IDFC SSKI

INDIA RESEARCH

Sector Report

# Power Finance

## *Alleviating 'power'ty*

26 August 2009

BSE Sensex: 15770

**The significant policy focus on reducing the acute power shortage prevalent in the system is driving huge investments into the power sector. This translates into a lucrative opportunity for power financiers like PFC and REC given that power projects typically entail a debt to equity ratio of 3:1. Based on the Rs10.3tn spend on power sector envisaged during the 11th 5-Year Plan period, we arrive at Rs1.3tn of disbursements opportunity for PFC and Rs1.2tn for REC (an aggregate 40% of the estimated debt component). On their part, the lenders are well-placed to capitalize on the prospects owing to competitive funding costs and a lean operating structure. Accordingly, we expect the growth momentum to propel 22-29% CAGR in earnings (pre-exceptional) of PFC and REC over FY09-11. Given the high earnings visibility and improving return ratios, valuations appear attractive. Initiating coverage with an Overweight stance and Outperformer on PFC and REC.**

**High growth visibility:** In view of the acute energy deficits and deficiencies in T&D infrastructure, massive investments are lined up in the power sector during the 11th (Rs10.3tn) and 12th (Rs11.4tn) 5-Year Plans. With rich experience in lending to the sector, PFC and REC are well-positioned to leverage the emergent financing opportunities. Accordingly, we expect 21% and 27% CAGR in disbursements for PFC and REC respectively over FY09-11.

**Earnings momentum to remain strong:** We expect structurally competitive funding costs to support healthy margins for PFC and REC in the near term. Robust business growth and steady margins are likely to propel a 23-28% rise in NII over the period. Also, while superior asset quality will keep credit costs insignificant, operating expenses are likely to be low, and PFC and REC would witness a strong 22% and 29% CAGR in pre-exceptional earnings over FY09-11.

**Attractive valuations; we see 23-30% upside:** Considering the high growth visibility, valuations of 1.8x-1.9x FY11E book are attractive. While PFC has historically traded at a 24% premium to REC, the premium differential has narrowed owing to REC's improving growth prospects, steady margins and a stronger RoE. We are Overweight on the sector with our target prices offering 30% upside on PFC (based on 2.4x FY11E book) and 23% on REC (2.3x) from CMP.

**Valuation metrics**

| Company | Price (Rs) | Mcap (Rs bn) | Reco | EPS# CAGR FY09-11E (%) | FY11E P/BV (x) | FY11E P/E (x) | FY11E RoA (%) | FY11E RoE (%) | Target price (Rs) | Upside (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| Power Finance Corporation | 229 | 264.4 | OP* | 10 | 1.8 | 11.0 | 2.6 | 17.5 | 300 | 30.0 |
| Rural Electrification Corporation | 212 | 181.0 | OP* | 29 | 1.9 | 8.6 | 2.7 | 23.5 | 260 | 22.6 |

**OP - Outperformer; # EPS includes exceptionals*

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# Content

# INVESTMENT ARGUMENT

**The Indian power sector is plagued with massive deficits (11% in FY09) as also inadequate distribution networks. Such shortcomings and relevance of power to the country's economic growth have prompted policymakers to attribute due importance on fortifying the power sector – evident from the high allocation at ~35% of the total spend of the 11th plan. The plan offers a massive debt financing opportunity of Rs7.7tn to power financiers like PFC and REC. We believe the ability to lend higher amounts for a longer term, long-standing client relationships, competitive cost of funds and low operating cost structure place PFC and REC in a position to capitalize on the huge power financing opportunity. Considering the strong growth and high earnings visibility, valuations of 1.8x-1.9x FY11E book appear attractive. We are Overweight on the sector with our target prices offering 30% upside on PFC and 23% on REC.**

## INDIAN POWER SECTOR: HUGE INVESTMENTS REQUIRED…

*Rs10.3tn of funding requirement envisaged for the power sector during the 11th 5-Year Plan*

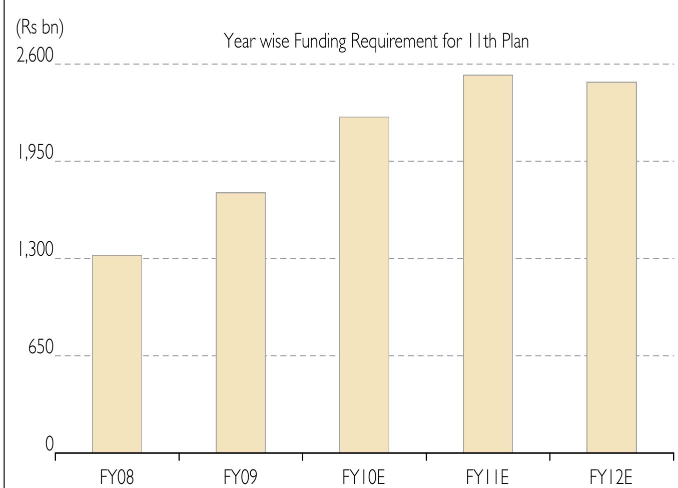
High power deficits and deficiencies in the transmission & distribution (T&D) infrastructure have prompted an aggressive government thrust on the power sector. Accordingly, the 11th 5-Year Plan lays high importance on augmenting the country's generation, distribution and transmission capacity. Notably, ~35% of the total US$500bn spend envisaged during the plan period has been assigned to the sector.

Government estimates peg the investment requirement at Rs10.4tn during the 11th Plan period for the sector. Of this amount, Rs4.1tn will be needed for generation capacity addition, Rs1.4tn for transmission, and Rs2.9tn for distribution.

**Exhibit 1: Funding requirement for 11th Plan***

| (Rs bn) | State | Central | Private | Total |
|---|---|---|---|---|
| Generation including nuclear | 1,238 | 2,021 | 850 | 4,109 |
| Transmission | 650 | 750 | - | 1,400 |
| Distribution including rural electrification | 2,870 | - | - | 2,870 |
| Decentralised Distributed Generation R&M - Renovation and Modernisation | - | 200 | - | 200 |
| R & M | 159 | - | - | 159 |
| HRD | - | 5 | - | 5 |
| R&D outlay | - | 12 | - | 12 |
| Demand Side Management | - | 7 | - | 7 |
| Total power sector | 4,917 | 2,994 | 850 | 8,761 |
| NCES and captive | 225 | - | 930 | 1,155 |
| Merchant plants | - | - | 400 | 400 |
| **Total funds requirement** | **5,142** | **2,994** | **2,180** | **10,316** |

**Total funding required per year**



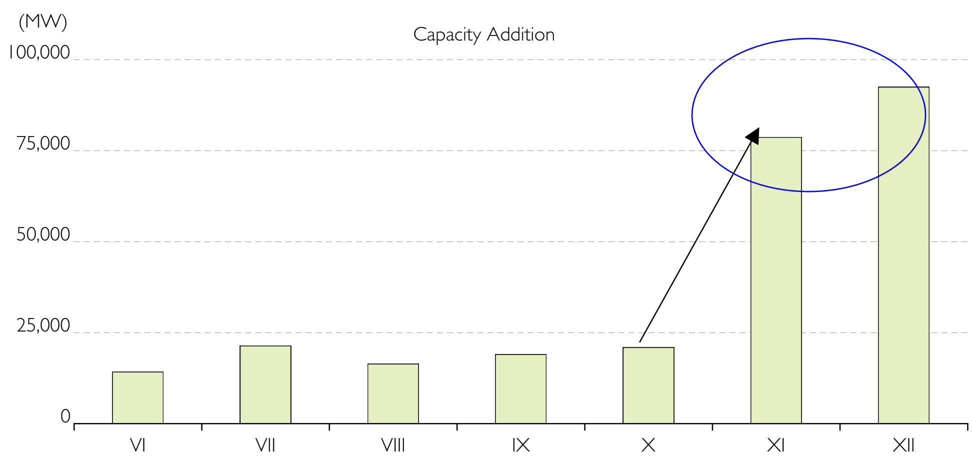

*Source: Ministry of Power; CEA; * CEA estimates dated February 2007*

Huge generation capacity additions lined up over the ongoing and next plan period

## ❑ Aggressive thrust on augmenting power generation capacity

The government has set a target of adding 78,700MW of generation capacity in the 11th Plan (as compared to 21,180MW added in 10th Plan). Government power utilities are expected to contribute 86% of the additions. An additional 12,000MW of generation capacity is expected to flow from captive plants. Another 92.5GW generation capacity addition is envisaged in the 12th 5-Year Plan.

