# The Tata Power Company Limited

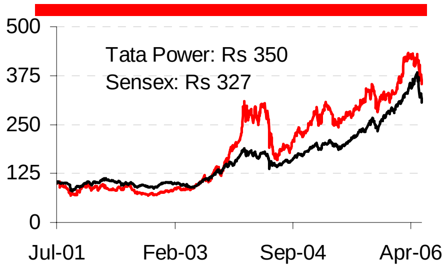
**Buy** **Target price: Rs 630**

### Market data

| | |
|---|---|
| Current price | Rs 476 (BSE) |
| Market cap | Rs 94,199 m |
| Face value (Rs) | 10 |
| FY06 Div/share | 8.5 |
| NSE symbol | TATAPOWER |
| No of shares | 197.9 m |
| Free float | 67.7% |
| 52 week H/L | Rs 613 / 374 |

### Share price chart


### Rs 100 invested is worth




### Shareholding

| Category | (%) |
|---|---|
| Promoters | 32.3 |
| Banks, MFs and FIs | 22.8 |
| FIIs | 21.2 |
| Public | 20.8 |
| Others | 2.9 |
| Total | 100.0 |

### Report prepared by

Quantum Information Services
www.equitymaster.com
info@equitymaster.com

### Investment Rationale

- **Growth plans in place:** Tata Power has lined up large expansion plans in the future, which include the entire spectrum of the power sector – from power generation to transmission and distribution. Apart from the 250 MW addition to generation capacity at Trombay (planned commission in FY09), which will cater to additional power requirement in the Mumbai region, the company has firmed up plans for the following expansion in the future.

  1. A 1,000 MW project in coastal Maharashtra to meet long-term power requirements of Mumbai and Maharashtra. This project is currently in its initial stages, as the company has approached the Maharashtra government for acquisition of land.
  2. Agreement with the Damodar Valley Corporation for setting up a 1,000 MW imported coal based plant at Maithon in Jharkhand. Tata Power has acquired a 74% stake in the venture. The project is likely to be commissioned in FY11.
  3. Constructing, operating and maintaining a 1,171 km 400 kV transmission network, which will transmit 3,000 MW of power from the Tala Hydro Project (THP) in Bhutan to the Delhi distribution area. Notably, TLP is the biggest Indo-Bhutan joint project and is entirely funded by the government of India by way of grants and loans. Tata Power has a 51% stake in the joint venture where the other partner is Power Grid Corporation of India (49% stake). The total cost of the project is nearly Rs 12 bn and Tata Power equity contribution to the venture will be around Rs 1.8 bn (calculated as 30% of 51% of the cost of Rs 12 bn). Return on equity for the same will be capped at 14% as per the electricity commission's norms.

  Apart from these stated plans of enhancement in generation capacity and transmission network, Tata Power has also received the Request for Qualification documents for the Sasan (Madhya Pradesh) and Mundra (Gujarat) ultra mega power projects (3,500 to 3,800 MW each). Towards this, the company had recently signed an agreement with Siemens Power Generation (Germany) and Doosan Heavy Industries & Construction Co. Ltd. (Korea) for design and construction of the projects.

  Overall, excluding the ultra mega power projects, the company has plans of raising its generation capacity by 4,500 MW (over 2,304 MW currently), which will involve an investment of around Rs 180 bn (or Rs 40 m per MW). This expansion shall be funded through a 70:30 mix of debt and equity. Considering strong cash accruals from the Mumbai region and also the US$ 200 m FCCB raised earlier in 2005, we believe that there will not be any major dilution to the company's equity in the future. While we have not factored in any of the abovementioned expansion (excluding the 250 MW increase at Trombay), as execution and timelines are still uncertain, there is an upside to our assumptions to that extent.

