Power Finance Corporation

Robust power sector investments buoy prospects

CMP	TARGET	RATING	RISK
Rs 129	Rs 145	HOLD	MEDIUM

BSE	NSE	BLOOMBERG
532810	PFC	POWF IN

Strong traction in loan sanctions: In light of India's rising energy deficit and inadequate T&D infrastructure, we expect large investments in the power sector during the 11th and 12th Five Year Plans. With more than 20 years of experience in lending to the power sector, Power Finance Corporation (PFC) is well-positioned to leverage the growing financing opportunities. The company has witnessed strong traction in loan sanctions over the last few years and currently has outstanding sanctions of Rs 1.1tn. A large proportion of these will be disbursed over FY10-FY12 which provides strong growth visibility. We expect PFC to clock a 19% CAGR in loan disbursals over FY08-FY10 and consequently a 22% CAGR in its loan book to Rs 772bn by FY10.

Margins to remain largely intact: In a rising interest rate scenario, PFC has benefited from re-pricing benefits on its loan assets (80% of which have a reset clause of three, five or ten years) and the fixed nature of its liabilities (90% fixed). With the recent decline in interest rate, PFC's incremental spreads now stand at 3–4% which will help in maintaining spreads of ~2.3–2.4% for FY10. However, interest margins may come under pressure from FY11 onwards when loans disbursed in FY08 and FY09 will be due for re-pricing. Access to tax-free bonds, if allowed by the government, will help PFC to maintain its interest spreads. We are not factoring in this possibility at present.

Robust asset quality: PFC's asset quality has remained robust with net NPAs hovering at near-zero levels. Loans to state and central sector utilities comprise ~88% of the total loan book. Moreover, loan to utilities have an escrow mechanism in place which provides further comfort on the asset quality front. Significant T&D losses and lower realisations have weakened the financial position of state utilities; however, losses have remained under control in the past few years and the subsidy burden as a percentage of state government revenues has declined significantly.

Favourable tax ruling to act as catalyst: PFC is eligible for tax exemption up to 20% of the profit derived from the financing business. However, it is providing for tax on this deduction by creating a deferred tax liability due to objections from the auditors in FY05. This issue is under consideration with the ICAI; if the outcome proves favourable for PFC, the company's tax rates for future years will be lower and its net worth will increase by ~Rs 13bn–14bn.

Positives priced in – Hold: We like PFC due to its superior domain knowledge and robust business outlook. We have valued the company at Rs 145 or 1.5x FY10E book value, assuming a cost of equity of 14% and stable ROE of 18%. In the event of a favourable decision on tax benefits, our target price would stand at Rs 161, ~11% higher than our current target.

Company data

Market cap (Rs mn / US$ mn)	148,234 / 2,861
Outstanding equity shares (mn)	1,148
Free float (%)	10.2
Dividend yield (%)	3.1
52-week high/low (Rs)	190 / 86
3-month average daily volume	153,375

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
PFC	129	(4.2)	4.1	(6.3)
Sensex	8,160	(15.4)	(15.5)	(44.3)

Valuation matrix

(x)	FY07	FY08	FY09E	FY10E
P/BV @ CMP	1.7	1.6	1.5	1.3
P/BV @ Target	1.9	1.8	1.6	1.5
P/ABV @ CMP	1.5	1.4	1.3	1.2
P/ABV @ Target	1.7	1.6	1.5	1.3
P/E @ CMP	15.0	12.3	11.2	8.8

* Adj. for deferred tax liability

Financial highlights

(Rs mn)	FY07	FY08	FY09E	FY10E
NII	14,146	17,804	21,740	25,070
Growth (%)	*16.6*	*25.9*	*22.1*	*15.3*
PPP	13,978	17,922	21,727	25,177
Growth (%)	*16.0*	*28.2*	*21.2*	*15.9*
FDEPS (Rs)	8.6	10.5	11.6	14.6
Growth (%)	*(8.8)*	*22.4*	*9.9*	*26.7*

Profitability and Return ratios

(%)	FY07	FY08	FY09E	FY10E
Net interest margin	3.5	3.7	3.7	3.5
Non-int inc/Total inc	3.4	5.8	4.3	4.8
Cost/Inc ratio	4.2	4.6	4.5	4.8
RONW	12.7	13.5	13.6	15.7
ROA	2.5	2.5	2.3	2.4
Net NPA	0.1	0.0	0.0	0.0

Ishank Kumar
(91-22) 6766 3467
ishank.kumar@religare.in

Abhishek Agarwal
(91-22) 6766 3466
abhishek.a@religare.in

Investment rationale

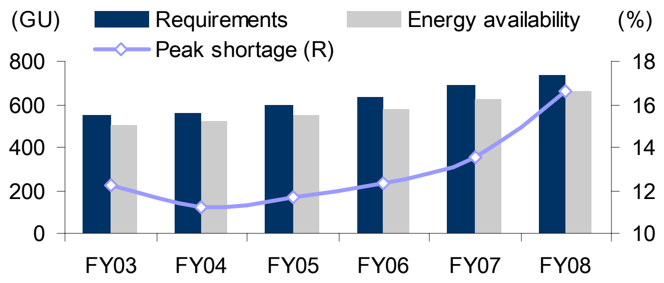
High growth visibility

India's peak power deficit has risen from 13.5% to 16.6% over FY07-FY08

India's power deficit continues to worsen

Rising energy consumption and the lack of adequate investments towards generation and transmission & distribution (T&D) infrastructure have exacerbated the demand-supply situation in India. As per the Central Electricity Authority (CEA), India's total energy deficit has increased to 72bn units in FY08 (9.8% of total energy demand) from 68bn units in FY07, while peak deficit has risen from 13.5% of peak demand to 16.6% during the same period.

Peak energy shortage at 17% of demand in FY08

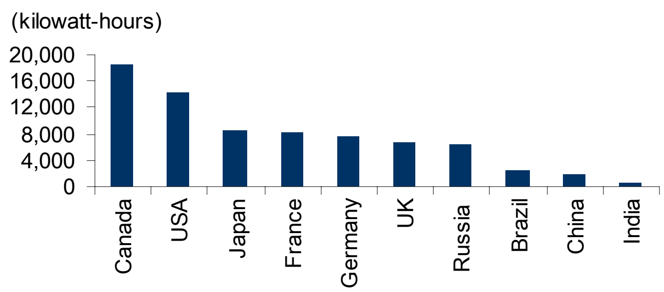


Source: CEA

Per capita consumption remains low due to unreliable supply

India's per capita energy consumption has remained low compared to other emerging economies like China and Brazil, due to unreliable supply and inadequate T&D infrastructure. To improve demand-supply conditions in India and to increase per capita consumption, the Government of India (GoI) has prepared a comprehensive blueprint for power sector development with a mission of "Power to all by 2012".