**Exhibit 2: Huge power generation capacity being added over the next 10 years (MW)**



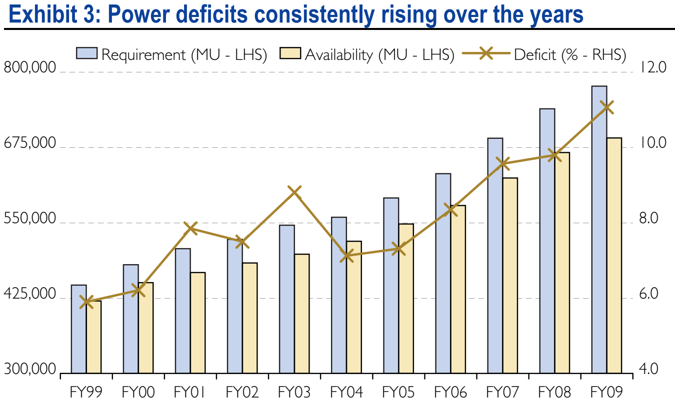

*Source: CEA*

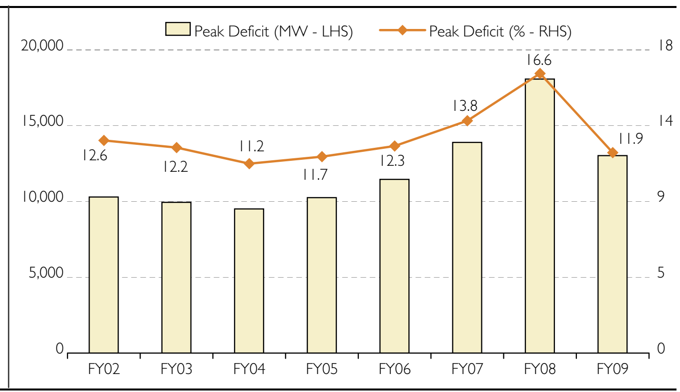
### *Power deficits remain high*

Acute power shortages mandating keen policy focus on the sector

The power industry in India suffers from colossal shortages. According to the Central Electricity Authority (CEA), India's total energy deficit has increased to 85bn units in FY09 (11% of total energy demand) from 73bn units in FY08, with peak deficit at 12% of the peak demand. Rising energy demand and the lack of adequate investments towards generation as also transmission & distribution (T&D) infrastructure have exacerbated the demand-supply gap. Regional deficits are even more chronic with the western region facing peak power shortage of 19%.

**Exhibit 3: Power deficits consistently rising over the years**




*Source: CEA*

### *Investments of Rs4.1tn envisaged*

To reduce the deficits and ensure adequate supply of power, the 11th plan envisages a capacity addition of 3.7x the actual addition in 10th plan. Correspondingly, the plan projects an investment of Rs4.1tn towards the generation segment.

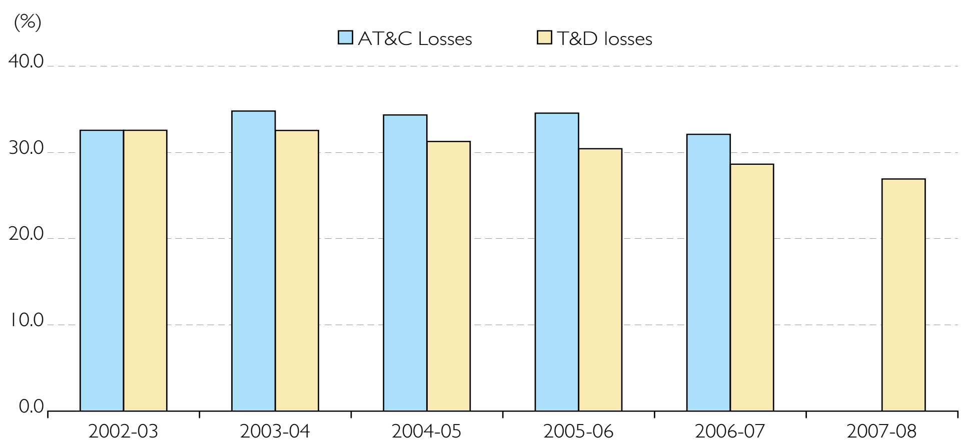
### ❑ …accentuated by deficiencies in the T&D infrastructure

***Investments now flowing into the T&D segment as well***

India's power T&D infrastructure has failed to keep pace with the generation capacity additions. The investment ratio between generation and T&D in India has historically been 1:0.5 against the ideal investment ratio of 1:1. In most states, the existing distribution network has been formed by expanding and interconnecting smaller and disjointed networks. As a result, the T&D system has been plagued by deficiencies – and this leads to high losses and low reliability.

Towards this end, the government has allocated Rs4.3tn for beefing up the transmission and distribution network in the country, and thereby reducing losses in transition.

**Exhibit 4: AT&C losses remain high**




*Source: CEA*

## …HIGH POTENTIAL FOR DEBT FINANCING

***Typical leverage of 3x in power projects; implies debt requirement of Rs7.7tn during the 11th plan***

Power projects require funding for a longer duration of 10-15 years and in large ticket sizes. As such, power projects are typically funded with a debt/equity ratio of 75:25 (i.e. leverage of 3x). Assuming average debt/equity ratio of 75:25 in power projects, 11th plan offers a power financing opportunity of Rs7.7tn over FY08-12. However, CEA estimates put the overall availability of funds only at 56% of the requirement (including allocations to RGGVY and R-APDRP) with a shortfall of ~50% in the debt as well as equity component.

