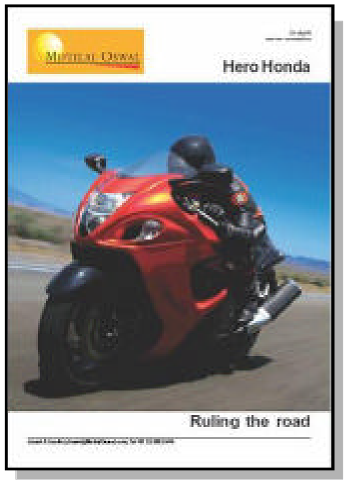
N O T E S





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Disclosure of Interest Statement	Rural Electrification Corporation
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