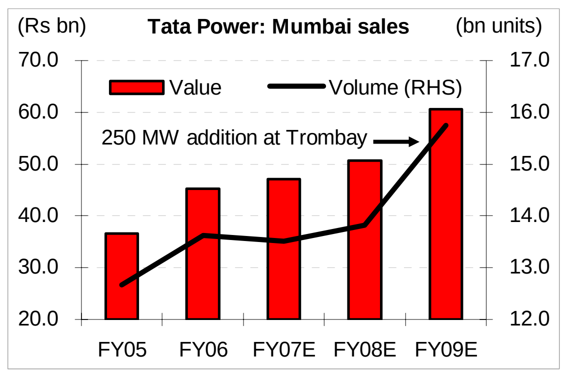
- **Positive strides in distribution:** The North Delhi Power Limited (NDPL), where Tata Power has a 49% stake and Tata Sons has 2% stake, was the company's first venture in retail distribution outside Mumbai. It is performing extremely well. In must be noted that at the time of privatisation of NDPL, the target for reducing the aggregate technical and commercial (AT&C) losses was set at 17%, i.e., to reduce AT&C losses from 48% to 31% within a span of five years (FY03-07). NDPL, under Tata Power, is in line to outperform that target as the AT&C losses have already been reduced to 35% by the end of FY06. Based on our assumptions, we expect these losses to reduce further to 28% levels by FY09. As per the APRDP Act, Tata Power is thus eligible for incentives. Strong reduction in AT&C losses and therefore better collection shall also ensure improved profitability for NDPL. From FY06 levels of 4.9%, we estimate NDPL's operating margins to improve to 8.3% levels by FY09. This period shall also see NDPL increase its contribution to Tata Power's consolidated EBIDTA to 6.6% from 4.0% in FY06.

**NDPL: AT&C Losses**

| | Unit | FY04 | FY05 | FY06 |
|---|---|---|---|---|
| Energy Input | MU | 5,552 | 5,549 | 5,655 |
| Power purchase cost | Rs m | 8,710 | 11,047 | 11,964 |
| Power purchase cost | Rs/kWh | 1.57 | 1.99 | 2.12 |
| Units Billed | MU | 3,196 | 3,667 | 3,845 |
| Units Realised | MU | 3,061 | 3,674 | 3,657 |
| AT&C Loss | MU | 2,491 | 1,875 | 1,998 |
| AT&C Loss | % | 44.9 | 33.8 | 35.3 |

Based on this success of NDPL, Tata Power has applied for parallel distribution licenses in seven areas of MSEB and has also expressed interest in taking franchises in Gujarat for power distribution. These are some positive moves by Tata Power towards establishing it as a major player in the distribution segment that we believe will contribute positively to the company's long-term growth.

- **Assured cash flows in Mumbai:** Supply of power to the Mumbai license area is the core business of Tata Power and contributes to around 85% of the company's power supply business revenues (estimated based on FY06 unaudited numbers). Apart from the over 13,000 m units (MUs) of electricity that it generates internally (66% contribution from the 1,330 MW Trombay thermal power plant), Tata Power also purchases power from other companies like MSEB and Jindal (around 450 MUs purchased in FY06). The available power is sold mainly to utilities like BEST (40% of volume sales), Reliance Energy (30%) and railways (8%). The company supplies around 10 bn units to these bulk customers and the returns are based on the 14% return on equity formula as per the CERC. This assures a steady stream of cash flows to Tata Power, which is also insulated from the loss-making state electricity board (as almost 80% of the power is supplied to the customers indicated above). We expect electricity sales in this region to grow at a rate of 5% per annum over the next three years (as has been the case in the past) and this shall provide Tata Power resources to fund its other growth initiatives in the generation, transmission and distribution spaces. The 250 MW capacity expansion at Trombay, which is likely to be commissioned in FY09 shall also contribute to the company's growth in the Mumbai region.




- **Power focus:** After hiving off Tata Petrodyne in January 2005, in September 2005, Tata Power sold off its stake in Tata Power Broadband (TPB) to VSNL for a consideration of Rs 2.4 bn (TPB had revenues of US$ 11 m in FY05). These moves seem to be in the right direction for Tata Power, as exiting from such non-core businesses shall not only help the company increase its focus on the core area of power (generation, distribution and transmission), but will also free up resources that can be used for future growth. As for its other investments in the telecom sector, the company holds a 40% stake in Panatone Finvest Limited, which is the largest shareholder in the international long distance major, VSNL. Also, the company holds 20% stake in Tata Teleservices and around 11% stake in Tata Teleservices Maharashtra (TTML).

The current value of Tata Power's investments and cash holdings works out to Rs 89 per share. Kindly note that we have excluded the Rs 8.8 bn cash that the company had raised through an FCCB in early 2005, and that is pending complete allocation.