Per capita electricity consumption in India is low



Source: Human Development Report 2007-08, UNDP

11th Plan target of adding 78,577MW of generation capacity

Aggressive government thrust on power generation in 11th Plan

The government has set an aggressive target of adding 78,577MW of generation capacity in the 11th Plan (as compared to 21,180MW added in the 10th Plan), taking India's installed generation capacity to ~210,000MW by 2012. State and central power utilities are expected to introduce ~86% of the planned additions, with private utilities contributing the rest. A further 12,000MW of generation capacity is expected to come from captive power plants.

The government also plans to tap the significant potential of power generation available from non-conventional energy resources such as wind, small hydro, bio mass and solar energy. It has targeted capacity additions of ~14,000MW from renewable energy in the 11th Plan (as compared to ~6,750MW added in the 10th Plan).

Power generation target for the 11th Plan (MW)

Particulars	Thermal	Hydro	Nuclear	Total
Central	26,800	9,685	3,380	39,865
State	24,347	3,605	-	27,952
Private	7,497	3,263	-	10,760
Total	58,644	16,553	3,380	78,577
Captive power plants				12,000
Non-conventional energy sources				14,000

Source: The Working Group of Power for Eleventh Plan, MoP, GoI, Feb '07

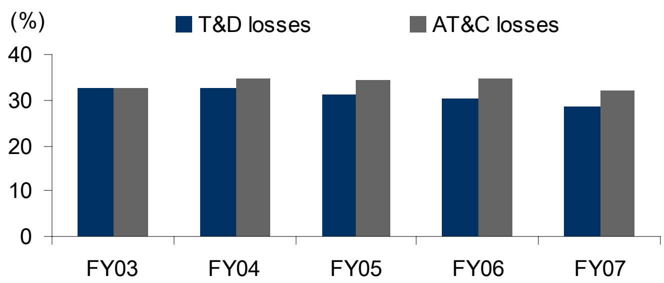
India's AT&C losses of 35% are more than double that seen in developed countries

T&D infrastructure also in need of an overhaul…

India's power T&D infrastructure is inadequate with an outdated distribution network and a lower degree of automation. Over the years, the transmission sector has failed to match up to generation capacity additions. Globally, every rupee invested in generation has an equal amount invested in T&D; however in India, the corresponding investment in T&D is only 50paise. As a result, nationwide AT&C losses are very high at ~32–35% compared to 10–15% in developed countries.

Due to high AT&C losses, state power utilities involved in power T&D have witnessed significant aggregate losses and are therefore heavily dependent on state governments for subsidy or capital infusions for further investments. As per a report of the 'Working Group on Power for 11th Plan', a 1% reduction in T&D losses will lead to savings of Rs 7bn–8bn and a 10% reduction in the loss will release energy equivalent to an additional capacity of 10,000–12,000MW.

AT&C losses



Source: CEA

Under APDRP, the government provides loans to projects with the aim of sustained loss reduction

…APDRP programme a step in this direction

In order to develop the requisite T&D infrastructure to support the planned generation capacity and minimise AT&C losses, the government has emphasised the need for significant expansion and upgrades to the T&D network in both urban and rural areas. It has also started an 'Accelerated Power Development and Reforms Programme (APDRP)' to hasten distribution reforms and improve the financial viability of state power utilities. Through this scheme, the government will provide loans to projects with the aim of sustained loss reduction.

The projects will be undertaken in two parts – the first will focus on establishment of reliable and automated systems for accurate collection of baseline data and adoption of information technology for energy accounting/auditing, whereas in the second part, renovation and modernisation of the T&D network will be undertaken. The government will provide 100% loans for the first phase and 25% funding (90% for special category states) in the second phase. The balance will be funded by PFC and REC. If the state utilities are able to achieve a 15% AT&C loss target in the project area, the entire loan given for the first part and 50% of the loan given for the second part (90% for special category states) will be converted into grants.

~Rs 10tn of investment expected in power sector over FY07-FY12

In view of the government's thrust to improve generation and T&D infrastructure in India, we expect massive investments in the power sector during the 11th and 12th Plans. As per government estimates, funds in excess of Rs 10tn are required during the 11th Plan alone for generation projects as well as upgrades and expansion of the existing T&D network. Of this amount, ~Rs 4.1tn will be required for generation capacity addition (including Rs 1.9tn in the 12th Plan), Rs 1.4tn for transmission, and Rs 2.9tn for distribution.

Potential financing opportunities of Rs 8.3tn over FY07-FY12

The state and central sectors are expected to account for ~79% of the total investments with the rest contributed by the private sector. Assuming an average debt/equity ratio of 80:20 in power projects, this will lead to financing opportunities of Rs 8.3tn over FY07-FY12.

Investment expected in the power sector in the 11th Plan

(Rs bn)	State	Central	Private	Total
Generation including nuclear power	1,238	2,021	850	4,109
DDG		200		200
Repair & Maintenance	159			159
Transmission	650	750		1,400
Distribution including rural electrification	2,870			2,870
Others		24		24
Total	4,917	2,995	850	8,762
NCES and Captive units	225		930	1,155
Merchant plants			400	400
Total fund requirement	5,142	2,995	2,180	10,317

Source: White paper on strategy for 11th Plan, CEA, Aug '07

Delays in project execution could lead to a shortfall in investments

However, delays in capacity addition can lead to lower than expected investments. In the last three plan periods, India has achieved only ~47–54% of the target capacity expansion due to poor execution and project delays. In the first two years of the 11th Plan as well, capacity addition has been in line with the historical trend. In FY08, India added new generation capacity of 9,263MW compared to the target of 16,335MW (57%) and in the first ten months of the current financial year, it added only 2,674MW (26% of the target).

Actual capacity addition falls short of planned targets

Plan	Target (MW)	Achievement (MW)	(%)
1st (1951-56)	1,300	1,100	84.6
2nd (1956-61)	3,500	2,250	64.3
3rd (1961-66)	7,040	4,520	64.2
4th (1969-74)	9,264	4,579	49.4
5th (1974-79)	12,499	10,202	81.6
6th (1980-85)	19,666	14,226	72.3
7th (1985-90)	22,245	21,401	96.2
8th (1992-97)	30,538	16,423	53.8
9th (1997-02)	40,245	19,015	47.2
10th (2002-07)	41,110	21,180	51.5
FY08	**16,335**	**9,263**	**56.7**

Source: CEA

Mega expansion projects already underway which bodes well for power financiers

But power plants with capacities of over 68,000MW are already under construction as on January 1, 2009, according to the CEA. Further, 70% of the capacity under construction is in the state and central sectors and therefore, will be relatively insulated from non-conducive capital market conditions. Consequently, we expect the robust demand to continue in the power financing space for the next few years.