**Exhibit 5: Typically 75:25 debt to equity**

| Project | Total cost (Rs bn) | Debt (Rs bn) | Gearing (x) |
|---|---|---|---|
| Sasan UMPP | 194.0 | 145.5 | 3 |
| Essar Mahan | 48.6 | 36.5 | 3 |
| Reliance Butibori | 18.6 | 15.0 | 4 |
| Lanco Uttrakhand | 5.2 | 4.16 | 4 |
| Reliance Rosa | 27.0 | 20.0 | 3 |

Typical gearing of 3-4 times

Source: IDFC- SSKI Research

**CEA estimates of funding for 11th Plan**

| (Rs bn) | State | Central | Private | Total |
|---|---|---|---|---|
| Funds required | 5,142 | 2,994 | 2,180 | 10,316 |
| Equity required (D/E - 75:25) | 1,285 | 748 | 545 | 2,579 |
| Total equity available* | - | 629 | 654 | 1,283 |
| Additional equity to be arranged | 1,285 | 119 | (109) | 1,296 |
| Debt required (D/E - 75:25) | 3,856 | 2,245 | 1,635 | 7,737 |
| Total debt available* | 1,650 | 1,588 | 479 | 3,717 |
| Additional debt to be arranged | 2,207 | 658 | 1,156 | 4,020 |
| Funding by special schemes | | | | |
| APDRP | 400 | - | - | 400 |
| RGGVY | 400 | - | - | 400 |
| **Total shortfall to be arranged** | **2,692** | **777** | **1,047** | **4,516** |

44% of the total requirement

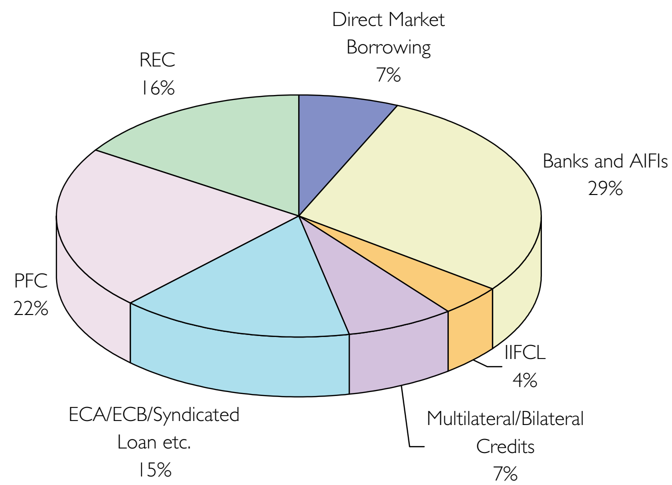
** CEA estimates dated February 2007, later revised to Rs516bn for APDRP and Rs1595 for RGGVY*

***PFC and REC have a distinct edge over other lenders***

## ❑ PFC and REC – expected to contribute 38% of the debt funding

With a CEA estimated market share of 22% and 16% respectively, PFC and REC are projected to disburse 38% of debt funds during the 11th plan. Higher loan/value (LTV) of ~80%, favorable exposure norms, low operating cost structure, ability to lend for a high tenure of more than 10 years and rich established relationships with clients give PFC and REC a distinct edge over other lenders.

**Exhibit 6: CEA estimates 38% of the funds to flow from PFC and REC**




**CEA estimated source of debt funds for 11th plan**

Source: CEA

***We project debt funding opportunity of Rs1.3bn for PFC and Rs1.2bn for REC over the 11th plan period***

However, in the past, investments in the sector have remained lower than expectations with only 66% of the plan expenditure being utilized in the 10th plan. The delays can be attributed to project delays and poor execution. During the 11th plan, we expect the actual total power spend to be Rs8.2tn, i.e. ~80% of the CEA estimate.

Correspondingly, we project debt funding opportunity of Rs1.3bn for PFC and Rs1.2bn for REC over the plan period.

**Exhibit 7: Funding opportunities for PFC and REC**

| (Rs bn) | Total |
|---|---|
| % of funds deployed in 11th plan (as a % of estimated requirement) | 80% |
| Debt required (assuming D/E of 75:25) | 6,190 |
| Less: funds where PFC & REC are unlikely to be active* | 1,937 |
| Long term disbursals by PFC assuming a 22% market share | 1,047 |
| **Total disbursement potential for PFC in 11th plan (assuming 80% long term funds)** | **1,309** |
| Long term disbursals by REC assuming a 19.5% market share | 924 |
| **Total disbursement potential for REC (assuming 80% long term funds)** | **1,155** |

*Source: RBI; IDFC-SSKI Research; * DDG, R&M, HRD, R&D Outlay and DSM*

### ❑ Significant contribution of banks; but restrained by exposure norms

*Bank lending to sector is restrained by single-entity (individual or group) lending norms*

Bank lending to the power sector is estimated to stand at ~Rs1tn in FY09. However, bank lending to the sector is restrained by single-entity (individual or group) lending norms and maximum exposure to a single borrower (restricted at 15-20% for a single group and 25-50% for infrastructure projects, including power). CEA estimates Rs1.1tn (~30% of the available funds) to flow from banks and financial institutions during the 11th plan period.

## PFC AND REC: LEVERAGING THE PROSPECTS

### ❑ Well placed to capitalize on the huge funding opportunity…

PFC and REC are well-poised to capitalize on the huge funding opportunity. We estimate funding opportunity of Rs1.3bn for PFC and believe that PFC is well capitalized to sustain this growth. However, projected disbursements of Rs1.2bn for REC over the plan period are estimated to require USD600m-700m of equity capital. The company has submitted a proposal to raise Rs30bn to the power ministry through a follow-on public offer/ QIP issuance.

### ❑ …with ability to lend for long-term …

*Average duration of banks' term deposits is 2-3 years while power finance is for much longer tenure*

The power sector requires long-term financing and considering that average duration of banks' term deposits is in the range of 2-3 years, it becomes difficult for them to commit a significant proportion of the book towards long-term maturity. While reset clauses mitigate the interest rate risk, generation projects still require long gestation periods.

### …with favourable exposure norms

*Banks have internal limits for lending to a particular sector – usually ~20% of total book with 5% leeway for infrastructure sectors*

Banks have internal limits for lending to a particular sector – usually around 20% of the total book with some additional leeway for infrastructure sectors, which restricts their ability to lend to the sector (average ticket size of PFC's loans at Rs8.15bn in FY09). NBFCs' lending norms enable them to take exposure up to 100% of their own net worth in the case of government entities (state/ central). In case of private companies, exposure is limited to 15% of the net worth for a single company and 25% for a single group.

*Though cost of funding is higher for PFC nd REC< they have a low operating cost structure*

### ❑ Low cost structure enhances competitiveness vis-à-vis banks

Being NBFCs, PFC and REC have a higher cost of funding as compared to commercial banks. However, a low operating cost structure imparts competitiveness to these entities vis-à-vis banks. While banks have to set aside 5% in CRR (which does not yield any interest) and 24% in SLR, PFC and REC are exempt from any such reserve requirements.

*High government ownership ensures the highest possible credit ratings for REC and PFC*

### ❑ Sovereign credit rating further aids funding cost

Given the significant government ownership in both the NBFCs, they enjoy the highest possible credit ratings of "AAA/Stable" from CRISIL, 'LAAA' from ICRA, and sovereign "Baa3" from Moody's and "BBB-" from both Fitch and S&P. Consequently, their corporate bonds can be priced attractively due to a lower perceived risk premium, and thus aid cost of capital.