## Comparative Valuations

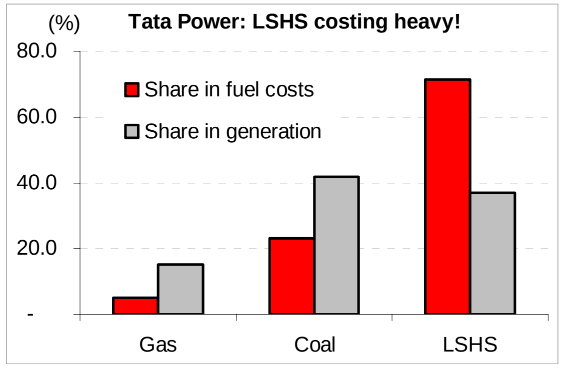
| (FY06) | Tata Power | Rel. Energy | NTPC |
|---|---|---|---|
| Revenue (Rs m) | 56,921 | 40,335 | 269,946 |
| Revenue growth* | 5.7% | 14.7% | 10.5% |
| PAT growth* | 24.0% | 15.5% | 17.3% |
| EBIDTA margins | 17.3% | 18.5% | 29.9% |
| Net profit margins | 13.0% | 16.1% | 21.6% |
| RoCE | 12.5% | 8.0% | 10.2% |
| Return on assets | 9.3% | 4.5% | 7.9% |
| Price to earnings (x) | 12.7 | 14.7 | 16.3 |
| Price to sales (x) | 1.7 | 2.4 | 3.5 |
| Price to BV (x) | 1.9 | 1.2 | 2.1 |

* 3-year CAGR

## Investment Concerns

- **Rising generation costs:** Tata Power's cost of generating electricity has traditionally been on the higher side, as compared to Reliance Energy. As a matter of fact, against Rs 1.18 fuel cost per unit of generation for the latter (for its Dahanu plant), the former's fuel cost at Trombay stands almost double at Rs 2.38 per unit. This has been largely due to Tata Power's use of the relatively expensive fuel like LSHS (low sulphur heavy stock), the price of which is dependent on the movement of global crude prices. While oil (mainly LSHS) constitutes 40% of the fuel mix based on units of generation, it makes up almost 72% of the total fuel costs for the company. Against this, coal forms almost 100% of fuel used at Reliance Energy's Dahanu plant.

  While we expect LSHS' contribution to total fuel cost to decline gradually over a period of time (assuming higher usage of coal by Tata Power), it shall continue to weigh heavy on the per unit fuel cost. This shall consequently suppress the overall margins of Tata Power. We have assumed consolidated operating margins to decline from 17.3% in FY06 to 16.3% in FY08. In breaking up operating margins for the Mumbai and Delhi power supply businesses, while the former is expected to see margins decline from 20.9% in FY06 to 19.7% in FY07, the latter's margins are estimated to improve from 4.9% in FY06 to 6.6% in FY08, mainly due to improved billing and realisations.




- **Issues of standby charges:** There is a long-standing dispute between Tata Power and Reliance Energy regarding the sharing of standby charges payable to MSEB for the standby support of 550 MVA given by MSEB to Tata Power. The dispute dates back to FY99 over sharing of standby charges of Rs 330 m per month payable to MSEB (Rs 3.9 bn per annum). MERC (Maharashtra Electricity Regulatory Commission) has now passed an order whereby an amount of Rs 3.2 bn was directed to be refunded by Tata Power to Reliance Energy against standby charges, together with an interest at the rate of 10% per annum commencing April 2004 till the date of payment. Add to this, the company is liable to pay MSEB Rs 2.3 bn towards interest and delayed payment charges. Also, the MERC has directed Tata Power to share standby charges payable to MSEB with Reliance Energy in the ratio of around 77:23, from the earlier ratio of 50:50. To this, the company has filed an appeal in the Supreme Court and is awaiting judgement. Now, since MERC has allowed Tata Power to set off these amounts against certain Statutory Reserves created by the company under the Electricity (Supply) Act of 1948, profits are unlikely to be impacted. However, the book value will reduce by this set-off. Since this issue is still under judicial consideration, we have not factored the same in our estimates.

## Background

Tata Power Company is the largest private player in the power sector with a generation capacity of 2,304 MW, which is around 19% of the total power generation capacity of the private sector in India. The Mumbai region constitutes around 85% of the company's power supply business revenues (estimated based on FY06 unaudited numbers).

Apart from power generation, the company also has interest in areas like transmission and distribution, power trading and telecom. During the period between FY02 and FY06, TPC's consolidated revenues and profits have grown at compounded rates of 10% and 11% respectively. During the same period, the company's generation has grown at a CAGR of 4%.