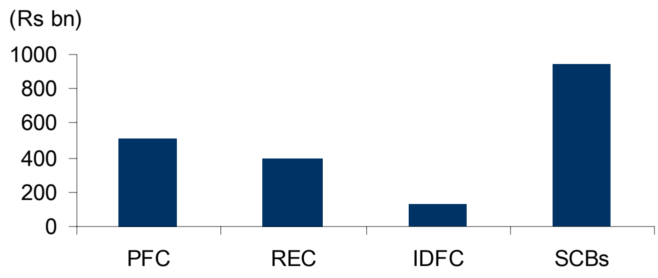
PFC a key player in the government plan to develop power infrastructure

PFC well positioned to leverage the growing financing opportunities

With more than two decades of experience in lending to the Indian power sector, PFC plays an integral role in the government's plan to develop the sector (along with Rural Electrification Corporation – REC). A specialised power financier, PFC has expanded its loan book at a 20% CAGR over FY03-FY08 to Rs 516bn as compared to a combined exposure of ~Rs 1tn for Scheduled Commercial Banks and Rs 393bn for REC at the end of FY08.

Exposure of Rs 516bn to the power sector at the end of FY08 as against Rs 1tn for all SCBs combined

Exposure to the power sector as on March 31, 2008



Source: Company, RBI

Disbursement to remain strong; outstanding sanctions at Rs 1.1tn

PFC has witnessed strong traction in loan sanctions over the past few years due to robust demand from the power sector, particularly in the generation space. Historically, the company has garnered a higher market share in generation projects, with sanctioned loans over FY06-9MFY09 exceeding Rs 1.3tn in this segment (as against Rs 630bn sanctioned by REC). However, REC has a relatively higher share in the T&D space. Generation projects constitute ~78% of PFC's loan book as on December '08.

Loan sanctions

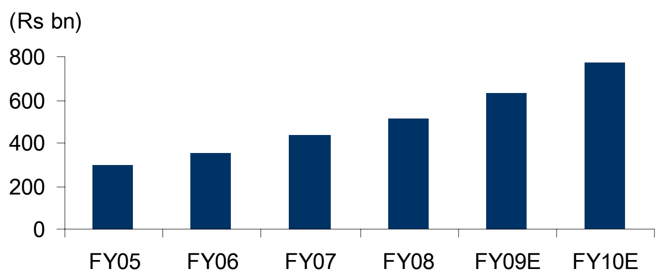
(Rs bn)	FY06		FY07		FY08		9MFY09	
	PFC	REC	PFC	REC	PFC	REC	PFC	REC
Generation	160.4	60.1	241.0	103.6	587.0	272.8	358.5	193.4
T&D	25.8	81.9	46.4	155.8	78.0	152.5	51.1	121.6
Other	31.5	45.8	24.1	22.1	30.0	26.9	23.5	19.5
Total	217.8	187.7	311.5	281.5	695.0	452.1	433.0	334.5

Source: Company

Currently, the company has outstanding sanctions of more than Rs 1.1tn which provides strong visibility to loan disbursement over the next few years. We expect PFC to clock a 19% CAGR in loan disbursals over FY08-FY10 and consequently a 22% CAGR in its loan book to Rs 772bn by FY10.

Outstanding sanctions of more than Rs 1.1tn lend visibility on loan disbursals

PFC's loan book



Source: Company, RHH

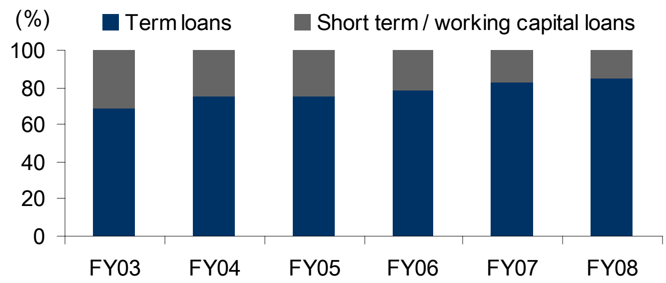
Rising leverage, low operating cost to improve ROE

85% of total disbursals are long-term in nature (10–15 years)

Long-term loans to power projects

PFC's loans are primarily long-term in nature (~10–15 years) as power generation and T&D projects have a longer gestation period. Further, the proportion of long-term loans in total disbursals has increased from 68% in FY03 to 85% in FY08 due to the financing of new power projects. Consequently, the average tenure of the company's loans is relatively higher (5.4 years at the end of Q3FY09) when compared to banks. Among its loan assets, ~21% are fixed whereas the remaining have reset clauses of three (60%), five (3%) or ten (15%) years.

PFC's disbursement skewed towards long-term loans

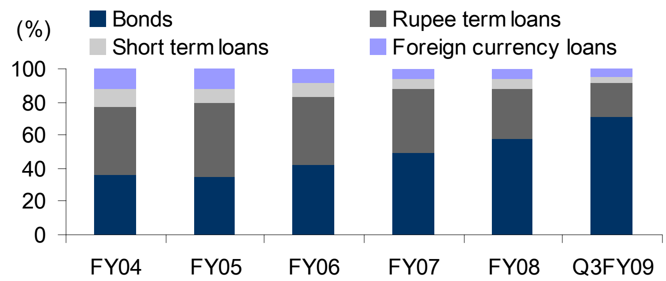


Source: Company

Sources of funds include long-term bonds, bank loans and ECBs

On the liability front, the company primarily relies on long-term bonds, loans from banks and long-term external commercial borrowings to fund its growth. Being a government owned company; PFC enjoys the highest credit rating and has been able to raise funds in both domestic and international markets at favourable rates. The average duration of maturity stands at 4.5 years at the end of Q3FY09 and ~90% of its borrowings are fixed in nature.

