MOTILAL OSWAL

the PolicyMaker
Insights from bureaucrats

PMO directive on coal FSAs

Reading between the lines; understanding winners across sectors

- **We interacted with bureaucrats, corporates and industry experts on the recent directive by the Prime Minister's Office (PMO) assuring fuel security for power projects. The attempt is to put in place a co-ordinated approach which addresses the viability issues for large number of capacities under construction.**
- **Reading between the lines suggests: i) Only 35GW of the 70GW projects under construction based on coal linkages to be eligible for FSAs ii) FSA commitment for 68% of capacity utilization, entailing protection of debt servicing but equity returns unlikely iii) Coal India's production required to increase by atleast 110-120m tons over next 3 years (CAGR of 8%), and will translate into a substantial operating leverage iv) Penalty for non-performance is possibly not severe, as even the current max penalty rate of 40% on say 50m tons shortfall will be an impact of INR20b and thus unlikely to act as a large deterrent / protection.**
- **The obvious beneficiary is the financial sector, where the risk of NPA threat has been partly mitigated given that the committed fuel supply will ensure 68% capacity utilization. Thus, the project developers will start working for debt servicing, while equity returns continue to be a question-mark. For Coal India, the possible upside is from a volume growth, leading to operating leverage. Capital goods companies, particularly for power generation are likely to witness 'order intake holiday' and elongated execution periods.**

Key takeaways from the interactions

- **Only 60GW capacities to enter into FSAs:** Fuel Supply Agreements (FSAs) will be signed with 25GW of capacity (already commissioned during FY10-12), plus another 35GW (expected to be commissioned during FY13-15).
- **FSA commitment for only 68% capacity utilization:** FSA commitment will be for 80% of the requirement, at 85% capacity utilization. Hence, effective project capacity utilization stands at 68% based on the fuel commitment. Thus, direct imports by power generators will continue to be an important part of the fuel procurement.
- **How can the incremental coal requirement of 200-225m tons be met?** We calculate the incremental fuel commitment for 60GW of capacities to be commissioned during FY10-15 at ~200-225m tons (at 68% PLF). This can be met through i) Diverting large part of the incremental coal production to the power sector at notified rates; and thus ~110-120m tons can be possibly met through increased production by COAL, SCCL, etc. ii) increased production from captive mines allocated to states / CPSUs (~20m tons), iii) diversion of part coal from existing FSAs (~30m tons), and iv) balance 15-20m tons through imports.
- **E-auction volumes provide a balancing mechanism.** FY12 e-auction volumes are expected at 47m tons +; and as per the directive from the Coal Ministry, the e-auction target may be lowered in a progressive manner to 7% of production from 10% by the end of the Twelfth Plan in case COAL is not being able to meet the FSA commitments. Hence, e-auction acts as a balancing mechanism with a cap and floor; and provides a 'carrot and stick' structure.

Walking the Talk

Committee of Secretaries has identified five key areas for government intervention in power sector. The timeline for three of these areas is set:

- ☑ Coal India fuel supply agreement **[completed]**
- ☐ Gas linkage for 8GW capacities [EGOM meeting on 24 Feb]
- ☐ Indonesian coal pricing issues relating to Mundra and Krishnapatnam UMPPs (ultra mega power projects) [EGOM meeting on 1 Mar]
- ☐ Diversion of surplus coal from captive mines [Date to be decided]
- ☐ Forest clearance for allocated captive coal mines in dense forests [Date to be decided]

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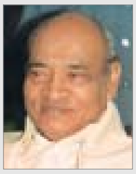
Also refer our full report released on 8 February 2012

India's PMO has a sound track record of getting things done

PM Narasimha Rao ('91-96)

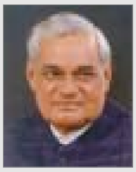
Involvement of PMO:



Involved in every important decision-making panel, including its economic policy agenda

PM AB Vajpayee ('96, '98-'04)

Involvement of PMO:



Steered several high impact schemes like national highways and telecom; including foreign affairs

PM Manmohan Singh (from '04)

