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Rural Electrification Corpn

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Issue Open: 19 February 2008

Issue Close: 22 February 2008

Issue Details

Pre-Issue Equity Share Capital:
Rs4,408cr (FV of Rs10)

Issue size: *Rs1,405cr - **Rs1,639cr
(Including Offer for Sale, comprising 50% of total issue)

Post issue Equity Share Capital:
Rs5,111cr – Rs5,228cr (FV of Rs10)

** at lower end of price band*
*** at upper end of price band*

Offer Price Band:
Rs90-105

Book Building (excluding Reserved for Employees Portion)	
MF/QIBs	At least 60%
Retail	Up to 30%
Non-Institutional	Up to 10%

Shareholding Pattern (%)

	Pre-Issue	Post-Issue
Promoters / Promoter Group	100	81.82
MF/Banks/Indian FIs/FIIs/Public & Others	-	18.18
Total	**100.0**	**100.0**

Rationale for our Subscribe View

Substantial funds requirement for Indian Power sector: Rural Electrification Corporation (REC) is a leading public financial institution exclusively focused on extending finance to the Indian Power Sector, which, going by the government's stated intentions, is slated for tremendous growth during the Eleventh Five-year Plan (2007-2012). It is estimated that Rs10.3 lakh crore of capital would be required to set up the power infrastructure targeted to be added by 2012. Within the available funding sources, the government envisages REC's share at Rs59,150cr at least. Accordingly, we expect REC to deliver a CAGR growth of 25% in Advances over FY2008-10E. Importantly, REC's mandate has evolved over the years and it now finances all segments of the Power sector throughout the country. REC's changing sanction mix corroborates this viz., the private sector borrowers and generation projects comprise an increasing share of sanctions, in line with the present dynamics of the Power sector.

Clear-cut, Profitable business model: REC's primary source of revenue is Interest Income from Power sector lending. Low-cost '54EC Bonds' comprise 45% of its borrowings. REC is expected to deliver NIMs of 3.2-3.4% over FY2008-10E. Given its lean organisational structure, inherently low credit risk and Tax benefit u/s 36(1)(viii), RoAs should sustain at 2% levels. REC's leverage cannot exceed 8-9x to maintain AAA credit rating (critical for cost competitiveness). Accordingly, it is expected to deliver RoE of around 16% by FY2010E, which should increase to around 18% at optimum leverage (post FY2010E).

Tax benefits and treatment of deferred tax liability (DTL): REC is eligible for tax benefit u/s 36(1) (viii) of IT Act, 1961 by creating a special reserve of upto 20% of profits. The company has created DTL in respect of this tax benefit – however, we believe the tax liability is unlikely to crystallize and consider it appropriate to treat the DTL so created (and to be created) as part of equity. Accordingly, we have increased book value by Rs9.5 (and have assumed the effective Tax rate for FY2008-10E to be 27% for the same reason).

Outlook and Valuation

In the past few months, the Power Sector (on which REC is an indirect play) has seen valuations reaching frothy levels, only to come off recently. Against this backdrop, we believe the REC Issue comes at a reasonable price based on fundamental value, considering the high visibility of credit demand in the Power Finance sector, REC's strong positioning in the same and its reasonably strong financial performance. At the upper end of the price band of Rs105, the stock is available at 1.3x FY2009E Adjusted Book Value of Rs80.7 and 1.2x FY2010E Adjusted Book Value of Rs90.5. The valuations compare favorably with its closest peer, PFC, which is trading at 1.8x FY2009E Adjusted Book Value of Rs104 and 1.6x FY2010E Adjusted Book Value of Rs117 at the CMP of Rs185. We believe REC can command upto 1.5x 1-year Forward Adjusted Book Value, implying reasonable upside even at the upper end of the price band. **Hence, we recommend subscribe to the issue.**

Exhibit 1: Comparative Valuation (FY2010 estimates)