PFC's borrowing profile



Source: Company

Interest margins to decline marginally in FY10

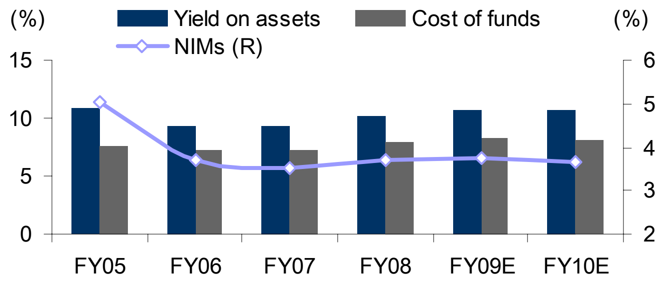
With interest rates moving up over the past couple of years, PFC has reported an improvement in interest spreads due to re-pricing benefits on its loan assets paired with the fixed nature of its liabilities. Its interest spread improved from 2.1% in FY07 to 2.3–2.4% in 9MFY09.

Interest spreads to remain stable at 2.4% in FY09 with a dip of 7–10bps in FY10

PFC is currently lending at 12–13% whereas with the recent softening in interest rate, its incremental cost of borrowings stands at 8.5–9%. In addition, we believe that average reset rates for loans due for re-pricing in FY10 will be higher, as a larger proportion of these loans were earlier reset or disbursed at a lower rate. Consequently, we expect PFC's spread to sustain at 2.4% in FY09 and decline marginally by 7–10bps in FY10 due to a reduction in lending rates. However, interest margins may come under pressure from FY11 onwards when loans disbursed in FY08 and FY09 come up for re-pricing.

Both PFC and REC may get access to tax-free bonds to mobilise funds for power projects. While we have not factored this into our valuations, we note that access to tax-free bonds would help the company maintain its interest spreads.

Interest spread and margins



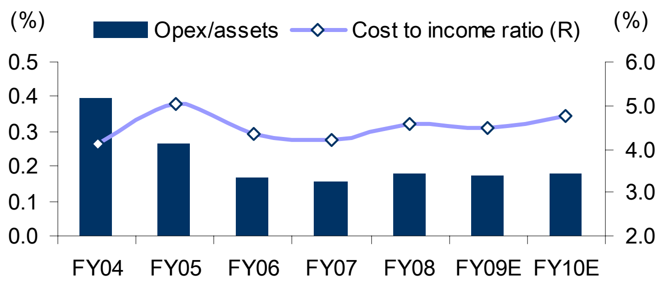
Source: Company, RHH

Operational efficiency boosting profitability

Among the lowest opex to asset ratios in the industry at 0.2%

Being a wholesale financier, PFC has very low operating expenses as it does not require a large distribution network or employee base to run its business. As a result, its cost to income ratio hovered in the range of 4–5% over FY05-FY08 while its opex to asset ratio is one of the lowest in the industry at 0.2%. We expect its opex to asset ratio to remain in this range over FY08-FY10.

Opex/asset ratio low at 0.2%



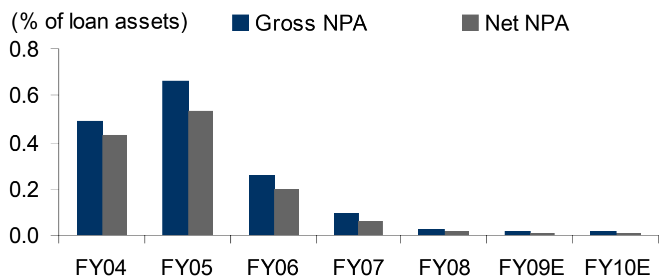
Source: Company, RHH

Robust asset quality

Gross and net NPAs at 0.03% and 0.01% of loan assets respectively

PFC's asset quality has remained robust without any major slippages in the past few years. Gross NPA declined from Rs 1.9bn in FY04 (0.7% of loan assets) to Rs 0.1bn in FY08 (0.03%) and net NPA declined from Rs 1.6bn (0.54%) to Rs 70mn (0.01%) during the same period.

NPAs have remained below 1%

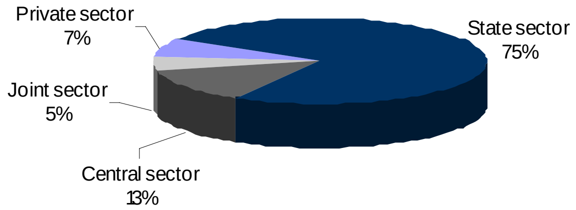


Source: Company, RHH

Being a financier to large power projects, ticket sizes of loans are high (averaging Rs 1bn) and the company has significant exposure to a few large state and central utilities. Loans to state and central sector utilities comprise ~88% of the total loan book as on December 31, 2008 whereas private sector utilities constitute 7% and the rest is contributed by joint ventures.

Loan to state and central utilities constitutes ~88% of loan book

Composition of loan assets as on December 31, 2008



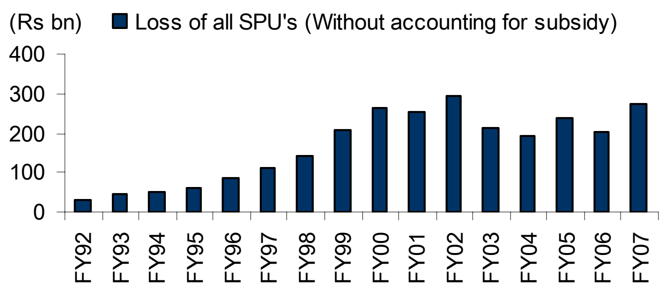
Source: Company

Weak T&D infrastructure undermines SPU financial position

Due to significant T&D losses and lower realisations per unit, state sector utilities (particularly distribution companies) are financially weak. As per PFC's report on the performance of state power utilities, 45 out of 88 utilities had negative ROE in FY07 and 29 utilities had negative net worth as on March 31, 2007. Aggregate losses of all state power utilities (without accounting for subsidies) increased from Rs 30bn in FY92 to Rs 293bn in FY02. However, since then, losses have remained under control.

Steep T&D losses and lower realisations weaken SPU financial position

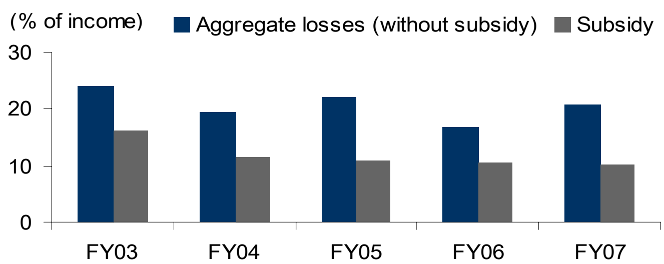
Aggregate losses of state power utilities



Source: PFC's report on performance of state power utilities for the years 2004-05 to 2006-07

On the other hand, the revenue of state governments has increased significantly over FY04-FY08 and therefore they are in a relatively better financial position to bear the subsidy burden or invest in improving T&D infrastructure at the state level. Further checks on AT&C losses will strengthen the financial health of utilities, since a 1% reduction in transmission losses will lead to estimated savings of Rs 7bn–8bn.