Involvement of PMO:

Currently pushing for progress on various issues, including contentious economic matters involving several ministries (e.g. power sector logjam)

Backdrop: Enter the PMO - Emerging like a phoenix

Its initiatives to kick-start economic engine has many beneficiaries

- After a long period of hiatus during which the Government was widely criticized for policy inaction while opposition and coalition politics too were blamed for stalling key reforms, government seems to have tightened its belt to streamline the decision making process.
- The mechanism of Prime Minister's Office (PMO) as the key authority has entered the policy-making scene to signal progress in several economic initiatives, including dealing with contentious economic matters involving several ministries.
- We believe that the PMO assuming a central role assumes great significance in the current stalemate, but execution still remains the key challenge.
- Key potential beneficiaries of PMO intervention
  Power Generators | Coal Miners | Financials | Capital Goods | Infrastructure
  (Also refer our full report released on 8 February 2012)

PMO directive on Coal FSAs

Our views: Sectoral implications

Private power developers: FSAs protect bankers, but meaningful equity returns unlikely

- We understand that of the 60GW of capacity (commissioned post FY09) being assured fuel linkages, private sector projects will account for just ~20-25GW. This compares with possible capacity under construction of ~45GW based on coal linkages (from private sector). Thus, several projects will not be a part of the list, and hence an understanding on the same is important to estimate the possible gains for developers. We believe that the gainers are companies like Indiabulls Power, Lanco, GMR, Adani Power, Jaiprakash, etc.
- Importantly, the FSA commitment for 80% at 85% utilization effectively translates into a PLF of 68%. Recovery of capacity charges are linked to ~80-85% plant availability under most of the PPAs. Thus, while 68% capacity utilization provides comfort to the bankers, it does not guarantee any meaningful equity returns.
- While we await details on the penalty structure for short supplies, historical trends suggest that the quantums are not severe, and may not act as a deterrent. Under the new FSAs being signed post March 2009, the penalty is 10% for shortfall below 50% commitment. For prior contracts, penalty is based on a graded scale of 10-40% for supplies below 90-80% of the commitment. Even assuming 40% penalty for say ~50m tons of shortfall (~25% of the incremental requirement during FY09-15), the possible quantum will be just INR20b. This does not act as a sufficient dis-incentive, nor provides enough protection in our opinion.

Financials: NPA threat addressed partly, as 50% of capacity under construction kept out

- Capacity under construction stands at 110GW+, of which we believe that ~70GW are based on coal linkages. The current directive provides fuel security to only 35GW of capacity to be commissioned during FY13-15, and several of the projects left out (~70%+) are from the private sector.
- Thus, post the PMO directive, while the financial system is much better off than the earlier stand; the current directive does not address the problem in totality.

Equipment Vendors / Capital Goods: Order intake holiday, elongating execution periods

- We believe that the business outlook for several players in the power generation equipment value chain has been significantly impacted. No further Letter of Assurances for fuel supplies are expected atleast for the next three years. This coupled with poor business visibility will lead to subdued order intake trends and elongated periods of project execution.
- BHEL will be the most impacted; companies like L&T, BGR, Thermax, etc that have set-up BTG manufacturing facilities will also be impacted by the challenging environment.