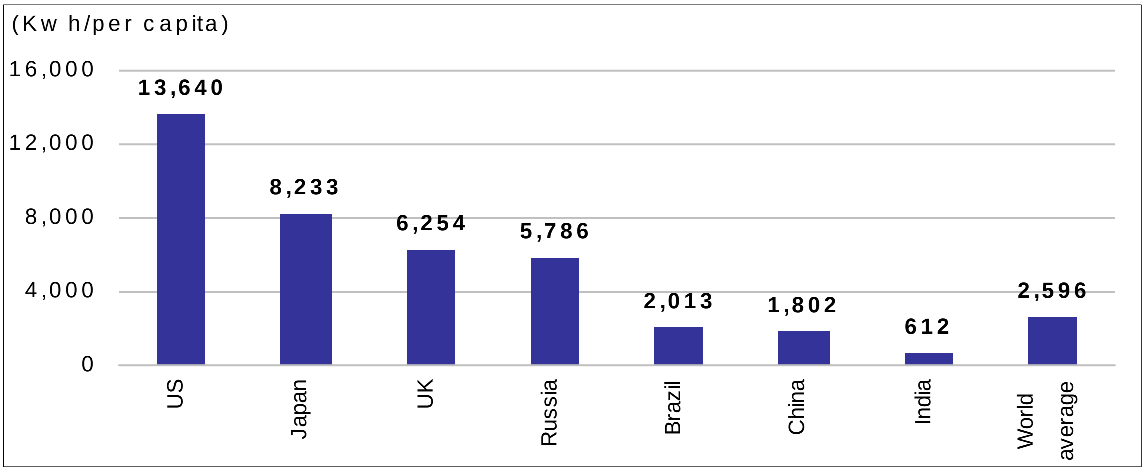
Company	CMP (Rs)	EPS (Rs)	BV (Rs)	RoA (%)	RoE (%)	P/E (x)	P/BV (x)
PFC	185	18	117	2.5	16.0	10.5	1.6
REC	105	14	90	2.0	16.2	7.6	1.2

Source: Angel Research

Substantial funds requirement for the Indian Power sector

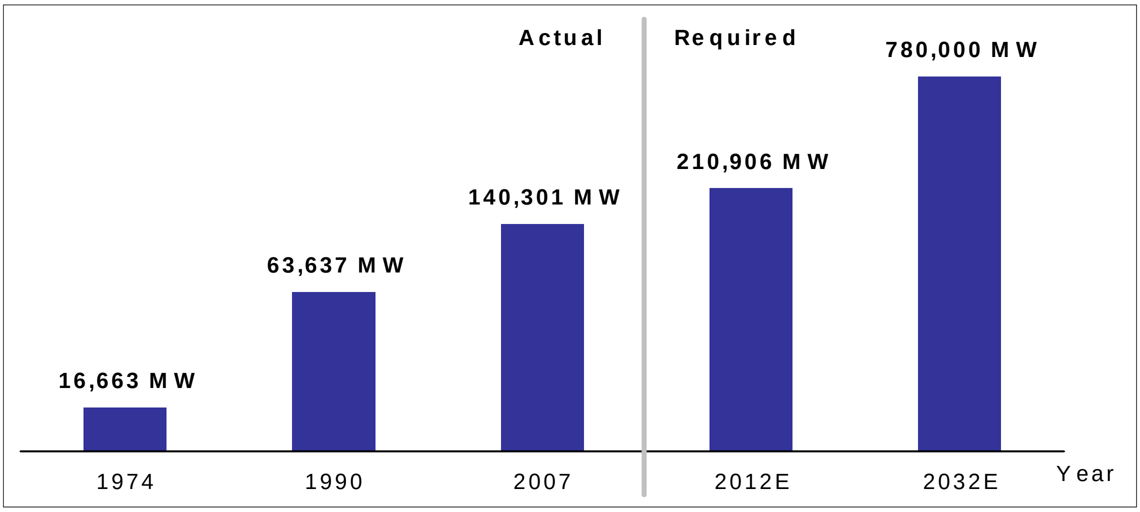
India is a chronically power deficit country, with very low per capita power consumption. The government in its stated mission 'Power for all by 2012' has targeted capacity addition of about 78,000 megawatts (MW) by 2012 (apart from 30,000-35,000MW from captive plants, windmills, etc.). In fact, according to studies done by the Planning Commission, India would need to increase capacity to around 780,000MW by 2032 to maintain 8% GDP growth.