Aggregate losses and subsidy as a percentage of income of SPUs



Source: PFC's report on performance of state power utilities

Escrow mechanism helps safeguard PFC's asset quality

To safeguard lenders in the event of defaults, loans given to state sector borrowers have an escrow mechanism in place, which provides comfort as regards PFC's asset quality.

Higher leverage to aid improvement in ROE

ROE set to rise from 13.5% in FY08 to 15.7% by FY10

PFC's CAR as on December 31, 2008 stands at 16.2% compared to the regulatory requirement of 10%, whereas its total asset to net worth ratio is at 6.3x. Further, the company can raise perpetual or subordinate bonds to meet the regulatory requirement going forward. As a result, we do not expect any equity dilution over the next 1-2 years. PFC's leverage will increase with robust growth in its loan book, fuelling an improvement in ROE from 13.5% in FY08 to 15.7% by FY10.

Consultancy services to augment fee-based income

Nodal agency for UMPPs and transmission projects

PFC has been appointed as nodal agency to facilitate the development of Ultra Mega Power Projects (UMPPs) with a capacity of 4,000MW each. The company has incorporated nine wholly owned subsidiaries which will be responsible for securing the necessary clearances as well as fuel and water linkages for each project, thereby mitigating development and pre-construction risks. These SPVs will then be transferred to successful bidders selected through a tariff-based international competitive bidding process.

Earns fees as nodal agency for UMPPs

The company has already transferred three UMPPs, namely Sasan Power, Mundra Power and Krishnapatnam Power in FY08. It is expected to transfer the Tilaya UMPP in Q4FY09 and two more in FY10. Consequently, we expect fee income of Rs 150mn in Q4FY09 and Rs 300mn in FY10. Fees from the Tilaya project will be booked in PFC's account while the others will be booked in its wholly owned subsidiary PFC Consulting.

UMPP status

Project	Capacity (MW)	Location	Fuel	Status
Sasan Power	6×660	Madhya Pradesh	Indigenous coal	Awarded in Q1FY08
Mundra Power	5×800	Gujarat	Imported coal	Awarded in Q2FY08
Krishnapatnam Power	5×800	Andhra Pradesh	Imported coal	Awarded in Q4FY08
Tilaya UMPP	5×800	Jharkhand	Indigenous coal	To be awarded in Q4FY09
Tamil Nadu UMPP	5×800	Tamil Nadu	Imported coal	Expected in FY10
Orissa UMPP	5×800	Orissa	Indigenous coal	Expected in FY10
Akaltara Power	5×800	Chhattisgarh	Indigenous coal	
Coastal Maharashtra Mega Power	5×800	Maharashtra	Imported coal	
Coastal Karnataka Power	5×800	Karnataka	Imported coal	

Source: Company, RHH

Appointed as facilitator for two transmission projects

To attract private sector investments in major transmission projects, the government has initiated a scheme where private developers would become transmission providers on a 'build, own and operate' basis. PFC has been appointed as nodal agency in two of the four transmission projects identified by the government – East-North Interconnection Project and Bokaro-Kodarma-Maithon Transmission Project. The company has already established two project-specific SPVs for the same.

PFC is also the nodal agency for APDRP, a government initiative to hasten distribution reforms and improve the financial viability of state power utilities, and will receive fee income equal to 1% of loans sanctioned in both phase A and phase B of APDRP.

Foray into consultancy services with projects worth Rs 376mn won in FY08

Capitalising on its domain experience to provide consulting services

PFC has further ventured into providing consultancy services to power utilities, state electricity regulatory commissions and governments through its subsidiary, PFC Consulting. During FY08, the company received nine consulting projects worth Rs 376mn, which include assisting the Jharkhand State Electricity Board (JSEB) and Rajasthan Rajya Vidyut Prasaran Nigam in selection of developers through a tariff-based competitive bidding process. PFC booked income of Rs 142mn from consulting assignments in FY08. We expect consulting income of Rs 100mn–150mn each in FY09 and FY10.

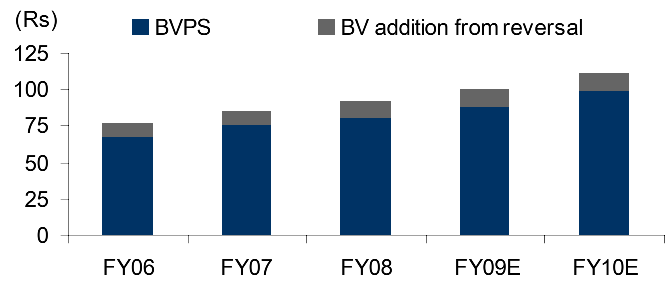
Positive tax ruling to act as catalyst

PFC, being a long-term financier to infrastructure projects, is eligible for tax exemption on up to 20% of the profits derived from the financing business (40% till FY07), upon transfer of these profits to a special reserve. The aggregate amount of this reserve cannot exceed twice the amount of paid up share capital and general reserve. The company is, however, providing for tax on this deduction by creating a deferred tax liability, following objections raised by the auditors in FY05.

Positive outcome on tax claim would add Rs 14.4bn in net worth

Consequently, its tax rate stands at 33% instead of 27% for other infrastructure companies. The issue of availability of these tax benefits is under consideration with the ICAI. In case of a favourable outcome for PFC, the company's tax rates for future years will reduce and the deferred tax provision will be reversed. This will add Rs 14.4bn in net worth for PFC in FY10 (Rs 12/share).

Reversal of deferred tax liability to add Rs 12 to book value in FY10E



Source: Company, RHH

To pick up 17% stake in power exchange

Agreement with TCS, NTPC and NHPC for set up of a power exchange

PFC has entered into an agreement with Tata Consultancy Services (TCS), National Thermal Power Corporation (NTPC) and National Hydroelectric Power Corporation (NHPC) for incorporation of a joint venture to set up and operate a power exchange with an authorised capital of Rs 500mn. TCS will hold 50.02% and the rest will be equally held by the other three companies. However, this venture is still at a very nascent stage and therefore will not influence earnings over the next few years.