## Industry Prospects

As per estimates, India has to generate an incremental 10,000 MW capacity per year for the next 10 years to plug the demand supply gap. The government has outlined a plan, which envisages addition of 100,000 MW of generation capacity by 2012 (as well as an additional 50,000 MW power from hydel projects). Apart from the generation initiative, focus will be also on improving the T&D versus generation infrastructure ratio, from the abysmal 0.3 currently, to a global benchmark of 1:1. Rural electrification continues to get a boost in each passing budget. Though the track record of execution of such reforms is appalling, the power sector is slowly but surely set for a change. Corporatisation of SEBs and linking profitability to the state government's plan outlay are likely to give some sort of fiscal strength to the key sector participants in the long run. To that extent, we are cautiously optimistic on the sector's progress in the years to come.

## Risk Matrix

**Sector:** The power industry in India had been mired in huge regulatory hurdles in the pre-Electricity Act 2003 period. However, the act has given a sense of relief to power sector companies, by encouraged investments. Though the track record of execution of such reforms is appalling, the power sector is slowly but surely set for a change. Corporatisation of SEBs and linking profitability to the state government's plan outlay are likely to give some sort of fiscal strength to the key sector participants in the long run. We are enthused by the direction as opposed to the pace of progress, as this can be unpredictable. However, considering the execution risks involved, we give a medium risk rating of 5 to the sector.

**Sales:** Tata Power generated average revenues to the tune of nearly US$ 1 bn per annum in the past five years. Further, in the latest fiscal (FY06), the company generated US$ 1.3 bn in revenues. Based on our parameters, we assign a low-risk rating of 7 to the stock.

**Current ratio:** Tata Power's average current ratio during the period FY02 to FY06 has been 1.6 times. This indicates that the company is comfortably placed to pay off its short-term obligations, which gives comfort to its lenders. We assign a medium-risk rating of 5.

**Debt to equity ratio:** A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. Especially for power sector companies, who generally fund capex through a 70:30 ratio of debt to equity, any deviation in execution can cost heavy. Considering the company's average debt to equity ratio of 0.7 over the past five fiscals, we have assigned a medium-risk rating of 5 to the stock.

**Long term EPS growth:** Tata Power has grown its net profits at a CAGR of 11% in the past five years. However, on the back of pressure on margins due to higher fuel and power purchase costs, we expect net profits to clock a 4% CAGR during the next five years (without factoring new investments/acquisitions). As such, the rating assigned to the stock on this factor is 2.

**Dividend payout:** A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. Tata Power's average payout ratio has been 26% over the past 5 fiscals. Thus, we have assigned a low-risk rating of 7.

**Promoter holding:** A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of March 2006, the promoter holding in Tata Power stood at 32.3%, which is healthy. We have assigned a medium-risk rating of 5 to the stock.

**FII holding:** We believe that FII holding of greater than 25% can lead to high volatility in the stock price. The FII holding in Tata Power at the end of March 2006 stood at 21.2%. Based on our parameters, the rating assigned is 5.

**Liquidity:** The average daily trading volumes of Tata Power's stock over the past 5 years stand at over 400,000 shares. Such high liquidity levels give us comfort with respect to stability in the stock's valuations. The rating assigned is 10.

**Margin of safety:** This is to determine the value of the stock relative to its price and the returns over a risk free rate. Margin of safety of a stock lies in its earning power, which is calculated as EPS divided by market price (reciprocal of P/E). Considering Tata

Power's P/E of 12.7 times its FY06 earnings, the earning power is 7.9%. This is close to the yield on 10-year paper. Thus, the rating assigned is 2.

**Considering the above parameters, the total ranking assigned to the company is 53. This makes the stock a medium-risk investment from a long-term perspective.**

### Risk Matrix

| | High Risk | Medium Risk | Low Risk |
|---|---|---|---|
| Rating | (1 to 3) | (4 to 6) | (7 to 10) |
| Sector | High | Medium | Low |
| Sales (US$ m) | < 500 | 501 - 1,000 | > 1,000 |
| Current Ratio (x) | < 1 | 1 - 2 | > 2 |
| Debt to equity ratio (x) | > 1 | 0.5 - 1 | < 0.5 |
| Long term EPS growth (%) | < 10 | 10 – 20 | > 20 |
| Dividend Payout (%) | < 15 | 15 - 25 | > 25 |
| Promoter holding (%) | < 25 | 25 - 40 | > 40 |
| FII holding (%) | > 25 | 10 – 25 | < 10 |
| Liquidity (Nos. '000) | < 100 | 100 - 200 | > 200 |
| Margin of Safety (%) | < 3 | 3 - 6 | > 6 |
| Final Rating | < 30 | 30 - 60 | > 60 |

### Valuations

We have done a discounted cash flow (DCF) calculation for arriving at a value for Tata Power's core distribution business. Through this model, Tata Power's power distribution business is valued at Rs 541 per share. As for the company's other investments, we have valued them on book value (except the investment in TTML, which is valued at the current market price), and the total investment value thus arrived is Rs 17.6 bn, or Rs 89 per share.