Coal India: Ramping production is the key

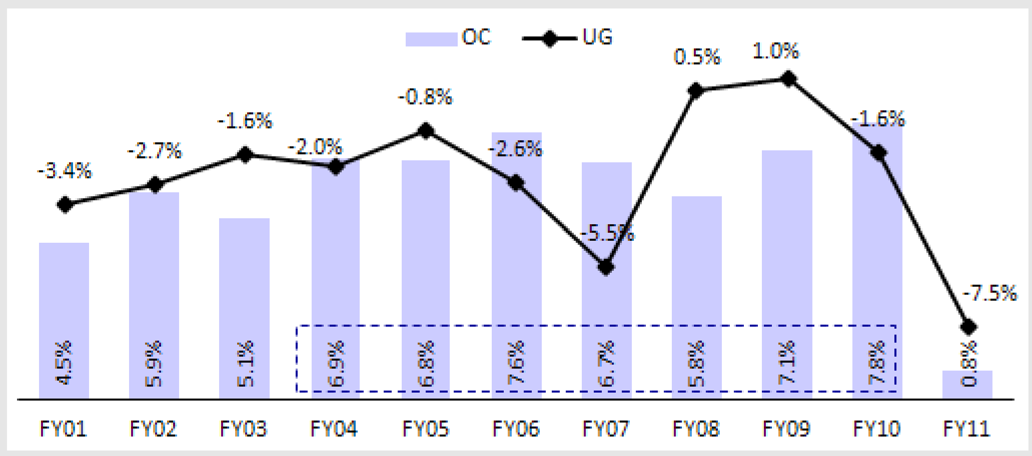
- We believe that the key message to COAL is to get its act together and ramp up coal production. After a long time, a co-ordinated effort involving the Environment, Railway, Coal and Power Ministries is being worked out to address the constraints. Coal production growth from open cast mines stood at 7-8% CAGR during FY04-10; but over the last 2 years, production has been largely stagnant. Production CAGR of 7-8% from open cast mines during FY13-15 will result in incremental coal production of ~100-110m tons by FY15 and will be crucial to achieve the targeted commitments.
- We continue to believe that COAL continues to be a non-controversial way to enhance production in the system and the company has a large operating leverage. We calculate the gains from 1m tons of incremental production at Rs700m; and thus possible incremental production of 40m tons pa in FY15 (over the current estimate of 60m tons) can lead to earnings upside of INR28b (EPS INR4/sh).
- Negatives are: possible diversion / stagnation of e-auction volumes (at ~44-45m tons) and penalty in the event of unable to meet the FSA obligations. As per the Coal Ministry directive, the target supplies under e-auction may be lowered to 7% of production from 10% currently, in a progressive manner by the end of the Twelfth Plan in case the company is not being able to meet the commitment. We calculate the impact of 1m tons e-auction diversion / shortfall at INR1b; and thus even in the event of shortfall of ~10m tons till FY15, the impact is manageable at INR1.5/sh of EPS (~3-4% of earnings). Even assuming 40% penalty for say ~50m tons of shortfall (~25% of the incremental requirement during FY09 -15), the possible quantum will be INR20b; which is an important but not a large enough deterrent.

COAL: Management clarifies on several intriguing issues

COAL management clarified their viewpoints on various issues being raised post the directive from the PMO, while they await further clarity from the Ministry.

- The management stated that in the event of coal imports, the attempt will be to pass on the cost of imported coal to the consumers, plus marketing margins. Also, on e-auction, FY12 volumes are expected at 47m tons +; and as per the directive from the Coal Ministry, the e-auction target may be lowered in a progressive manner to 7% of production from 10% by the end of the Twelfth Plan in case the company is not being able to meet the FSA commitments. Hence, e-auction acts as a balancing mechanism with a cap and floor; and provides a transparent structure with a carrot and stick.
- The management clarified that one of the options for meeting the increased coal requirement, will be through redistributing from the existing FSAs signed prior to FY09. These old FSAs had a trigger level of 90%, and the supplies currently stands at 94-95%. Thus, this provides option for redistribution of coal towards the new FSAs. However, there is no attempt to revise the old FSAs to lower the trigger level to 80% in line with the new FSAs; and thus the coal supplies to the power capacities commissioned prior to March 2009 will not be impacted much.
- Company has applied to Ministry of Environment and Forests for clearances on additional capacity in existing mines. A fast track process is being set up, and this can possibly lead to enhanced output by 20-25m tons shortly. Environment clearances for new mining projects are being expedited; and recently Amrapali mine project has received MoEF clearance (expected capacity 15m tons) while clearances for several projects are expected to be fast tracked. This will possibly lead to a meaningful improvement in production volumes in the Twelfth Plan till FY17. The optimistic production target in the event that environmental clearances are fast tracked is 615m tons in FY17 (CAGR of 7.2%) as compared to the earlier target of 556m tons (CAGR of 5%).
- Wage negotiations have been signed with most of the unions and the annual impact on a recurring basis is INR40b. In addition, the company will have to provide for gratuity / actuarial expenses on the increased levels and this will be an additional provision of INR25b. COAL has been making provisions for wage increases at the rate of INR7.5b per quarter and thus the balance incremental provisions wef 2QFY12 will be made in 4QFY12. We have factored in staff cost of INR71b in 4QFY12, vs INR56b in 3QFY12.
- We maintain Buy on COAL with a price target of INR396/sh and believe that any declines should be used as a buying opportunity. The stock quotes at a PER of 14x FY13E and 11.7x FY14E.