Exhibit 2: Per capita consumption of Electricity



Source: IEA's Key World Energy Statistics 2007, RHP, Angel Research. Note: As per IEA, India's per capita consumption is even lower at 480kwh

Exhibit 3: Power Generation capacity in India



Source: CEA, Angel Research, Note: Values on Y-axis are plotted on a log-scale

As a thumb rule, each MW of capacity requires around Rs8cr of funds to create the necessary generation and transmission assets (Rupee appreciation should reduce this cost to an extent). According to the report of The Working Group on Power for Eleventh Plan (2007-12), estimated funds requirement for the Indian Power Sector during the Eleventh Plan is Rs10,31,600cr. It is envisaged that this will be met through a 70:30 combination of debt and equity. While the government has provided for Rs80,000cr as subsidy, out of the remaining Rs9,51,000cr, the total funding available is estimated at Rs5,00,000cr and the shortfall is still estimated at Rs4,51,000cr.

Within the available funding, REC's share is envisaged by the government at Rs59,150cr (in terms of disbursements) during FY2007-12. Considering the funding shortfall, the government is evaluating alternatives such as infrastructure bonds with Tax benefits, etc., and we believe it is likely that REC's actual role may exceed initial government estimates.

Exhibit 4: Power Sector Funds - Requirement and availability as per Eleventh Plan

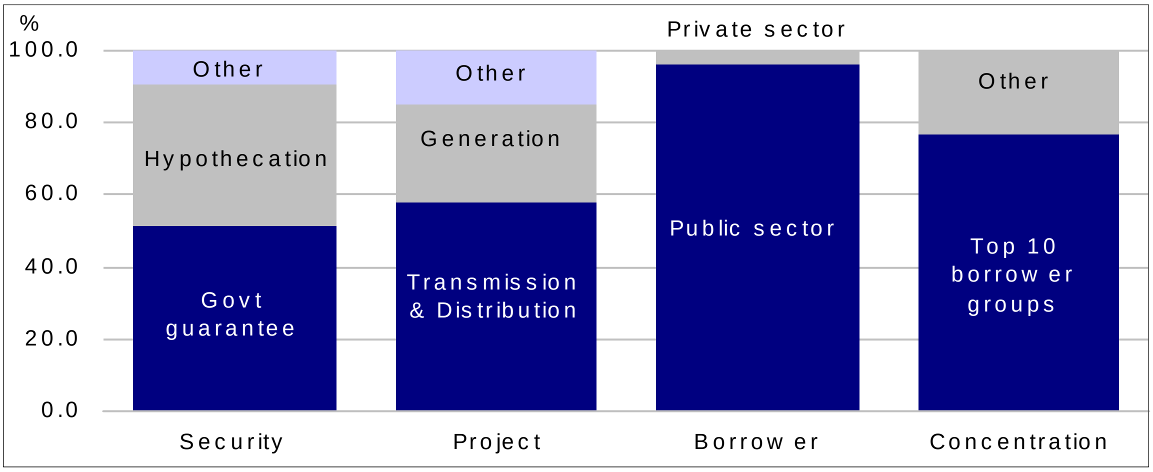
Funds Required	(Rs cr)	Envisaged sources of debt	(Rs cr)
Generation	6,02,271	Bonds	25,000
Transmission	1,40,000	Banks & FI	1,06,210
Distribution and Rural Electrification	2,89,329	PFC	81,200
	10,31,600	**REC**	**59,150**
Funding sources		IIFC	15,000
Equity	2,49,480	Other	27,600
Debt	7,02,120	ECB	57,500
Subsidy	80,000		**3,71,660**
	10,31,600		
Estimated availability			
Equity	1,28,333		
Debt	3,71,660		
Subsidy	80,000		
	5,79,993		
Funding Gap	**4,51,607**		

Source: Report of The Working Group on Power for Eleventh Plan (2007-12), Angel Research

Evolving mandate of REC

Historically, REC's main focus has been financing Electrification projects in the rural areas, primarily comprising transmission and distribution projects of State PSUs and SEBs [as opposed to PFC's focus on generation projects].