Financial overview

Net revenues to grow at 18% CAGR over FY08-FY10

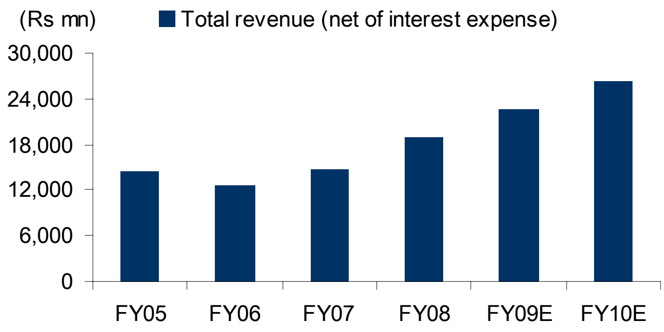
We believe that PFC will continue to witness traction in the power financing business given the huge investments expected in the sector. We expect the company's loan disbursement to grow at a 19% CAGR over FY08-FY10 to Rs 230bn, driven by robust sanctions over the last few years (outstanding sanctions of Rs 1.1tn to be disbursed as on December 31, 2008). Loan repayment will remain in the 14–15% range, lower than the average rate of 19% over FY04-FY08 due to longer-term loans disbursed in the last few years. Consequently, the company's loan asset base is expected to grow at a 22.3% CAGR over FY08-FY10 to Rs 772bn.

NII to log 19% CAGR over FY08-FY10 to Rs 25.1bn

With decline in interest rate, incremental spreads of PFC currently stand at 3-4% which will help in maintaining spreads at ~2.3-2.4% for FY10E. Consequently, net interest income (NII) is expected to log a 19% CAGR over FY08-FY10 to Rs 25.1bn.

PFC will also generate fees from its role as nodal agency to facilitate development of UMPPs, and from consultancy services provided to state utilities. We expect the company to transfer the Tilaya UMPP in Q4FY09 and two more UMPPs in FY10, thereby generating fees of Rs 450mn–500mn in the next 12–18 months. The company is also expected to earn consulting fees of Rs 100mn–150mn each in FY09 and FY10.

Net revenue growth over FY08-FY10



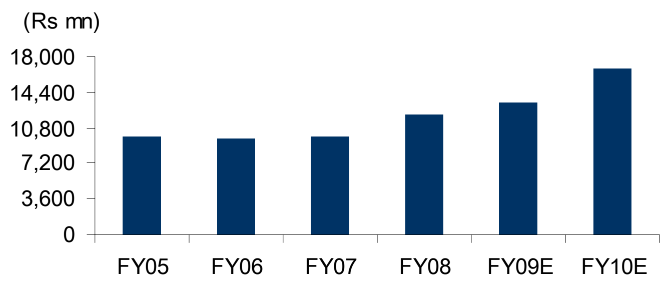
Source: Company, RHH

PAT to grow at 18% CAGR over FY08-FY10

PAT (excluding exchange gain or loss) to grow at 16% in FY10

PFC's profit growth in FY09 is likely to be muted at 10% due to an expected notional mark-to-market loss of Rs 1.6bn (net of tax benefits) on its unhedged foreign currency borrowings (compared to a loss of Rs 150mn in FY08). Adjusting for the notional loss, the company is expected to report a PAT of Rs 14.9bn in FY09, a 22% YoY growth. FY10 profits are expected to grow at 13% to Rs 16.8bn. We are not factoring in any mark-to-market gain or loss in FY10 at present.

Trend in profitability



Source: Company, RHH

Valuation

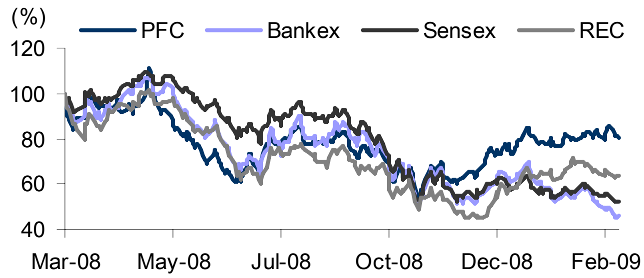
We like PFC due to its superior domain knowledge and strategic positioning in the Indian power sector. Massive investments anticipated in the sector provide high visibility to growth in its loan book and profitability. We expect the company's loan portfolio to clock a 22% CAGR over FY08-FY10 with a PAT CAGR of 18% over the same period.

Premium valuation justified by high growth visibility, better asset quality and higher ROA

Target valuation of 1.5x FY10E BV – a premium to PSUs

We have valued the company at Rs 145 assuming a cost of equity of 14% and stable ROE of 18% (stable ROA of 2.25% and leverage of 8x). At our target valuation, the stock will trade at 1.5x FY10E book value – a premium to public sector banks, which we believe is justified given the high visibility to growth over the next 3–5 years, better asset quality and higher ROA stemming from stronger operating efficiencies. But considering the limited pricing upside from current levels, we initiate coverage on the stock with a Hold rating. We note that a favourable decision on the reversal of deferred tax liability by the ICAI will act as a catalyst for the company. If we were to take into account the deferred tax liability, our target price would stand at Rs 161, ~11% higher than our current target.

PFC has outperformed BSE Bankex in the last 12 months



Source: RHH

PFC trading at a premium to REC

PFC has traded at an average premium of ~22% over REC since listing in March '08 and is currently trading at a 28–30% premium to the latter's valuation of 0.9x FY10E BV. PFC has better asset quality as its loan book consists mainly of generation projects (as against T&D projects for REC) and ~95% of its loans are covered under the escrow mechanism (compared to ~70% for REC). Further, being highly leveraged, REC may need to raise capital in FY10 or FY11. However, REC will continue to post a stronger ROE in FY09 and FY10 due to better interest margins and higher leverage. Consequently, we believe that it should trade at a lower discount of 15–20% to PFC.