COAL: Open cast production impacted from FY11 (% YoY)



Source: MoP/MOSL

Coal supplies to Power sector (m tons)

	FY10	FY11	FY12E
CIL	296.4	302.0	305.0
SCCL	33.4	32.0	32.0
Captive	22.4	22.0	24.0
Imports	23.2	30.0	38.0
Total	**375.4**	**386.0**	**399.0**

Source: MoP/MOSL

Projects under construction/development: Absorbing the existing pipeline will likely take long

Category (MW)	Central Sector	State Sector	Private Sector	Total
1. Coal Based				
A. Projects already Commissioned	3,100	3,620	9,845	16,565
B. Under construction or order for main plant placed and clearances tied up	10,470	16,910	52,840	80,220
C. Coal Tied Up but where order for Main Plant yet to be placed or certain clearances are yet to be tied up	6,940	3,420	20,480	30,840
D. Projects where Environmental clearance obtained on Imported coal but projects are yet to be taken up for construction			24,470	24,470
E. Projects accorded Environmental clearance hut have no coal tie up	1,200	4,900	5,285	11,385
I. Total Coal Based	**21,710**	**28,850**	**112,920**	**163,480**
II. Total Gs Based	3,504	9,135	12,738	25,371
III. Total Other Projects		120	3,935	4,055
Grand Total (I+II+III)	**25,214**	**38,105**	**1,29,593**	**1,92,912**

Source: Infraline/MOSL

Power sector imbroglio could get resolved?

90-day revival plan with monthly milestones

Walking the Talk

Committee of Secretaries has identified five key areas for government intervention in power sector. The timeline for three of these areas is set:

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- ☐ Indonesian coal pricing issues relating to Mundra and Krishnapatnam UMPPs (ultra mega power projects) [Date to be decided]
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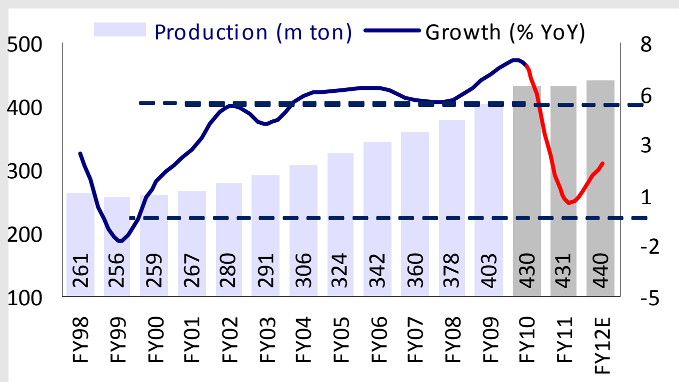
A high-powered meeting led by PMO was held on 18 January 2012 with several Cabinet Ministers and CEOs of power companies including from Tata group, ADAG, GMR, GVK, Adani, Vedanta, Jindal, Lanco, etc. The key agenda was to address the logjam in the power sector.