Exhibit 5: Profile of REC's Loan book

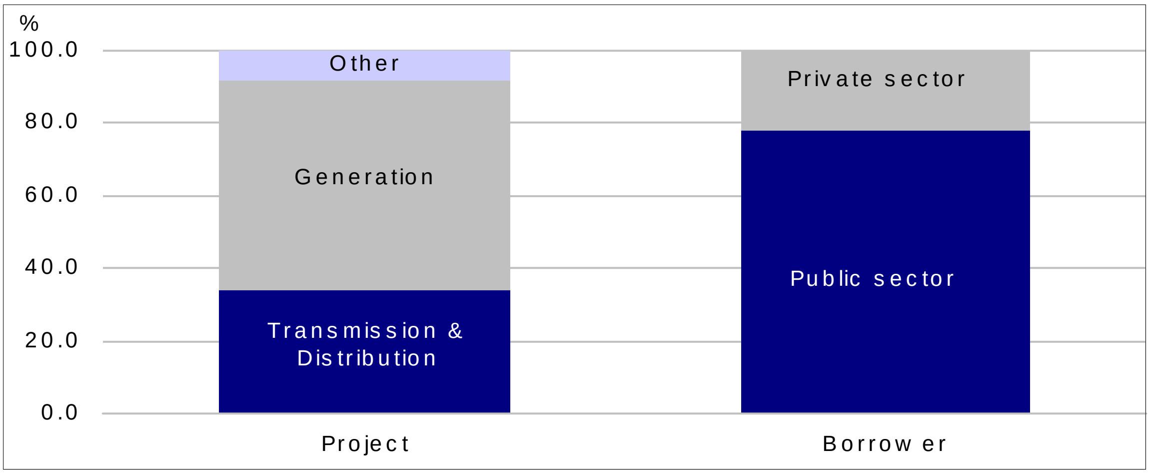


Source: RHP, Angel Research, Note: As on September 30, 2007

However, it is important to note that REC's mandate has evolved in accordance with the development priorities of the government and permits it to finance ***all*** segments of the Power Sector throughout the country. This indication by management is corroborated by the changing profile of its sanctions – private sector borrowers and generation projects comprise larger share of sanctions in line with the present dynamics of the Power Sector.

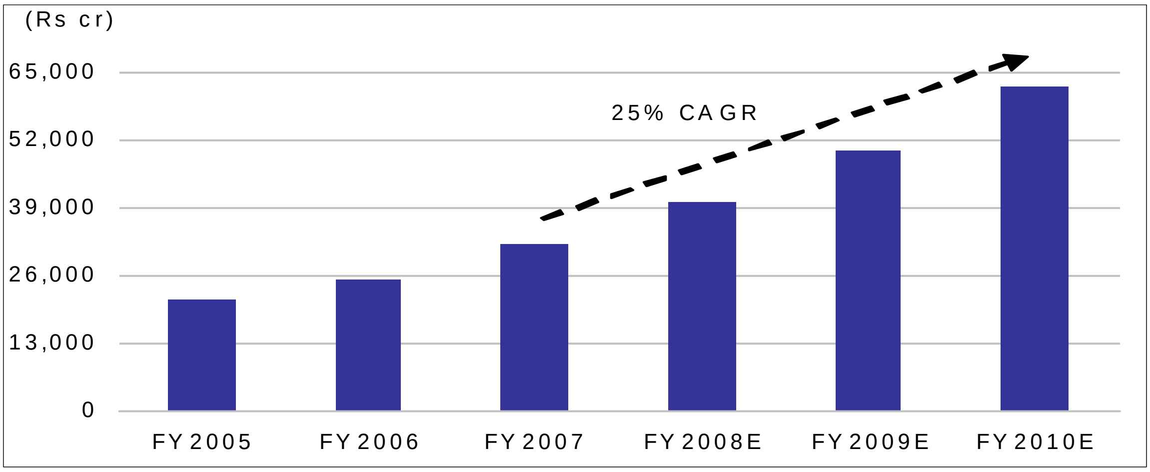
Thus, REC's addressable financing opportunity consists of the entire Rs7,02,120cr estimated to be required by the Power Sector by way of debt during FY2007-12. REC has the necessary appraisal abilities to address this market (although it is relatively new in the generation space). Consequently, we expect it to deliver around 25% CAGR in Advances during FY2008-10E.