**Exhibit 8: How do PFC and REC stack up against banks**

| Reserve requirements | Banks | PFC | REC |
|---|---|---|---|
| CRR | 5% of NDTL to be maintained with RBI | Not required for PFC | Not required for REC |
| SLR | 24% of NDTL to be maintained with RBI | Not required for PFC | Not required for REC |
| CAR norms | Minimum capital adequacy requirement of 9% | Minimum capital adequacy requirement of 10% | Minimum capital adequacy requirement of 10% |
| Single party exposure limits | • Individual exposure limit of 15% of net owned funds<br>• 5% additional permitted with the board approval<br>• Group exposure ceiling of 50% | • Individual exposure limit of 100% of net worth for government entities and 15% for private players<br>• 50% additional permitted with the board approval for state/ central entities<br>• No group exposure ceiling for govt. and 25% for private sector | • Individual exposure limit of 100-250% of net worth for government entities (depending on type)<br>• 5% additional permitted with the Board approval<br>• Group exposure ceiling of 50% for private sector |
| NPA recognition norms | • NPA defined as an asset where interest or principal amount at 90 days past due<br>• Sub standard: NPAs for not more than 12 months<br>• Doubtful assets: NPAs for greater than 12 months<br>• Loss assets: Assets on which bank does not expect any recovery or fully written off assets | • NPA defined as an asset where interest or principal amount at 180 days past due<br>• Sub standard: NPAs for not more than 12 months (overdue for not more than 18 months)<br>• Doubtful assets: NPAs for greater than 12 months<br>• Loss assets: A doubtful asset for greater than 36 months | • NPA defined as an asset where interest or principal amount at 180 days past due<br>• Sub standard: NPAs for not more than 18 months<br>• Doubtful assets: NPA for a period exceeding 24 months<br>• Loss assets: A doubtful asset for greater than 5 years |
| NPA provisioning norms | • Standard: 0.4% of the outstanding loan amount<br>• Sub standard: 10% of the loan<br>• Doubtful assets: 20-100% of loans depending upon the period<br>• Loss assets: 100% - fully written off | • Standard: nil<br>• Sub standard: 10%<br>• Doubtful assets:<br>o Up to 1 year - 20%<br>o 1 -3 years - 30%<br>o More than 3 years - 100%<br>o Unsecured - 100%<br>• Loss assets: 100% - fully written off | • Standard: nil<br>• Sub standard: 10%<br>• Doubtful assets: 100% provision to the extent the loan is not realizable<br>o Upto 1 year - 20% of provision<br>o 1- 3 years - 30% of provision<br>o > 3 years - 50% of provision<br>• Loss assets: 100% - fully written off |

Source: IDFC – SSKI Research

## ATTRACTIVE VALUATIONS; WE ARE OVERWEIGHT

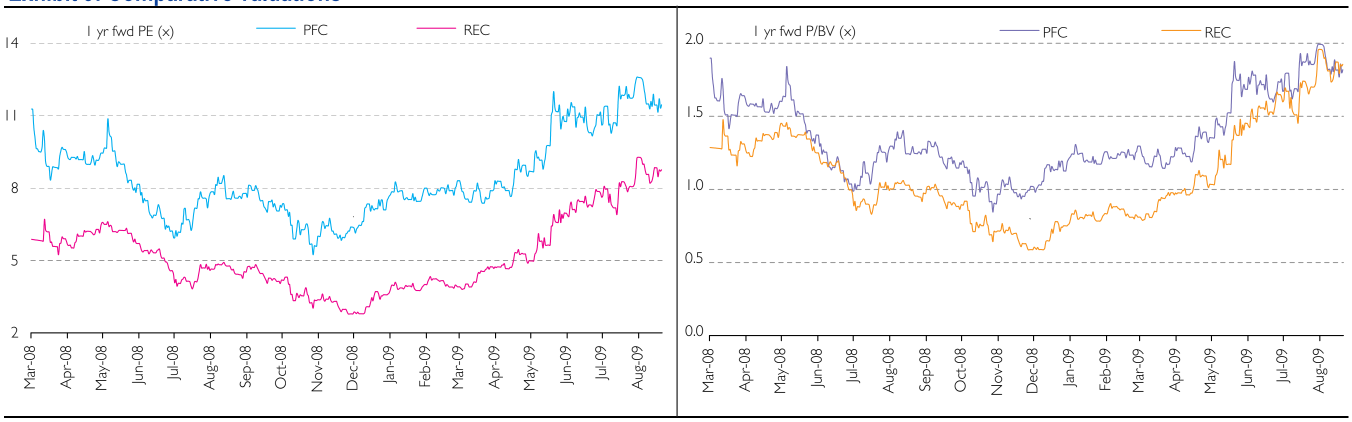
Considering the strong growth visibility, earnings of PFC and REC are likely to remain robust. We expect the traction in growth as also steady margins to drive a 22-30% CAGR in earnings for these entities over FY09-11. In context of robust profit growth, valuations of 1.8-1.9x FY11E book appear attractive. We are Overweight on the sector and see 30% upside on PFC and 23% on REC.

*PFC has historically traded at an average premium of 24% to REC*

### ❑ PFC has had traded at a premium to REC…

Despite both PFC and REC being government-owned NBFCs and catering to the power sector, PFC has historically traded at a premium to REC. Over the trading history of past 2-3 years, PFC has commanded an average premium of ~24% over REC.

**Exhibit 9: Comparative valuations**




*Source: Bloomberg*

*Owing to greater exposure to generation, PFC's NPAs have remained low*

### ❑ …owing to diverse focus areas and better NPA history

In the past, majority of REC's business stemmed from the T&D segment. At the same time, bulk of PFC's business has come from the generation segment with limited exposure to T&D sector. Being exposed to collection and distribution inefficiencies to a greater extent, T&D sector is riskier and more prone to losses than the generation segment. Higher exposure to the riskier T&D segment led to high level of NPAs for REC, which touched 11% in FY04. At the same time, owing to its high dependence on generation projects, PFC has been able to restrict its NPAs to less than 1%.

*With improving asset quality and disbursal mix, REC is catching up with PFC in terms of valuations*

### ❑ The differential has, however, closed

Factoring in deferred tax liability (DTL) write-back for REC as well, we see the stock trading at a similar price to book multiple as PFC. The narrowing of the differential can be attributed to an increasing proportion of REC's disbursements flowing towards generation projects (46% in FY09 as against 33% in FY08), which augurs well for asset quality and offers better growth visibility.

Subsequent to a favorable ruling by the ICAI, PFC has reversed deferred tax provision of Rs7.5bn through balance sheet and another Rs4.8bn through P&L in FY09, adding Rs12.3bn to net worth. REC is also likely to reverse ~Rs3bn of deferred tax provision through P&L and ~Rs6bn through balance sheet in FY10.

*Buy with a price target of Rs260 and Rs300 for REC and PFC respectively*

### ❑ Valuations are attractive – expect 23-30% upside

Considering the strong growth visibility, valuations of 1.8-1.9x FY11E book appear attractive. While we believe REC will continue to post a stronger RoE in FY10 and FY11, rise in leverage will aid expansion in PFC's RoE over the medium term.

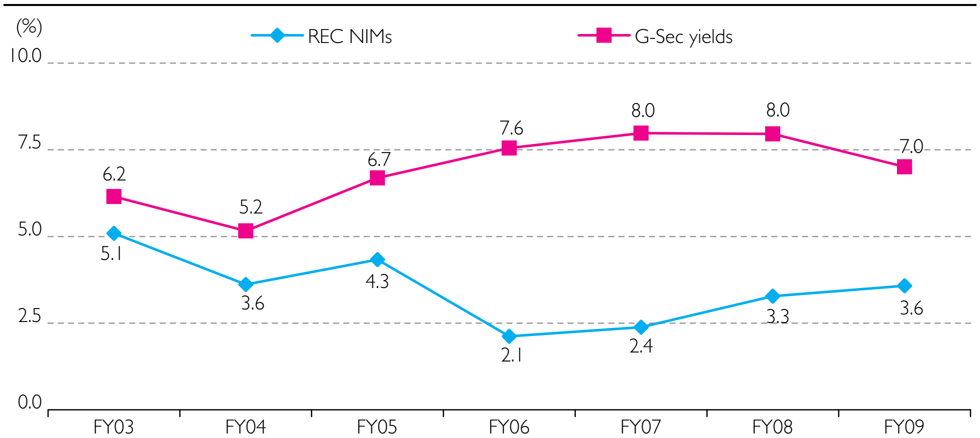
We value REC on 2.3x FY11E book, and we assign a price target of Rs260 to the stock, which offers an upside of 23% from the current levels. Valuing PFC at 2.4x FY11E price to book, our price target of Rs300 offers 30% upside.