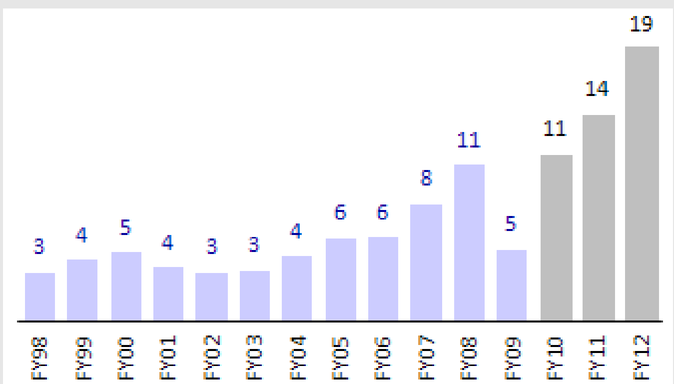
Complete lack of co-ordination across ministries, persistent delays and logjam had led the matter to be escalated to the highest level. The initiatives taken now indicate the seriousness, and urgency on the part of authorities for an important sector.

- **Domestic coal production is near stagnant for 3 years in a row**. Coal India's production target is now at 440m tons in FY12 v/s 431m tons in FY11 and 430m tons in FY10). This is due to multiple reasons: 1) Environment/forest clearances, 2) Evacuation issues, 3) Operational slippages owing to adverse climatic conditions, etc. We believe that Coal India remains the most non-controversial way to increase domestic production and thus, this leads to hopes for uptick in production in FY13/14. Similarly, declining gas supply/production and capacity addition by several IPPs have led to both existing and new projects being stranded for fuel.
- **Support for UMPP projects based on imported coal needs more clarity**. Our past discussions with incumbents (Tata Power, Reliance Power) suggested several hurdles which need to be addressed including "State government willingness (as power is procured by discoms, which are counterparty to such PPA)". This, in our view, is unlikely to be resolved in haste, and would go into several deliberations before any final outcome. We would be watchful of any development on this front. TPWR could be biggest beneficiary, assuming "support" indicates 100% fuel cost pass through (v/s 50% currently).
- **Development of captive coal block**, in our view, is an equally pressing issue and thus, resolving issues on related environment and forest clearance and land acquisition is critical.
- Another contentious issue has been the **Power Purchase Agreements (PPAs)** between states and developers, which have been jeopardized given lower domestic coal supply, high imported coal prices, regulatory changes in countries like Indonesia and Australia, etc. This remains to be watched.

Coal India production stagnant for 3 years now ...

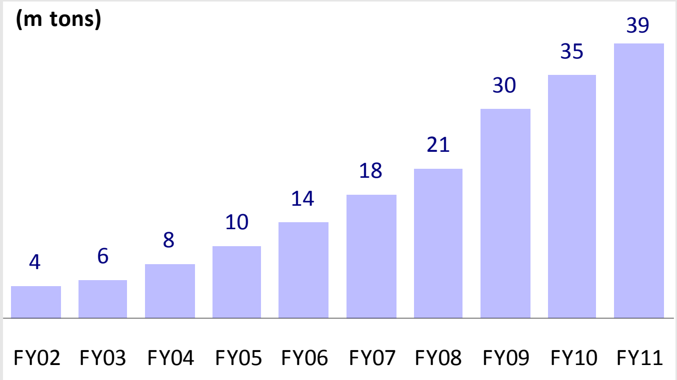


... while 42-45GW thermal capacity added in FY10-12E

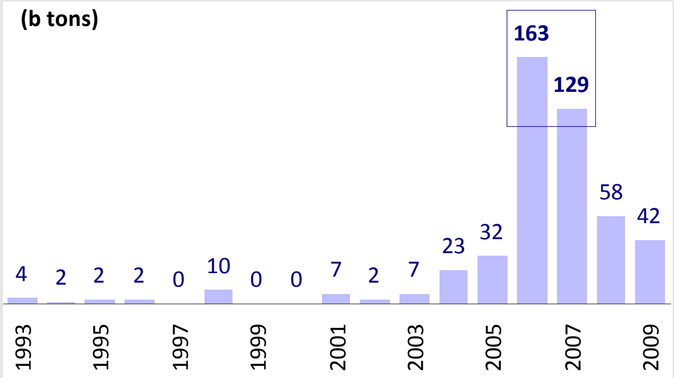


Source: Company/MOSL

Captive mines production ramp up slow ...