Exhibit 6: Profile of REC's Sanctions



Source: RHP, Angel Research, Note: As on September 30, 2007

Exhibit 7: Loan growth



Source: RHP, Angel Research

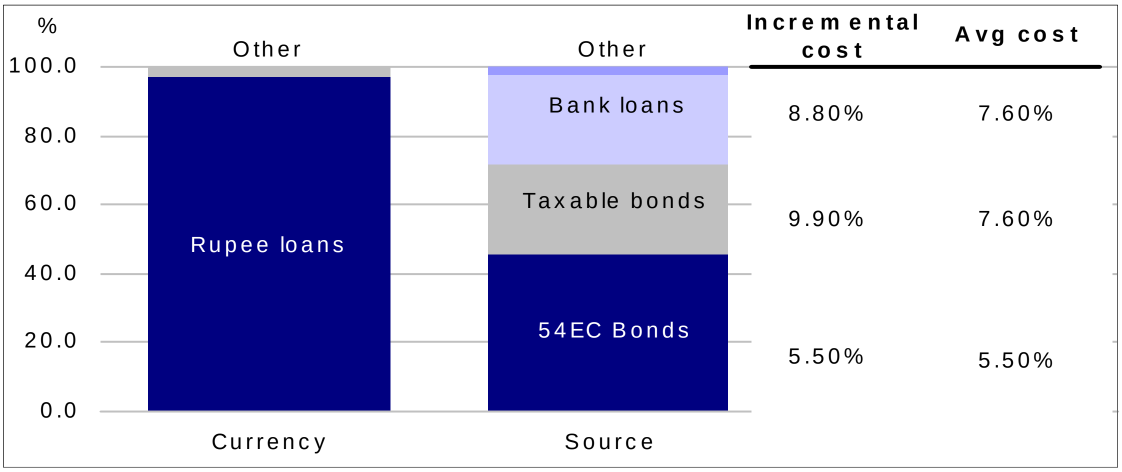
Clear-cut, Profitable business model

Sole activity - Power Sector Lending; Sustainable RoE of 18% over the long-term
REC's primary source of revenue is Interest Income from Power Sector lending. On an average, around 98% of its assets are expected to comprise term loans to the Power Sector (SLR/CRR requirements do not apply). Even after factoring some compression in spreads, REC is expected to deliver NIMs of around 3.2% by FY2010E. Fee income is negligible. Given its lean organisational structure, inherently low credit risk and Tax benefit u/s 36(1) (viii), RoAs should sustain at 2%. Generally, leverage for term-lending institutions cannot exceed 8-10x to maintain Credit Ratings and consequently, cost-competitiveness. Thus, REC should be able to deliver RoE of around 16% by FY2010E, which should increase to around 18% at optimum leverage. During FY2008-10E, we expect 15% CAGR in Net Profits.

Low cost of funds
Apart from NHAI, REC is the only other company that issues Capital Gains Tax Exemption Bonds u/s 54EC of the Income Tax Act. REC is able to price such bonds at a lower rate of interest than would otherwise be available to it. With the market for these bonds at Rs4,000-5,000cr per annum at present and an average duration of 3 years (due to put option), REC has built up a 54EC Bond book of Rs14,000cr that had an average (and incremental) cost of 5.5% as on September 30, 2007. REC management has indicated that in case 54EC is withdrawn (unlikely, we believe), the company will compensate by discontinuing the concessional lending it pursues where it is the lead arranger (75bp below market rates).

Highest Credit Rating
REC enjoys the highest domestic credit ratings and its international credit rating is on par with India's sovereign rating. Aided by a high credit rating, REC's market borrowings of Rs17,000cr by way of Taxable bonds and Term loans from banks had an average cost of around 7.5% as on September 30, 2007.

Exhibit 8: Profile of REC's Borrowings



Source: RHP, Angel Research, Note: As on September 30, 2007

Healthy Net Interest Margins
As a result of its funding mix, REC's overall cost of funds of around 6.5% is about 100bp lower than other term-lending institutions like PFC. NIMs would also be benefited for sometime on account of the capital being raised. We have conservatively factored in 20bp compression in spreads to 2.4% by FY2010E to account for decreasing proportion of low-cost borrowings such as 54EC bonds. At these spreads, REC would be able to deliver NIMs of 3.2% for FY2010E.

Low Credit risk
Around 96% of REC's loan book comprises loans to public sector entities. Around 91% of the loans are either secured or enjoy government guarantee. Most of the loans are also backed by default escrow account mechanism to provide further security. Most of the borrowers rely on the company regularly for funds. On account of these factors, NPAs are inherently low. Gross NPAs are 0.9% of total loans, of which 0.75% fall in the sub-standard category (recent NPAs) and a large portion of the same should be recovered once Budgetary support is released to the concerned SEBs. Even after making conservative estimates for slippages, we expect provisioning expenses on account of NPAs to remain low at about 0.2% of average assets during FY2008-10E.

Non-Interest Income – Additional upside
REC has been appointed as the nodal agency for 2 out of the 14 transmission projects proposed to be developed by private sector companies on BOOT basis. The model resembles PFC's nodal agency role for UMPP projects (for which it earns around Rs15cr per project). REC has floated 2 project-specific SPVs and we believe there is a high likelihood that it will be allocated more such projects out of the 10 that remain.