## KEY INVESTMENT RISKS

### ❑ Wholesale funded – risk of volatility

Given the wholesale funding mix, PFC and REC remain vulnerable to interest rate cycles. Notably, the cost of funds for the financiers had spiked during October-December 2008 due to tight liquidity and increased risk aversion in the system. While the sovereign rating stands them in good stead relative to banking peers, PFC and REC are exposed to the risk of volatility in costs, and thereby margins, in the absence of a diverse resource base.

**Exhibit 10: Margins vulnerable to interest rate cycles (REC's margins over FY03-09)**




*Source: Company, IDFC-SSKI Research*

### ❑ Vulnerable to execution delays

Though PFC and REC's borrower profile (predominantly state and central government entities) is a source of comfort in terms of asset quality, it also leaves them vulnerable to delayed project execution (and therefore sanction draw-downs).

### ❑ Regulatory risk

*Potential reversal of decision on DTL write-back – a risk to numbers*

The lenders are well-placed within India's regulatory landscape, with forbearance in terms of prudential norms (provisioning, capital adequacy, reserve requirements), special sanction to issue low-cost capital gains exemption bonds and government's significant focus on bridging the demand and supply gap for the power sector in India. However, any change in the regulatory requirements remains a risk to the business model and our estimates. Also, REC and PFC face the risk of reversal of write-back of deferred tax liability – while PFC reversed Rs7.5bn through balance sheet and another Rs4.8bn through P&L in FY09, REC is expected to reverse Rs3bn through P&L and ~Rs6bn through balance sheet in FY10.

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# COMPANIES

# PFC

Rs230

OUTPERFORMER

## *Power drive*

Mkt Cap: Rs264.4bn; US$5.4bn

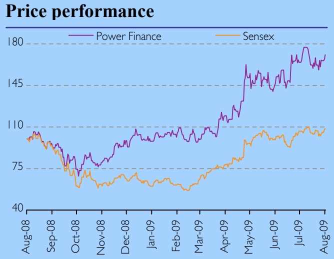
Initiating coverage

**26 August 2009**

**BSE Sensex: 15770**

| Stock data | |
|---|---|
| Reuters | PWFC.BO |
| Bloomberg | POWF IN |
| 1-yr high/low (Rs) | 240/85 |
| 1-yr avg daily volumes (m) | 1.38 |
| Free float (%) | 10.2 |

**Price performance**




**Performance (%)**

| | 3-mth | 6-mth | 1-yr | 3-yr |
|---|---|---|---|---|
| PFC | 22.5 | 64.1 | 74.7 | - |
| Sensex | 16.0 | 76.1 | 8.9 | 36.3 |

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**Government impetus on power sector implies a huge opportunity for power financiers. Power Financing Corporation (PFC), a dominant player in the space with 20%+ market share, would be a key beneficiary of the same. While a robust sanctions pipeline (Rs1.3tn) offers high growth visibility, lower funding costs and a lean operating cost structure enhance PFC's competitiveness. Despite catering primarily to the financially weak state power utilities (SPUs), prudent recovery mechanisms have helped PFC maintain superior asset quality with negligible net NPAs. Strong business growth and steady margins would lead to 22% CAGR in pre-exceptional PAT over FY09-11E (10% reported CAGR) with stable RoA of ~2.6%. At 2.01x FY10E and 1.77x FY11E book, valuations are attractive. Initiating coverage with a 12-month price target of Rs300 (2.4x FY11E book).**

**Strong business outlook:** PFC has witnessed strong traction in loan sanctions over the last few years. Outstanding sanctions of ~Rs1.3tn provide high visibility on disbursements over the next 5-6 years. Given the huge funding gap for power projects and PFC's competitiveness, we expect its market share to be sustained at 20%+. Disbursements are estimated to show 21% CAGR over FY09-11, driving a 24% CAGR in the loan book.

**Steady margins and asset quality strength to keep RoA elevated:** We are structurally bullish on PFC due to high medium-term growth visibility, resilient asset quality (NPAs at below 1%) and a strong liability franchise. As assets and liabilities get re-priced in tandem, we expect steady margins for PFC. Superior asset quality would keep the provisions negligible and pre-exceptional net profit is expected to exhibit 22% CAGR over FY09-11 with RoA of ~2.6%.

**RoE expansion ahead; Outperformer**: We expect PFC's RoE (pre-exceptional) to expand by ~200bp to 17.5% in FY11. However, a full scale-up towards the sustainable level of 20% is likely to be achieved only in the medium term as leverage rises gradually. Also, the company is adequately capitalized to sustain the growth momentum for the next few years. At 1.77x FY11E book, the stock is attractively valued. Initiating coverage with an Outperformer rating and a price target of Rs300.

**Key financials**

| As on 31 March | FY07 | FY08 | FY09 | FY10E | FY11E |
|---|---|---|---|---|---|
| Disbursements (Rs bn) | 140.6 | 162.1 | 210.5 | 252.6 | 308.2 |
| Net profit (Rs m) | 9,861 | 12,068 | 19,700 | 19,996 | 24,019 |
| *yoy growth (%)* | *1.6* | *22.4* | *63.2* | *1.5* | *20.1* |
| Shares in issue (m) | 1,148 | 1,148 | 1,148 | 1,148 | 1,148 |
| EPS (Rs) | 9.1 | 10.5 | 17.2 | 17.4 | 20.9 |
| EPS growth (%) | (3.9) | 16.1 | 63.2 | 1.5 | 20.1 |
| PE (x) | 24.90 | 21.45 | 13.14 | 12.94 | 10.78 |
| Book value (Rs/share) | 79 | 81 | 100 | 112 | 127 |
| P / BV ( x) | 2.9 | 2.8 | 2.2 | 2.0 | 1.8 |
| RoAE (%) | 12.7 | 13.5 | 18.9 | 16.4 | 17.5 |

# INVESTMENT ARGUMENT

**PFC has over 20 years of experience in providing finance to the power sector, predominantly government entities. Catering primarily to the generation segment, the financier holds a substantial 20%+ market share in power financing. Favorable exposure norms, robust ALM, substantial government ownership (an 89.8% stake), negligible NPAs and low operating costs (leading to sovereign ratings by credit agencies) have augmented the profitability of PFC's operations over the years. While the huge market potential will spur future growth, core profitability will evidence traction as NIMs remain largely stable. We forecast 22% CAGR in pre-exceptional earnings for PFC over FY09-11 (10% rise in reported PAT) with a high RoA of 2.6%. We recommend Outperformer on the stock with a 12-month price target of Rs300.**