... despite ~300b tons of captive reserves awarded in 2006/07



Source: Ministry of Coal/MOSL

Domestic gas production declining during FY11-13E ...

	FY08	FY09	FY10	FY11	FY12E	FY13E
APM - ONGC & new	48.3	48.2	50.3	50.0	50.0	50.0
APM - OIL	5.0	4.8	5.3	6.1	6.5	7.1
RIL KG-D6			40.0	56.2	43.0	35.0
Private / JVs	21.0	25.0	25.0	25.0	23.0	22.0
Others - ONGC, Essar			1.5	5.0	6.0	7.0
Domestic Supply	**74.3**	**78.0**	**122.1**	**142.3**	**128.5**	**121.1**

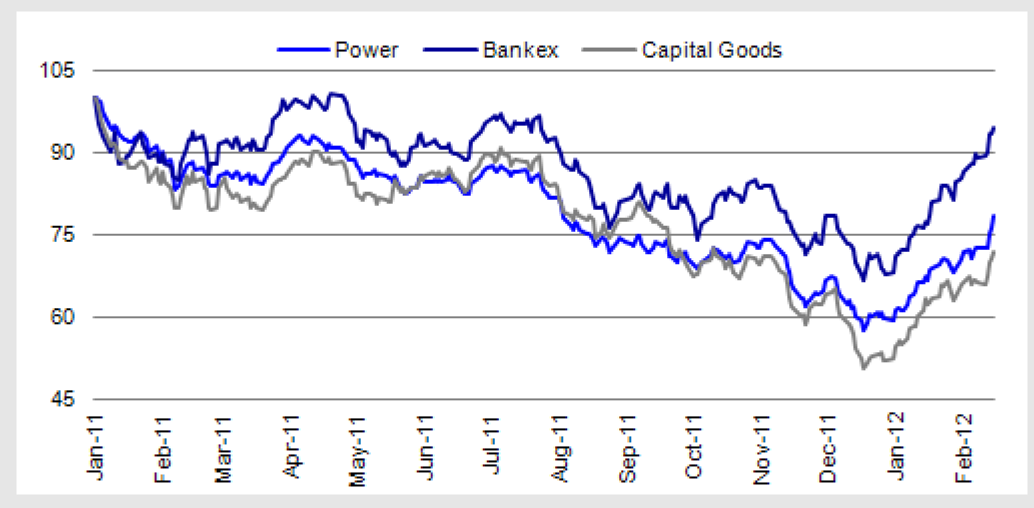
Source: MOPN/Infraline/MOSL

... but new gas projects of 7GW+ await fuel allocations

Project	Company	Total (MW)	XI Plan (MW)	State
Pragati Ph III	Bawana	1,500	1,250	Delhi
Hazira	Guj State Energy Generation	351	351	Gujarat
Pipavav	Pipavav Power Company	702	702	Gujarat
Kashipur	Shravanti Energy	450	450	Uttarakhand
Kondapalli	Lanco	770	770	Andhra
Vemagiri	GMR	768	768	Andhra
Sugen Unit 4	Torrent	382	382	Gujarat
Dahej SEZ	Torrent	1,200	400	Gujarat
Samalkot	Reliance Power	2,400	1,400	Andhra
West Godavari	Panduranga Energy	100	100	Andhra
Rajahmundry	RVK Pvt	436	196	Andhra
Kashipur	Beta Infratech	225	225	Uttarakhand
Kashipur	Gama Infratech	225	225	Uttarakhand
Total		**9,509**	**7,219**	

Source: Media/MOSL

Trend in BSE Financials, Power Utilities, Capital Goods sector index over past 1 year