REC has also floated a subsidiary for the purpose of operating as well as providing consultancy services to private sector companies involved in power distribution projects, leveraging its specialised knowledge in this domain.

In the absence of clarity on these potential revenue streams, we have not factored the same, leaving room for upside to our estimates.

Certain non-recurring items in restated Financial Statement up to FY2007:

- Interest on restructuring contributed about 25bp to NIMs in FY2007. However, NIMs were lower by around 30bp on account of 5% of assets being deployed in low-yielding bank deposits, which have since been deployed into loans.
- Other income up to 1HFY2008 comprises write back of NPA provisions, which is not expected to recur going forward.

Exhibit 9: Dupont Analysis

	REC					PFC
	FY2006	FY2007	FY2008E	FY2009E	FY2010E	FY2008-10E Avg
Net Interest Income	3.3	3.4	3.3	3.3	3.1	3.5
Other Income	0.9	0.3	0.7	0.0	0.0	0.2
Operating Income	**4.1**	**3.7**	**4.0**	**3.3**	**3.1**	**3.7**
Staff Expenses	0.1	0.2	0.1	0.1	0.1	0.1
Other Opex	0.1	0.1	0.1	0.1	0.1	0.1
PPP	**3.9**	**3.4**	**3.7**	**3.0**	**2.9**	**3.5**
Provisions	0.0	0.1	0.2	0.2	0.2	0.1
Taxes	0.9	1.0	1.0	0.8	0.7	0.9
RoA	**3.0**	**2.4**	**2.6**	**2.1**	**2.0**	**2.5**
TA to NW	7.5	7.7	7.3	7.4	8.2	5.8
RoE	**22.3**	**18.1**	**18.9**	**15.4**	**16.2**	**14.8**

Source: RHP, Angel Research

Tax benefits and treatment of deferred tax liability (DTL)

REC claims a deduction of 5% of total income towards provision for bad debts u/s 36(1)(viia) of I.T. Act, 1961. Being a government company providing long-term finance to the Power Sector, it is also eligible for Tax benefits u/s 36(1)(viii) of the IT Act, 1961. By creating a special reserve (upto a maximum of twice its paid-up capital and general reserves), it is eligible for deduction upto 20% of profits.

On the auditor's recommendation, REC has created DTL in respect of the special reserve created u/s 36(1)(viii) though the Tax liability would crystallise only in the unlikely circumstance that REC has to withdraw amounts from this reserve for distribution to shareholders. Based on the going concern assumption, we consider it appropriate to treat the DTL so created (and to be created) as part of Equity.

Accordingly, we believe Rs740cr charged this far as DTL should be treated as effectively being part of Equity thereby increasing the Book Value by Rs9.5 (we have assumed future effective tax rates to be 27% for the same reason).

Concerns

Credit offtake falling short of estimates

In the past, the government has often fallen short of targeted capacity addition in its Five-year Plans. The Ninth Plan had targeted a capacity addition of 40,245MW, of which only 47.8% was actually added during the Plan. Similarly, in the Tenth Plan, only 51.5% of the targeted capacity addition of 41,110MW was actually achieved. The Eleventh Plan has an ambitious targeted capacity addition of 78,577MW, of which 13.7% (10,760MW) is expected to be in the Private sector. Various factors such as delays in environmental clearance, land acquisition, financial closure (on the Equity or Debt front) may result in shortfall in targeted capacity addition, as a result of which loan disbursements for REC may fall short of estimates.

Nonetheless, the environment is more enabling during the Eleventh Plan, driven by Power Sector reforms including enabling regulations such as the Electricity Act, which provide a framework for the private sector to expand viably and for the SEBs to be restructured and corporatised. Moreover, greater competition from banks or development of deeper bond markets could result in a deteriorating NIM-credit growth trade-off for REC. This may be exacerbated by improving financial profile of Power Sector entities, with greater share of capacity addition moving to the private sector.

Withdrawal of Tax benefits

Withdrawal of capital gains exemption u/s 54EC Income Tax Act will result in REC's cost of funds gradually increasing by around 100bp as the existing Bonds mature. However, REC does pass on part of the benefit to borrowers by charging concessional rate of interest, which we expect will be discontinued if the section is withdrawn. Withdrawal of tax exemption u/s 36 (1) (viii) of the Income Tax Act will result in REC's effective tax rate going up by 6-7%, potentially bringing down sustainable RoEs from about 18% to about 16.5%.