## POWER FINANCE CORPORATION: POWER PLAY

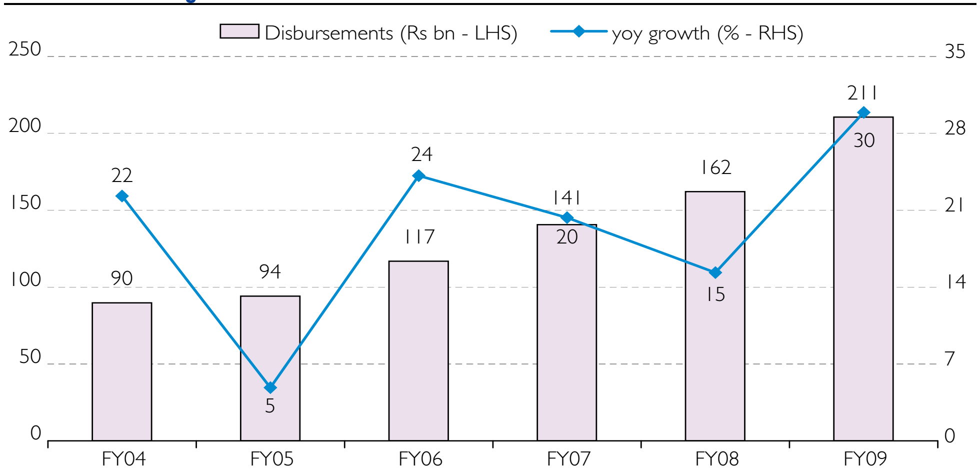
With rich experience of over 20 years, Power Finance Corporation (PFC) has emerged as a preferred lender to the power sector. PFC has predominantly focused on funding generation projects, with government entities such as state power utilities as key clients. PFC's internal norms enable it to take exposure up to 100% of its net worth in the case of government entities (up to 150% by a board approval). PFC is the nodal agency for implementation of the Restructured Accelerated Power Development & Reform Programme (R-APDRP). It is also the nodal agency for development of nine Ultra Mega Power Projects (UMPPs) with a capacity of 4,000MW each.

### ❑ Among the largest financiers to the sector

*PFC has a 20%+ maket share in power financing*

PFC is well-placed to leverage on the huge funding opportunity arising from the development of power sector in India. With 20%+ market share and disbursement of Rs515bn as against an initial target of Rs433bn during the 10th 5-Year Plan period (FY03-07), the company is one of the largest financiers to the sector. We expect PFC to maintain its market share over the 11th Plan (FY08-12), translating into disbursements of Rs1.3tn over the period (assuming ~80% utilization of funds during the plan period).

**Exhibit 1: Robust growth in disbursements**



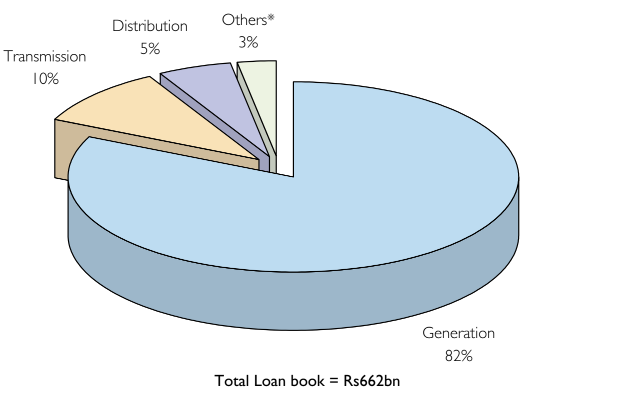

*Source: Company, CEA, IDFC-SSKI Research*

*70% of disbursals to generation segment over FY08- 09 though share of T&D has been rising*

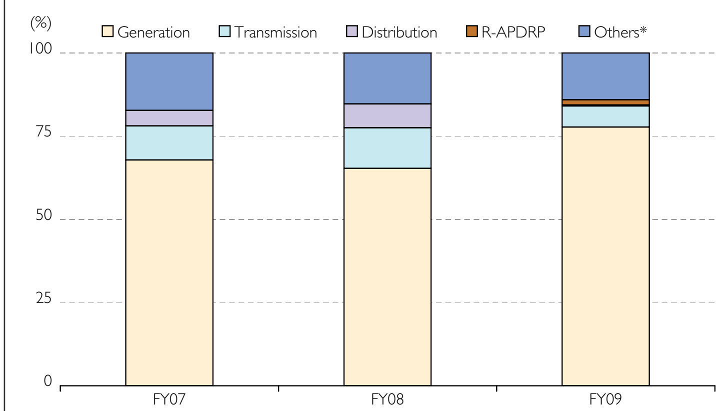
## ❑ Generation projects have been the focus area…

PFC has witnessed strong traction in sanctions over the past few years owing to robust financing demand from the power sector, predominantly in the generation space. Historically, the company has maintained a higher market share in generation projects, with 70% of the disbursals going to the segment over FY08-09. While the share of T&D disbursals is on a rise over the past few years, generation projects continue to dominate the book. With capital requirement for generation projects pegged at Rs4.1tn in the 11th Plan, we expect PFC's disbursals to be driven by the generation segment in the near term.

**Exhibit 2: Loan book skewed towards generation projects**




**Bulk of disbursements towards generation projects**



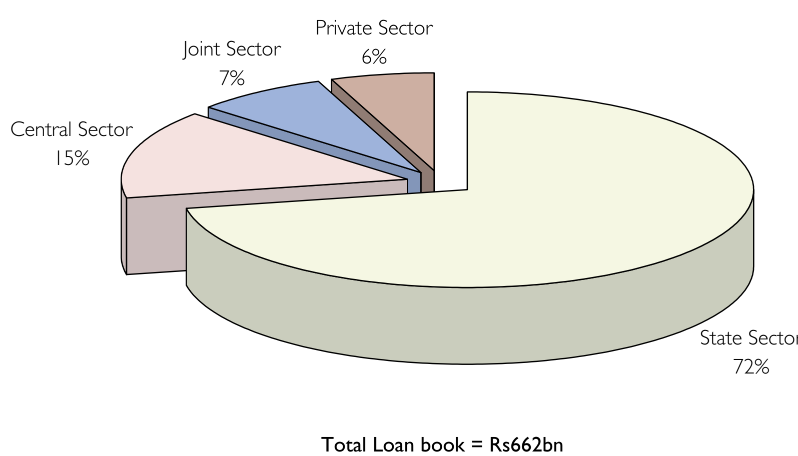

*Source: Company*

*Loans to government sector comprised 86% of the loan book as of March 09*

## ❑ …with bulk of the funds flowing to State Power Utilities

A bulk of PFC's business is driven by the government sector, which comprises 86% of the book as of March 2009. At 72% of book, the company has a large exposure to state power utilities. With government entities expected to contribute ~85% of the planned capacity addition and accounting for ~80% of the total power spend in the 11th Plan, we expect the structure of PFC's loan book to remain largely stable.

