

JUNE 28, 2011

UPDATE

 Coverage view: **Cautious**

 Price (Rs): **24**

 Target price (Rs): **30**

 BSE-30: **18,412**

Attractive valuations, improving pace of execution. We reiterate our BUY rating on NHPC, as the CMP offers an attractive entry point with 30% upside to our target price of Rs30/share and reasonable trading multiples—0.9X P/B and 10X P/E on FY2013E. We are encouraged by the improved run-rate of capex that will likely translate into timely execution, even as we draw comfort from low-cost hydro generation that insulates the company from coal availability as well as offtake risk.

Company data and valuation summary

NHPC				Forecasts/Valuations		
Stock data		2011	2012E	2013E		
52-week range (Rs) (high,low)	34-22	EPS (Rs)	1.3	1.9	2.3	
Market Cap. (Rs bn)	289.1	EPS growth (%)	(27.2)	39.6	20.8	
Shareholding pattern (%)		P/E (X)	17.4	12.5	10.3	
Promoters	86.4	Sales (Rs bn)	49.6	58.8	69.1	
FIs	1.7	Net profits (Rs bn)	16.6	23.2	28.0	
MFs	0.6	EBITDA (Rs bn)	34.5	46.9	56.0	
Price performance (%)	1M	3M	12M	EV/EBITDA (X)	12.9	8.8
Absolute	(5.4)	0.4	(17.5)	ROE (%)	6.3	8.2
Rel. to BSE-30	(6.2)	2.6	(21.3)	Div. Yield (%)	1.8	2.2
					2.6	

Valuation attractive; CMP ascribes no value to growth portfolio

NHPC offers a stable stream of operational cash flows driven by regulated returns on 5,270 MW of operational capacity (valued at Rs12.5/share) while investment and cash and equivalents account for another Rs11/share. The current market price, thus, implies limited value to the growth portfolio aggregating to 4.5 GW of capacity already under advance stages of construction. NHPC is trading at attractive valuations of 0.9X FY2013E book and 10X on FY2013E EPS and offers a stable stream of operational cashflow driven by regulated returns on 5,270 MW of operational capacity. We reiterate our BUY rating on NHPC with a target price of Rs30.

Uptick in capex run rate encouraging, commissioning could drive stock performance

NHPC has significantly upped its capex run rate with an estimated consolidated capex of Rs47 bn in FY2011 against Rs33 bn in FY2010. In our view, this signals an uptick in execution and augurs well for estimated capacity addition of 3.2 GW (effective) in FY2012-14E period. NHPC has just added 120 MW (Sewa II) in the past four years and, in our view, the incremental commissioning of capacities in the next few years could be a strong catalyst for the stock as it would restore investor faith in NHPC's delivery credentials which has admittedly taken a hit due to this long draught of capacity addition. We, however, do not rule out marginal slippages in commissioning owing to uncertainties inherent in the implementation of hydropower projects and highlight this as a key risk to our earnings and valuation estimates.

Recently introduced water charges likely to be a pass through

Jammu and Kashmir Government, as per the provisions of J&K Water Resources Act 2010, has started levying charges for usage of water in the state which directly impacts the hydro plants located in J&K. NHPC made a provisioning of Rs1.4 bn in FY2011 towards water charges payable to the state government. However, the management has indicated that it is confident of getting this charge approved by CERC and accordingly passed on to the beneficiaries. Current CERC regulations allow for pass through of taxes on raw materials for thermal power projects and any charge on usage of water should come under the ambit of raw material tax and should be a pass through, in our view.

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RoE to improve as capacities come on stream

NHPC earns effective yield on operational equity of 18-20% compared to the 15.5% RoE assured under the CERC-based tariff guidelines. The incremental returns are contributed by capacity incentives and savings, secondary energy sale and unscheduled interchange charges. However, large investments in low-income yielding treasury bonds and capital work in progress for future development projects draw down the overall return profile for NHPC. We note that as the projects commission, a bulk of CWIP will convert into return-yielding operational equity thus giving a boost to NHPC's overall RoE. We estimate NHPC's RoE to increase from extant levels of 6.5% to 10.6% by FY2015E.

Relatively better placed to weather the macro headwinds

Hydro generation insulates NHPC from any adverse movement in either pricing or availability of fuel—a macro concern across most other utilities in the generation space. NHPC's generation is contingent on external factors such as water flow, though risk to earnings is limited since NHPC sells through regulated route under a cost-plus environment. Further, offtake risk is limited for NHPC as hydro-based generation makes NHPC one of the lowest cost producers of power in India. Deteriorating financials of State Electricity Boards (SEBs) have raised questions on their ability to buy high-cost power, and NHPC ranks highest in the merit order of dispatch.