UTILITIES: Comparative valuations

	Recom	Mkt Cap (INR b)	CMP	EPS (INR) FY12	EPS (INR) FY13	EPS Gr. (%) FY12	EPS Gr. (%) FY13	RoE (%) FY12	RoE (%) FY13	P/BV (x) FY12	P/BV (x) FY13	P/E (x) FY12	P/E (x) FY13	EV/EBITDA (x) FY12	EV/EBITDA (x) FY13
CPSUs															
NTPC	Buy	1,418	186	10.1	11.0	4.6	9.0	11.8	12.0	1.9	1.8	17.0	15.6	12.6	12.0
PGCIL	Buy	487	110	6.5	7.4	18.7	13.7	13.5	14.0	2.1	1.9	16.1	14.2	11.8	10.8
Coal India *	Buy	2,034	322	24	28	41.4	15.7	28.3	26.3	4.7	3.6	13	11	8.3	6.5
NHPC	Neutral	256	22	1.6	2.0	-0.7	26.6	6.3	7.8	0.9	0.9	13.3	10.5	9.2	8.7
Private Sector															
Tata Power	Neutral	264	110	7.9	8.0	7.5	0.6	12.0	12.3	2.3	2.1	14.0	13.9	18.4	17.6
Adani Power	Neutral	197	92	5.4	9.6	131.0	76.3	18.6	25.8	2.5	2.0	15.2	8.6	17.7	8.3
JSW Energy	Neutral	90	72	1.8	1.9	-64.6	2.7	5.2	5.2	1.6	1.5	30.3	29.5	13.1	8.1
Lanco Infra	Buy	38	23	1.3	3.7	-51.1	177.3	6.9	17.7	0.8	0.7	11.8	4.2	10.6	8.7
Reliance Infra	Buy	148	640	68.2	77.3	68.8	13.3	10.1	10.5	0.8	0.7	8.1	7.2	1.8	1.3
CESC	Buy	32	288	39.0	41.6	0.4	6.6	10.4	10.1	0.7	0.6	6.4	6.0	4.5	4.5
PTC	Buy	15	67	6.3	7.6	10.8	21.3	4.8	5.0	0.7	0.7	8.1	6.7	7.1	6.5

* RoE Adjusted for OB reserves provisions

Source: Company/MOSL

CAPITAL GOODS: Comparative valuations

Company	Rating	M-Cap USD	CMP INR/sh	EPS (INR) FY12	EPS (INR) FY13	RoE (%) FY12	RoE (%) FY13	P/E (x) FY12	P/E (x) FY13	EV/EBITDA (x) FY12	EV/EBITDA (x) FY13
ABB#	Neutral	3.8	892	8.0	17.0	6.8	13.2	112.0	52.5	60.6	32.4
BHEL	Neutral	15.0	303	25.5	25.8	28.1	23.8	11.9	11.8	7.4	7.5
BGR Energy	Neutral	0.5	340	29.3	26.0	20.8	16.4	11.6	13.1	6.9	8.3
Crompton	Neutral	2.1	160	7.1	10.6	14.6	18.0	22.6	15.1	11.3	5.4
Cummins	Buy	2.6	471	19.8	24.3	29.8	34.0	23.8	19.4	16.7	13.7
L&T	Buy	17.6	1,449	75.6	83.5	17.7	15.6	19.2	17.3	15.4	14.3
Siemens##	Neutral	5.6	820	22.9	30.6	19.2	23.0	35.9	26.8	21.6	15.8
Thermax	Neutral	1.2	538	34.4	34.5	28.1	23.6	15.6	15.6	9.1	8.9
Havells	Buy	1.3	531	28.9	35.8	38.0	33.8	18.4	14.8	11.2	9.3