**Exhibit 3: State power utilities have been the focus area so far (FY09)**



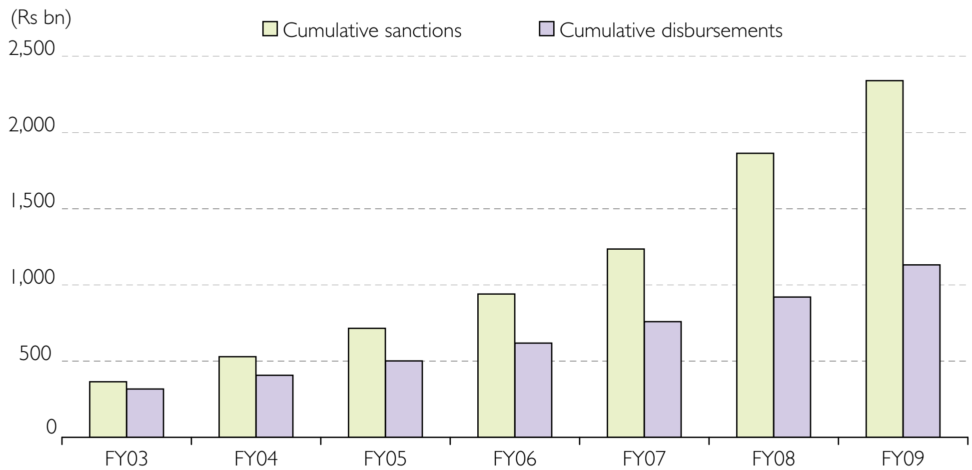

*Source: Company*

*We expect PFC to register 21% CAGR in disbursals over FY09-11*

## ❑ Robust sanctions pipeline offers high growth visibility

PFC has outstanding sanctions of Rs1.3tn as of March 2009, which provide high growth visibility over the next 5-6 years. We expect PFC to register 21% CAGR in disbursals over FY09-11 driven by the robust pipeline, and disbursements in FY10 and FY11 are likely to be only 20% and 25% of the cumulative sanctions.

**Exhibit 4: Robust sanctions pipeline**




*Source: Company*

*PFC can take exposure up to 100% of its net worth in the case of state/ central government entities*

## ❑ Favourable exposure norms

PFC's internal norms enable it to take exposure up to 100% of its net worth – amounting to ~Rs120bn – in the case of government entities (state/ central). The company can lend up to 150% of its net worth (Rs180bn) by a special approval of the board. In case of private companies, exposure is limited to 15% of net worth for a single company and 25% for the Group.

**Exhibit 5: Exposure norms**

| Type of borrower/ project | Exposure norms (% of PFC's networth) |
|---|---|
| State Power Utility/ State Government/ Central Government PSUs in Power Sector – automatic | Not greater than 100% |
| State Power Utility/ State Government/ Central Government PSUs in Power Sector– with board approval | Not greater than 150% |
| Single company | Not greater than 15% |
| Single Group of companies | Not greater than 25% |

*Source: Company*

*PFC expects to disburse Rs19bn under the R-APDRP scheme in FY10*

## ❑ Nodal agency for transmission projects

PFC is the nodal agency for implementation of R-APDRP – a government programme to accelerate distribution reforms and reduce aggregate transmission and commercial (AT&C) losses to ~15% from 32% in FY08. PFC disbursed Rs3.25bn for phase A of the programme in FY09 and sees a further disbursement of Rs19bn in FY10 under the scheme. Over a longer term, PFC expects the scheme to boost its lending business. Currently, PFC is entitled to receive a fee of 1% of loans sanctioned in both phase A and phase B of APDRP, and has correspondingly received Rs250m in FY09.

***Restructured APDRP – bringing in efficiency***

Total spend under the scheme in the 11th plan is projected to be ~Rs516bn. The projects are to be taken up in two parts. First part would include projects establishing baseline data and IT applications for energy accounting. The Centre will provide 100% loan for the stage, which shall be converted into a grant after the data system is verified by an independent agency.

Later part shall include regular distribution strengthening projects, for which the government will provide up to 25% of the cost as loan (90% for special category states). The remaining is funded by PFC and REC. Up to 50% of the loan provided (90% for special category states) for implementing the second stage shall be converted into grant in five equal tranches on achieving 15% AT&C loss on a sustainable basis.

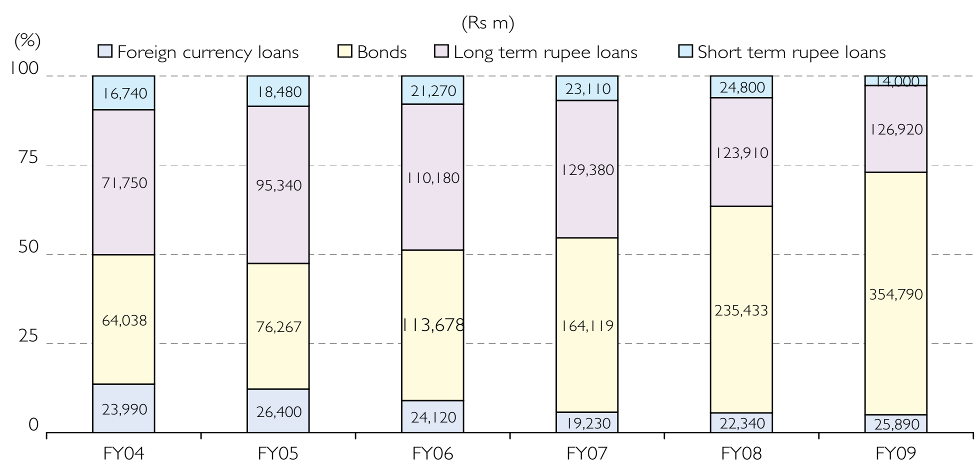
## ❑ Funding profile skewed towards long-term loans…

***For funding, PFC relies on long-term bonds, bank term loans and ECBs***

The power sector requires long-term financing for 10-15 years and it is difficult for banks to commit a significant proportion of the book towards such a long-term maturity. PFC, being a specialized lender, is in a better position to do that and also as it primarily relies on funding from long-term bonds, term loans from banks and external commercial borrowings.

PFC attracts only 20% risk weight in a bank's book as a borrower. The average duration of liabilities stands at four years as of Q1FY10 and 81% of its borrowings are fixed in nature.

**Exhibit 6: Increasing proportion of borrowings from long-term bonds**



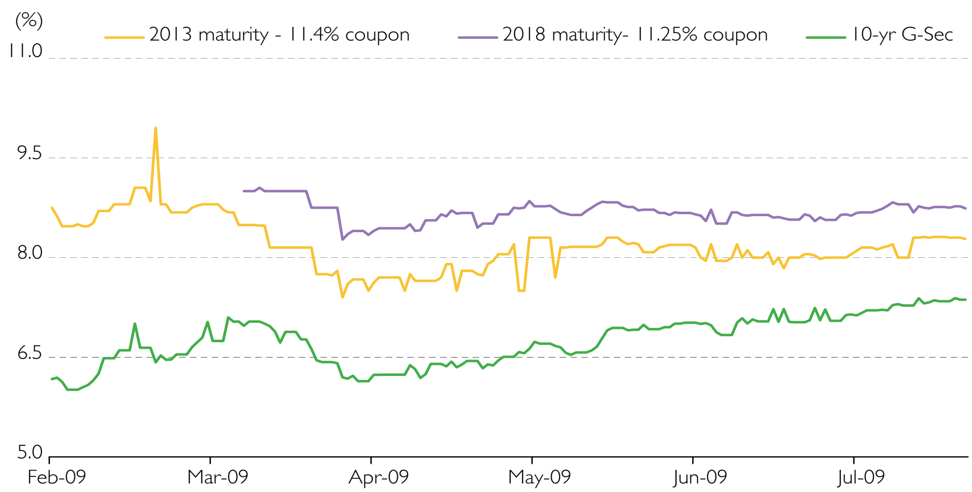

*Source: Company*

## ❑ …procured at competitive costs given the sovereign credit rating

***Despite a tough FY09, PFC managed to restrict the rise in its cost of funds to ~60bp yoy to 8.9%***

Given the substantial government ownership (89.8% as of June 2009), PFC has been rated as AAA by domestic rating agencies and on par with sovereign ratings by international rating agencies – Baa3 (stable)/ BBB- (negative)/ BBB- (stable) by Moody's, S&P and Fitch respectively. Consequently, its corporate bond yields are priced at a lower risk premium and the lender is able to raise funds at the most competitive rates in both the domestic and international markets.