Exhibit 1: Our SOTP-based valuation yields a target price of Rs30/share
SOTP, NHPC (Rs mn, Rs/share)

	Value (Rs mn)	Value per share (Rs/share)
SOTP of power projects (Rs mn)	233,854	19
Cash (Rs mn)	111,816	9
Investments (Rs mn)	10,219	1
Loans and advances (Rs mn)	17,137	1
Total value (Rs mn)	373,025	30

Source: Kotak Institutional Equities estimates

Exhibit 2: NHPC is trading at 0.9X P/B on FY2013E net worth
Valuation of NHPC at CMP.

	2010	2011	2012	2013	2014	2015	2016
Valuations (at CMP)							
			533096-IN				23.4
No. of shares	12,301	12,301	12,301	12,301	12,301	12,301	12,301
Book value (Rs)	20	22	23	25	27	29	31
Networth	241,564	264,625	282,732	303,479	326,832	351,605	377,703
Market cap	287,837	287,837	287,837	287,837	287,837	287,837	287,837
P/B (X)	1.2	1.1	1.0	0.9	0.9	0.8	0.8
EPS	1.9	1.3	1.9	2.3	2.3	2.8	3.1
P/E (X)	13	17	12	10	10	8	8
RoE (%)	10	7	9	10	9	11	11
RoCE (%)	7	5	7	7	8	9	9
Net debt	101,620	125,063	90,459	75,229	50,843	1,515	(51,889)
EV	389,457	412,900	378,296	363,066	338,680	289,352	235,949
EV/EBITDA (X)	9.4	12.0	8.1	6.5	4.7	3.7	3.1

Source: Company, Kotak Institutional Equities estimates

Exhibit 3: Effective RoE to increase as more operational equity replaces CWIP equity
Effective RoE of NHPC (%)

	2010	2011E	2012E	2013E	2014E	2015E
Regulated return on equity (%)	15.5	15.5	15.5	15.5	15.5	15.5
Incremental return						
Capacity incentive and savings	0.1	0.8	1.0	1.3	1.4	1.5
Secondary energy sale	0.5	1.1	1.0	1.0	1.0	1.1
UI	0.9	1.2	1.1	1.1	1.2	1.3
Effective return on operational equity	17.0	18.6	18.6	18.9	19.2	19.3
Return from other income	5.0	5.2	6.6	6.0	5.6	5.8
Effective RoE	10.3	6.8	7.8	8.3	9.5	10.5

Source: Company, Kotak Institutional Equities estimates

Exhibit 4: Execution slippages could be a dampener, though capex incurred comforting
Details of NHPC's projects under construction

	Total capacity (MW)	Design energy (mn units)	COD			Project execution cost (Rs bn)		Remarks
			Initial	Revised	Assumed	Latest	Original	
Teesta Low Dam III	132	594	FY2007	FY2011	Mar-12	14.1	7.7	Work held up at site from May-July 2010 due to local issues. Frequent interruption of work
Teesta Low Dam IV	160	720	FY2010	FY2012	Sep-11	14.6	10.6	Work held up at site from May-July 2010 due to local issues. Frequent interruption of work
Uri II	240	1,124	FY2010	FY2011	Apr-12	17.0	17.2	Work affected by earthquake and landslides
Parbati II	800	3,109	FY2010	XIth plan	Mar-13	40.8	39.2	E&M work on power house has nowbeen resumed
Chamera III	231	1,108	FY2011	FY012	May-11	19.4	14.1	T&G erection for Unit 3 in progress
Nimmo-Bazgo	45	239	FY2011	FY2012	Aug-11	9.1	6.1	Delay in supply of E&M and HM parts by BHEL due to civil disturbance in Kashmir.
Parbati III	520	1,963	FY2011	FY2012	Sep-11	21.0	23.0	Delay in award of E&M contract
Chutak	44	213	FY2011	FY2012	Aug-11	9.8	6.2	Delay in supply of E&M and HM parts by BHEL due to civil disturbance in Kashmir.
Subansiri (Lower)	2,000	7,422	FY2011	XIth plan	Sep-13	81.6	62.9	Plagued by law and order problems
Kishanganga	330	1,350	FY2017	FY2017	Jun-16	36.4	36.4	Progress affected due to civil disturbance in Kashmir
Total	4,502	17,842				263.9	223.4	

Source: CEA, Company, Kotak Institutional Equities

Exhibit 5: Profit model, balance sheet, cash model of NHPC 2008-15E, March fiscal year-ends (Rs mn)