Increase in borrowing / credit (NPA) costs

Competitive pressures may force REC's spreads below projected levels. Due to the concentrated nature of its Asset Book, major systemic problems in the Power Sector may increase its NPA levels and drastically impact its profits.

Exhibit 11: Income Statement

Y/E. March (Rs cr)	FY2005	FY2006	FY2007	FY2008E	FY2009E	FY2010E
Interest Earned	2,291	2,228	2,838	3,537	4,309	5,305
Interest Expended	1,206	1,340	1,716	2,216	2,722	3,434
Net Interest Income	1,085	888	1,123	1,321	1,587	1,871
- *YoY Growth (%)*	-84.1	-18.1	26.4	17.6	20.2	17.9
Other Income	1,373	232	93	259	14	21
- *YoY Growth (%)*	-70.6	-83.1	-59.8	178.6	-94.7	50.0
Net Operating Income	**2,458**	**1,120**	**1,216**	**1,580**	**1,601**	**1,891**
- *YoY Growth (%)*	-78.6	-54.5	8.6	30.0	1.3	18.2
Operating Expenses	62	65	88	105	125	150
- *YoY Growth (%)*	-88.5	5.5	34.5	19.3	19.5	19.7
Pre - Provision Profit	**2,396**	**1,054**	**1,128**	**1,475**	**1,476**	**1,742**
- *YoY Growth (%)*	-78.1	-56.0	7.0	30.8	0.0	18.0
Provision and Contingencies	0	1	21	72	90	113
- *YoY Growth (%)*	#DIV/0!	54.5	4026.5	241.9	25.2	25.1
Profit Before Tax	**2,396**	**1,054**	**1,107**	**1,404**	**1,386**	**1,629**
- *YoY Growth (%)*	-78.1	-56.0	5.1	26.8	-1.3	17.6
Provision for Taxation	374	246	332	379	374	440
- *as a % of PBT*	15.6	23.3	30.0	27.0	27.0	27.0
PAT	**2,022**	**808**	**775**	**1,025**	**1,012**	**1,189**
- *YoY Growth (%)*	-76.5	-60.0	-4.1	32.2	-1.3	17.6

Source: RHP, Angel Research

Exhibit 12: Balance Sheet

Y/E. March (Rs cr)	FY2005	FY2006	FY2006	FY2008E	FY2009E	FY2010E
Share Capital	781	781	781	859	859	859
Reserve & Surplus	2,524	3,153	3,847	5,362	6,073	6,911
Borrowings	19,378	24,039	30,279	35,863	45,394	57,107
Other Liabilities & Provisions	1,588	1,744	1,172	1,124	1,395	1,916
Total Liabilities	**24,271**	**29,717**	**36,079**	**43,209**	**53,721**	**66,792**
Cash / Bank	485	1,914	2,297	648	806	1,002
Investments	1,417	1,325	1,195	1,231	1,262	1,236
Advances	21,249	25,111	31,974	39,968	49,960	62,450
- *Growth (%)*	2.3	1.8	2.7	2.5	2.5	2.5
Fixed Assets	26	64	64	65	81	100
Other Assets	1,093	1,303	549	1,296	1,612	2,004
Total Assets	**24,271**	**29,717**	**36,079**	**43,209**	**53,721**	**66,792**

Source: RHP, Angel Research

Exhibit 13: Ratio Analysis

Y/E March	FY2005	FY2006	FY2006	FY2008E	FY2009E	FY2010E
Per Share Data (Rs)						
EPS (Rs)	25.9	10.3	9.9	11.9	11.8	13.9
ABVPS (75% Coverage for NPAs)	42.3	50.4	59.3	72.5	80.7	90.5
Profitability Ratios (%)						
NIM	5.4	3.4	3.5	3.4	3.4	3.2
Return on Avg. Assets	9.6	3.0	2.4	2.6	2.1	2.0
Return on Avg. Equity	85.2	22.3	18.1	18.9	15.4	16.2
Valuation Ratio						
PER (x)	4.1	10.1	10.6	8.8	8.9	7.6
P/ABVPS (x)	2.5	2.1	1.8	1.4	1.3	1.2

Source: Angel Research

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