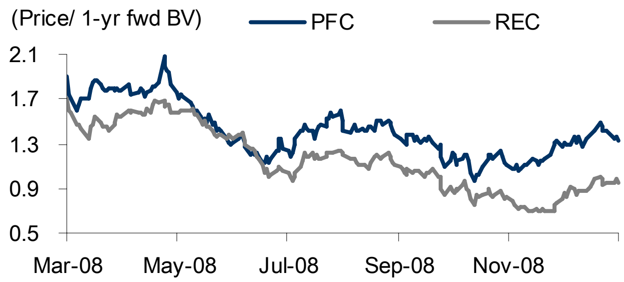
Valuation premium of 15–20% to REC justified due to better asset quality

Comparative valuation – PFC and REC

Company	Price (Rs)	Market Cap (Rs mn)	P/BV (x) FY09E	P/BV (x) FY10E	P/ABV* (x) FY09E	P/ABV* (x) FY10E	P/EPS (x) FY09E	P/EPS (x) FY10E
PFC	129	148,234	1.5	1.3	1.3	1.2	11.2	8.8
REC	79	67,662	1.1	0.9	0.9	0.8	5.6	4.9

Source: Company, RHH ** Adj. for reserves created for deferred tax liability*

PFC has traded at a premium to REC



Source: Company, RHH

Key risks

Vulnerable to an asset-liability mismatch as well as project delays

- PFC is subject to risks arising from an asset-liability mismatch as a majority of its loans are long-term in nature due to wholesale financing of large power projects whereas its borrowings are of a relatively short tenure.
- The company is exposed to project-specific risks inherent to the power sector. Any delay in the power projects due to lack of fuel supplies or supply of key equipment may result in delays in loan disbursal or slippages.
- Being a specialised financier lending to major power projects, the ticket size of loans disbursed by PFC is large. Though the company's gross NPAs are currently at a low level, any major slippages or ineffective recoveries can raise NPAs significantly.
- PFC has significant exposure to a few state power utilities which are financially weak due to heavy T&D losses and lower realisations per unit. Though state guarantees and the escrow mechanism provide comfort on the asset quality front, any slippages or loan restructuring will considerably increase NPAs.

Access to tax-free bonds presents an upside risk

- A key upside risk is the availability of tax-free bonds to PFC. Access to such bonds will lower the overall cost of funds and help the company to maintain its interest spreads and to post higher profitability.

Company profile

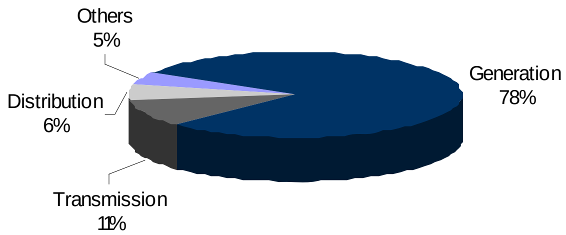
Key player in government's power sector development plan

Incorporated in 1986, Power Finance Corporation (PFC) is a leading public institution primarily involved in the financing of power projects across India and a strategic player in the government's plan to develop the country's power sector. The company provides long-term, short-term and working capital loans to power utilities (state, central and private sector) and power equipment manufacturers. As on December 31, 2008, loans to state and central power utilities comprised ~88% of its total loan assets whereas private sector utilities constituted 7% and the rest is contributed by joint ventures.

PFC has witnessed strong traction in loan sanctions over FY05-FY08 due to the government thrust on boosting India's power generation capacity and improving transmission and distribution (T&D) infrastructure. The company has sanctioned loans worth Rs 1.7tn over FY06-9MFY09 and has outstanding sanctions of over Rs 1.1tn to be disbursed in the next few years. Loan assets have logged a 20% CAGR over FY03-FY08 to Rs 516bn and stand at Rs 604bn at the end of Q3FY09. The company is the preferred lender to generation projects (while REC garners a higher share of T&D projects), which constitute ~78% of the total loan book as on December 31, 2008.

Preferred lender to generation projects

Loan book composition by project type

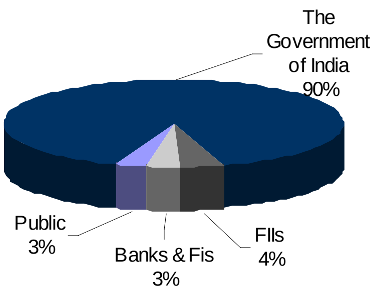


Source: Company

Nodal agency for government power programmes

PFC is promoted by the government of India which holds 89.8% as on December 31, 2008. The company has been appointed as nodal agency to facilitate development of Ultra Mega Power Projects (UMPPs) with a capacity of 4,000MW each and for development of transmission projects by private developers on a 'build, own and operate' basis. It is also the nodal agency for the ARDRP (along with REC), a government initiative to improve the financial viability of state power utilities. This apart, it provides consultancy services to power utilities, state electricity regulatory commissions and governments through its wholly owned subsidiary PFC Consulting.

Shareholding pattern



Source: Company

Standalone financials

Profit and Loss statement

Y/E March (Rs mn)	FY07	FY08	FY09E	FY10E
Interest earned	37,767	49,310	61,603	75,832
Interest expended	23,621	31,506	39,863	50,762
Net interest income	**14,146**	**17,804**	**21,740**	**25,070**
Non-interest income	494	1,090	984	1,264
Operating expenses	663	973	997	1,157
Pre-provisioning profits	13,978	17,922	21,727	25,177
Provisions & contingencies	(49)	(105)	18	98
PBT	14,026	18,026	21,709	25,079
Income tax, Interest tax	4,894	5,859	6,838	8,276
Net profit	9,132	12,168	14,871	16,803
Extraordinaries (net of tax)	730	(100)	(1,608)	-
Reported PAT	**9,862**	**12,068**	**13,263**	**16,803**

Balance sheet

Y/E March (Rs mn)	FY07	FY08	FY09E	FY10E
Cash and Bank balances	5,077	6,745	7,066	6,076
Loans and Advances	10,065	12,592	14,679	16,772
Other current assets	11,061	10,559	13,469	16,655
Investments	589	656	616	636
Advances	439,028	515,683	631,315	771,632
Net Block (inc CWIP)	815	770	758	748
Total assets	**466,634**	**547,005**	**667,904**	**812,518**
Share Capital	11,478	11,478	11,478	11,478
Reserves & surplus	74,453	81,821	89,712	101,144
Net Worth	85,931	93,298	101,190	112,621
Unsecured Loans	335,842	406,478	515,049	642,422
Current Liabilities	11,879	12,125	15,354	19,021
Provisions	9,240	12,033	13,866	15,899
Deferred Tax liability	11,426	12,402	13,278	14,387
Interest subsidy fund	12,316	10,668	9,168	8,168
Total liabilities	**466,634**	**547,005**	**667,904**	**812,518**

Y/E March (Rs mn)	FY07	FY08	FY09E	FY10E
Disbursements	311,303	694,928	521,196	599,375
Growth (%)	*38.3*	*123.2*	*(25.0)*	*15.0*
AUM	140,547	162,072	191,437	229,963
Growth (%)	*20.3*	*15.3*	*18.1*	*20.1*

Per share data

Y/E March	FY07	FY08	FY09E	FY10E
Shares outstanding (mn)	1,147.8	1,147.8	1,147.8	1,147.8
FDEPS (Rs)	8.6	10.5	11.6	14.6
DPS (Rs)	2.3	3.5	4.0	4.0
Book value (Rs)	74.9	81.3	88.2	98.1
Adjusted book value (Rs)*	84.8	92.1	99.7	110.7