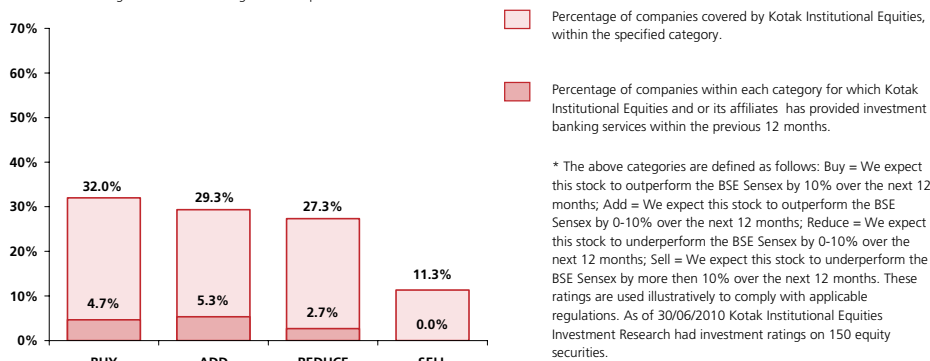
	2008	2009	2010	2011	2012E	2013E	2014E	2015E
Profit model								
Net revenues	29,726	34,767	52,273	49,650	58,828	69,082	89,384	97,133
EBITDA	22,150	23,110	41,290	34,524	46,890	56,043	72,190	77,417
Other income	4,572	5,953	6,473	9,858	12,084	12,868	13,644	14,134
Interest expense	(6,377)	(7,760)	(7,394)	(6,709)	(11,244)	(13,197)	(22,107)	(19,891)
Depreciation	(5,455)	(6,441)	(12,827)	(11,666)	(12,538)	(14,914)	(18,927)	(22,149)
Pretax profits	14,890	14,863	27,542	26,008	35,191	40,800	44,800	49,510
Tax	(1,896)	(1,552)	(3,475)	(6,934)	(7,094)	(8,219)	(9,538)	(10,644)
Deferred taxation	—	—	(1,292)	(1,011)	(2,223)	(1,660)	(3,912)	(1,400)
Minority interest	(1,533)	(1,462)	(1,020)	(1,466)	(2,700)	(2,917)	(2,692)	(2,804)
Net income	11,462	11,849	21,756	16,597	23,173	28,004	28,658	34,663
Extraordinary items	—	—	—	6,565	—	—	—	—
Reported profit	11,462	11,849	21,756	23,162	23,173	28,004	28,658	34,663
Earnings per share (Rs)	1.0	1.1	1.9	1.3	1.9	2.3	2.3	2.8
Balance sheet								
Paid-up common stock	111,825	111,825	123,007	123,007	123,007	123,007	123,007	123,007
Total shareholders' equity	189,310	197,678	251,072	273,880	289,765	308,852	328,293	351,667
Advance against depreciation (AAD)	13,033	14,245	15,398	15,076	13,112	11,968	10,825	9,682
Minority interest	13,968	14,944	15,895	17,357	20,058	22,975	25,667	28,471
Total borrowings	128,555	149,310	163,515	167,716	218,228	216,449	201,581	186,713
Deferred tax liabilities	—	—	2,521	2,774	4,997	6,656	10,568	11,968
Total liabilities and equity	344,865	376,177	448,402	476,803	546,158	566,900	576,935	588,501
Net fixed assets	236,171	238,323	223,016	221,576	269,067	284,109	387,231	365,082
Capital work-in progress	74,098	105,050	140,620	177,427	154,950	150,277	36,824	45,420
Investments	20,468	17,912	33,455	43,194	10,219	7,654	5,090	2,525
Miscellaneous expenses not w/o	3	23	—	—	—	—	—	—
Cash	23,459	26,061	61,895	42,653	127,769	141,220	150,739	185,199
Net current assets (incl. cash)	14,124	14,868	51,311	34,606	111,923	124,860	147,790	175,473
Total assets	344,865	376,177	448,402	476,803	546,158	566,900	576,935	588,501
Free cash flow								
Operating cash flow, excl. working capital	20,594	20,964	39,277	36,223	38,671	46,352	53,046	59,873
Working capital changes	5,017	1,858	(608)	(2,538)	7,799	514	(13,411)	6,777
Capital expenditure	(35,265)	(39,545)	(33,090)	(47,032)	(37,552)	(25,284)	(8,596)	(8,596)
Free cash flow	(9,654)	(16,723)	5,579	(13,347)	8,918	21,582	31,039	58,053
Ratios								
Net debt/equity (%)	0	34	33	26	24	23	21	20
Return on equity (%)	6.7	6.5	10.3	6.6	8.6	9.7	9.3	10.6
Book value per share (Rs)	16	17	20	22	23	25	27	29
ROCE (%)	5.7	5.7	7.4	4.9	6.7	7.4	8.2	9.0

Source: Company, Kotak Institutional Equities estimates

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