Thus, the fair value of Tata Power works out to be Rs 630 per share. This is around 33% higher than the current market price of Rs 476. Investors should note that this value is without considering the dilution in equity on conversion of the US$ 200 m FCCB that the company had issued in February 2005. However, we do not expect the dilution to impact the fair value in a meaningful manner, and to that extent, investors can take their call on the stock.

### Valuation table

| (Rs m) | FY06UA | FY07E | FY08E | FY09E |
|---|---|---|---|---|
| Revenue (Rs m) | 56,921 | 60,223 | 65,063 | 76,795 |
| PAT (Rs m) | 7,426 | 6,189 | 6,394 | 8,272 |
| EPS (Rs) | 37.5 | 31.3 | 32.3 | 41.8 |
| Price to earnings (x) | 12.7 | 15.2 | 14.7 | 11.4 |
| Price to sales (x) | 1.7 | 1.6 | 1.4 | 1.2 |
| Price to BV (x) | 1.9 | 1.8 | 1.7 | 1.5 |

### Over the past few years

| | FY03 | FY04 | FY05 | FY06 |
|---|---|---|---|---|
| Promoter holding (%) | 32.5 | 32.5 | 32.5 | 32.3 |
| Net sales (Rs m) | 48,194 | 50,020 | 49,548 | 56,921 |
| EBDITA margin (%) | 28.4 | 28.6 | 24.0 | 17.3 |
| Net profit (Rs m) | 3,898 | 5,024 | 5,911 | 7,426 |
| Net margin (%) | 8.1 | 10.0 | 11.9 | 13.0 |
| Debt to equity (x) | 0.7 | 0.5 | 0.9 | 0.6 |
| Return on NW (%) | 10.0 | 12.0 | 13.7 | 15.2 |
| Dividend /share (Rs) | 6.5 | 7.0 | 8.4 | 8.5 |

## Financials at a glance

| (Rs m) | FY06UA | FY07E | FY08E | FY09E |
|---|---|---|---|---|
| Sales | 56,921 | 60,223 | 65,063 | 76,795 |
| *Sales growth (%)* | *14.9%* | *5.8%* | *8.0%* | *18.0%* |
| Operating profit | 9,839 | 10,643 | 10,597 | 13,028 |
| *Operating profit margin (%)* | *17.3%* | *17.7%* | *16.3%* | *17.0%* |
| Net profit | 7,426 | 6,189 | 6,394 | 8,272 |
| *Net profit margin (%)* | *13.0%* | *10.3%* | *9.8%* | *10.8%* |
| | | | | |
| **Balance Sheet** | | | | |
| Current assets | 35,720 | 33,124 | 30,182 | 39,166 |
| Fixed assets | 34,672 | 34,558 | 32,787 | 31,860 |
| Investments | 35,000 | 40,000 | 45,000 | 45,000 |
| **Total Assets** | **105,392** | **107,682** | **107,969** | **116,026** |
| | | | | |
| Current liabilities | 19,924 | 20,981 | 23,049 | 26,985 |
| Net worth | 48,333 | 52,547 | 56,853 | 62,923 |
| Loan funds | 29,802 | 26,822 | 20,735 | 18,786 |
| Other Liabilities | 7,332 | 7,332 | 7,332 | 7,332 |
| **Total liabilities** | **105,392** | **107,682** | **107,969** | **116,026** |

## Sector Statistics

| Sales (Rs m) | | Market cap. (Rs m) | | EBDITA margin (%) | | Net profit margin (%) | | Return on NW (%) | |
|---|---|---|---|---|---|---|---|---|---|
| NTPC | 269,946 | NTPC | 948,175 | NTPC | 29.9% | NTPC | 21.6% | **Tata Power** | **15.2%** |
| **Tata Power** | **56,921** | **Tata Power** | **94,199** | Rel. Energy | 18.5% | Rel. Energy | 16.1% | NTPC | 12.9% |
| Rel. Energy | 40,335 | Rel. Energy | 89,249 | **Tata Power** | **17.3%** | **Tata Power** | **13.0%** | Rel. Energy | 8.3% |

**Important Notice:** Quantum Information Services Pvt. Limited (Equitymaster) is an Independent Equity Research Company.

**Disclosure:** The author of this article does not hold shares in the recommended company. QIS does not hold shares in the recommended company.