Year end December; ## Year end September

Source: Company/MOSL

Financials: Valuation Matrix

	Rating	CMP	Mcap	EPS (INR)		P/E (x)		P/BV (x)		RoA (%)		RoE (%)	
		(INR)	(USDb)	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
ICICIBC*	Buy	991	23.2	55	62	13.8	11.7	1.9	1.7	1.5	1.4	13.8	14.3
HDFCB	Neutral	531	5.0	22	28	24.0	19.0	4.2	3.6	1.7	1.7	18.9	20.5
AXSB	Buy	1,288	10.7	97	112	13.3	11.5	2.4	2.1	1.5	1.5	19.9	19.5
KMB	Neutral	575	4.3	13	15	41.3	36.3	5.2	4.5	1.8	1.6	14.2	14.1
YES	Buy	368	2.6	28	33	13.1	11.2	2.8	2.3	1.5	1.3	23.3	22.3
IIB	Buy	315	3.0	17	21	18.4	15.0	3.3	2.8	1.6	1.5	19.3	20.1
VYSB	Buy	360	0.9	30	34	12.0	10.7	1.4	1.3	1.0	1.0	14.0	12.3
FB	Buy	451	1.6	43	50	10.4	9.0	1.4	1.2	1.3	1.3	13.8	14.5
J&KBK	Buy	842	0.8	162	180	5.2	4.7	1.0	0.9	1.4	1.4	20.8	19.7
SIB	Buy	28	0.1	3	4	8.1	7.2	1.6	1.3	1.1	1.0	21.1	20.3
Private Aggregate			**52.2**			**12.7**	**10.8**	**1.8**	**1.6**				
SBIN (cons)*	Buy	2,452	31.6	241	280	9.7	8.3	1.5	1.3	0.9	0.9	16.4	17.1
PNB	Buy	1,071	6.9	155	181	6.9	5.9	1.4	1.2	1.3	1.2	24.3	21.7
BOI	Neutral	397	4.4	45	59	8.8	6.8	1.2	1.1	0.7	0.8	14.6	16.7
BOB	Neutral	867	6.9	122	133	7.1	6.5	1.4	1.2	1.2	1.1	21.9	20.2
CBK	Buy	554	5.0	73	89	7.6	6.2	1.2	1.0	0.9	0.9	16.7	17.7
UNBK	Buy	267	2.8	27	45	9.8	5.9	1.1	1.0	0.6	0.8	12.2	18.2
IOB	Neutral	110	1.4	11	19	9.7	5.8	0.8	0.7	0.4	0.5	8.4	13.1
OBC	Buy	314	1.9	42	50	7.5	6.3	0.8	0.7	0.7	0.7	11.4	12.4
INBK	Buy	247	2.2	44	48	5.5	5.1	1.1	1.0	1.4	1.3	21.6	20.0
CRPBK	Neutral	512	1.5	106	120	4.8	4.3	0.9	0.8	1.0	1.0	20.2	19.8
ANDB	Buy	131	1.5	24	26	5.5	5.0	1.0	0.9	1.1	1.1	19.0	18.5
IDBI *	Neutral	118	2.4	17	21	5.5	4.5	0.7	0.6	0.6	0.7	12.6	14.0
DBNK	Buy	96	0.6	22	26	4.4	3.7	0.8	0.7	0.9	1.0	17.9	18.4
Public Aggregate			**69.2**			**9.1**	**7.6**	**1.4**	**1.2**				
HDFC*	Neutral	714	21.3	27	31	18.6	15.5	5.1	4.6	2.8	2.9	26.6	28.8
LICHF	Buy	271	2.6	19	28	14.0	9.8	2.6	2.2	1.6	1.8	20.3	24.3
DEWH	Buy	257	0.5	30	39	8.6	6.6	1.4	1.2	1.3	1.4	18.7	19.5
IDFC	Neutral	151	4.5	11	11	14.3	13.2	1.7	1.5	3.0	2.7	13.9	13.2
RECL	Buy	242	4.9	29	34	8.5	7.1	1.7	1.5	3.1	3.1	20.7	21.8
POWF	Buy	214	5.0	23	28	9.4	7.7	1.4	1.2	2.6	2.6	16.6	16.6
SHTF	Buy	591	2.7	57	64	10.4	9.2	2.2	1.8	3.0	3.0	23.6	22.0
MMFS	Neutral	751	1.6	55	70	13.7	10.8	2.6	2.2	3.8	3.8	20.8	22.4
NBFC Aggregate			**43.0**			**14.4**	**12.0**	**3.4**	**2.9**				

*Multiples adj. for value of key ventures/Investments; For ICICI Bank, HDFC Ltd BV is adjusted for investments in subsidiaries

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