** Adj. for reserves created for deferred tax liability*

Key ratios

Y/E March (Rs mn)	FY07	FY08	FY09E	FY10E
Valuation ratios (x)				
P/E	15.0	12.3	11.2	8.8
P/BV	1.7	1.6	1.5	1.3
P/ABV*	1.5	1.4	1.3	1.2
Return Ratios (%)				
Interest spread	2.1	2.2	2.4	2.3
Net interest margin	3.5	3.7	3.7	3.5
Yield on assets	9.4	10.0	10.6	10.7
Cost of funds	7.3	8.0	8.2	8.4
Non-int Inc/ Total income	3.4	5.8	4.3	4.8
Opex cost/ Total income	4.2	4.6	4.5	4.8
RoE Calculation (%)				
Net interest income/assets	3.5	3.7	3.7	3.5
Non interest income/assets	0.1	0.2	0.2	0.2
Net revenues/Assets	3.6	3.9	3.9	3.7
Operating expense/Assets	(0.2)	(0.2)	(0.2)	(0.2)
Taxes/Assets	(1.2)	(1.2)	(1.2)	(1.2)
Extraordinaries/Assets	0.2	(0.0)	(0.3)	-
ROA	2.5	2.5	2.3	2.4
Equity/Assets	19.3	18.5	16.8	15.1
ROAE	12.7	13.5	13.6	15.7
Growth ratios (%)				
Net interest income	16.6	25.9	22.1	15.3
Non-interest Income	0.7	120.8	(9.8)	28.4
Total income	15.9	29.1	20.3	15.9
Pre-provisioning profit	16.0	28.2	21.2	15.9
Net profit (excl extraord.)	(2.1)	33.2	22.2	13.0
Reported profit	1.6	22.4	9.9	26.7
EPS	(8.8)	22.4	9.9	26.7
Book value	11.2	8.6	8.5	11.3
Adjusted Book value	10.5	8.6	8.3	11.0
Asset quality (%)				
Gross NPA	0.1	0.0	0.0	0.0
Net NPA ratio	0.1	0.0	0.0	0.0

Quarterly trend

Particulars	Q1FY08	Q2FY08	Q3FY08	Q4FY08	Q1FY09	Q2FY09	Q3FY09
NII (Rs mn)	4,147	4,470	4,640	4,850	5,140	5,420	5,610
YoY Growth (%)	*37.5*	*38.0*	*42.3*	*4.7*	*23.9*	*21.3*	*20.9*
QoQ Growth (%)	*(10.5)*	*7.8*	*3.8*	*4.5*	*6.0*	*5.4*	*3.5*
Total income (Rs mn)	4,284	4,590	4,760	5,170	5,220	5,660	5,720
YoY Growth (%)	*39.5*	*38.7*	*43.4*	*7.5*	*21.8*	*23.3*	*20.2*
QoQ Growth (%)	*(11.0)*	*7.1*	*3.7*	*8.6*	*1.0*	*8.4*	*1.1*
PPP (Rs mn)	4,168	4,430	4,540	4,813	5,047	5,430	5,490
YoY Growth (%)	*40.9*	*39.3*	*41.4*	*3.9*	*21.1*	*22.6*	*20.9*
QoQ Growth (%)	*(10.0)*	*6.3*	*2.5*	*6.0*	*4.9*	*7.6*	*1.1*
Adj net profit (Rs mn)	2,779	2,981	3,189	3,225	3,367	3,860	3,781
YoY Growth (%)	*60.5*	*36.7*	*44.0*	*5.6*	*21.1*	*29.5*	*18.6*
QoQ Growth (%)	*(9.0)*	*7.3*	*7.0*	*1.1*	*4.4*	*14.7*	*(2.1)*

Company profile

Power Finance Corporation (PFC) is a leading public institution primarily involved in the financing of power projects across India. The company provides long-term, short-term and working capital loans to power utilities (state, central and private sector) and power equipment manufacturers. PFC is promoted by the government of India (which holds an 89.8% stake) and plays a strategic role in the government's plan to develop the country's power sector.

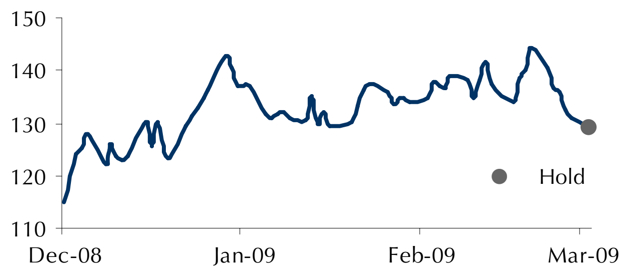
Shareholding pattern

(%)	Jun-08	Sep-08	Dec-08
Promoters	89.8	89.8	89.8
FIIs	4.2	4.4	4.2
Banks & FIs	2.3	2.6	3.1
Public	3.8	3.3	2.9

Recommendation history

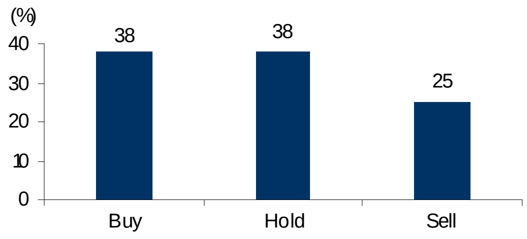
Date	Event	Reco price	Tgt price	Reco
12-Mar-09	Initiating Coverage	129	145	Hold

Stock performance

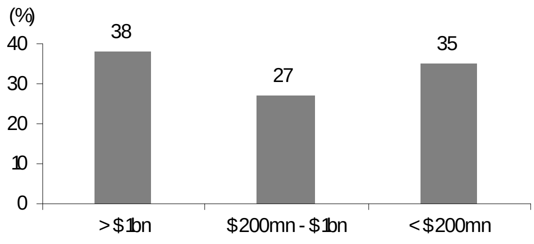


Coverage Profile

By recommendation



By market cap (US$)



Recommendation interpretation

Recommendation	Expected absolute returns (%) over 12 months
Buy	More than 15%
Hold	Between 15% and –5%
Sell	Less than –5%

Recommendation structure changed with effect from March 1, 2009

Expected absolute returns are based on share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst's discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

Religare Capital Markets Ltd

4th Floor, GYS Infinity, Paranjpe 'B' Scheme, Subhash Road, Vile Parle (E), Mumbai 400 057.

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