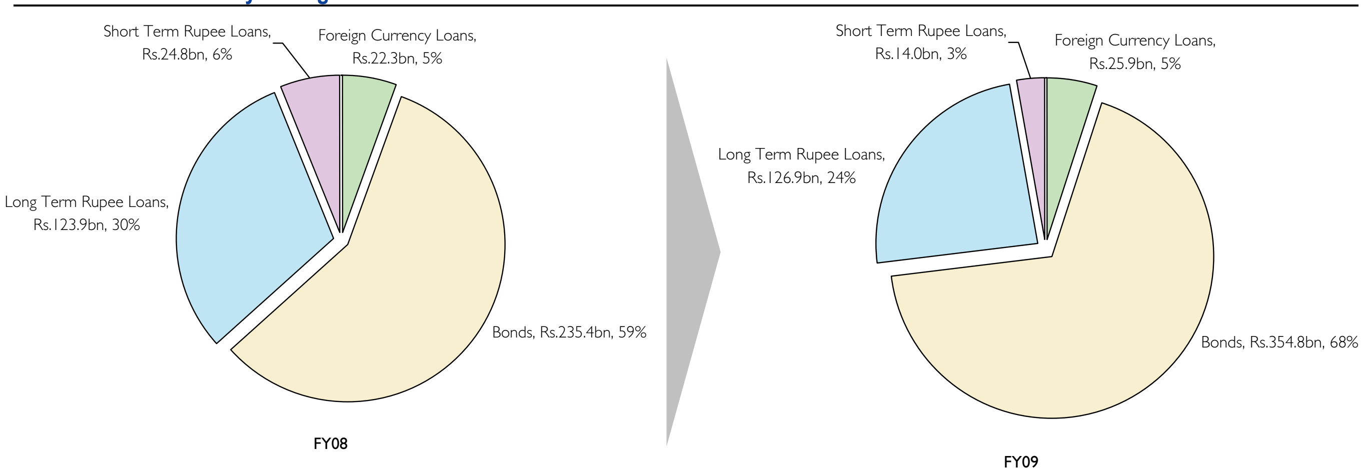
**Exhibit 7: PFC's corporate spreads typically at ~100bp**




*Source: Bloomberg*

PFC's efficient liability management has stood it in good stead as despite FY09 being a tough year for financial companies, PFC managed to restrict the rise in its cost of funds to ~60bp yoy to 8.9%. As borrowings from banks became much costlier in FY09, PFC focused more on borrowing through bonds, which grew by over 50% against a small decline in funds from banks.

**Exhibit 8: Active liability management**




*Source: Company*

## ❑ Robust capital adequacy – plenty of headroom to sustain growth

***With Tier-I of 17.5%, PFC is well capitalized to grow***

PFC (as also peer REC) is exempt from RBI's capital adequacy norms applicable to other NBFCs, and has to maintain a minimum CAR of 10%. With Tier-I of 17.5% as of June 2009 (nil Tier-II), PFC is well capitalized to grow and does not need any capital dilution for the next several years. Further, the company assumes a risk weight of 100% on government-guaranteed loans (~21% of the book in June 2009) against the RBI norm of 20% risk weight on such loans.

We believe that even when the lender requires capital, it is likely to opt for Tier-II capital and capital release from lower risk weights on government guaranteed loans before resorting to equity dilution.

### ❑ UMPPs – augmenting the fee income

PFC has been appointed as the nodal agency to facilitate the development of Ultra Mega Power Projects (UMPPs) in the country with a capacity of 4,000MW each. PFC has formed nine wholly-owned subsidiaries responsible for procuring the required clearances for each project. These SPVs will then be transferred to successful bidders selected through a tariff-based international competitive bidding process.

*The fees from UMPPs to be booked in wholly-owned subsidiary – PFC Consulting*

PFC has already transferred four UMPPs, namely Sasan Power, Mundra Power, Krishnapatnam Power and Tilaya Power, till FY09 and is expected to transfer three more to successful bidders in FY10. Going forward, the fees from these projects will be booked in its wholly-owned subsidiary PFC Consulting.

**Exhibit 9: Status of UMPPs**

| Project | Location | Status |
|---|---|---|
| Sasan Power | Madhya Pradesh | Awarded in FY08 |
| Mundra Power | Gujarat | Awarded in FY08 |
| Krishnapatnam Power | Andhra Pradesh | Awarded in FY08 |
| Tilaya UMPP | Jharkhand | Awarded in FY09 |
| Tamil Nadu UMPP | Tamil Nadu | Expected in FY10 |
| Orissa UMPP | Orissa | Expected in FY10 |
| Akaltara Power | Chhattisgarh | Expected in FY10 |
| Coastal Maharashtra Mega Power | Maharashtra | |
| Coastal Karnataka Power | Karnataka | |

*Source: Company*

### ❑ Leveraging expertise to provide consulting services

PFC provides consultancy services to state power utilities, independent power producers (IPPs), state electricity regulatory commissions and governments through PFC Consulting – its 100% subsidiary.

## IMPECCABLE ASSET QUALITY

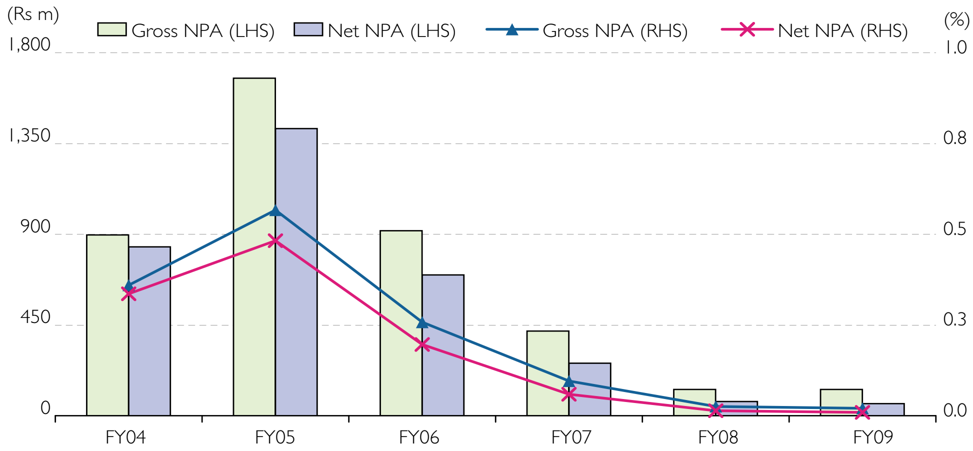
PFC's asset quality has remained robust with net NPAs hovering at near-zero levels. Despite significant exposure to SPUs, which have been making cash losses, PFC has established mechanisms to receive timely interest payments from them. Besides a primary security, an escrow payment mechanism is formed in almost all loans to ensure timely payment of the loan.

### ❑ Asset quality has displayed strength…

*Gross NPAs declined from Rs1.9bn in FY04 to Rs0.1bn in FY09*

PFC's asset quality has remained healthy over a long period of time. Gross NPAs declined from Rs1.9bn in FY04 (0.7% of loan assets) to Rs0.1bn in FY09 (0.02%) and net NPAs declined from Rs 1.6bn (0.54%) to Rs 60m (0.01%) over the same period.

**Exhibit 10: Strong NPA history**




*Source: Company*

*Focus on generation sector, a sound recovery mechanism, irrevocable government guarantees…*

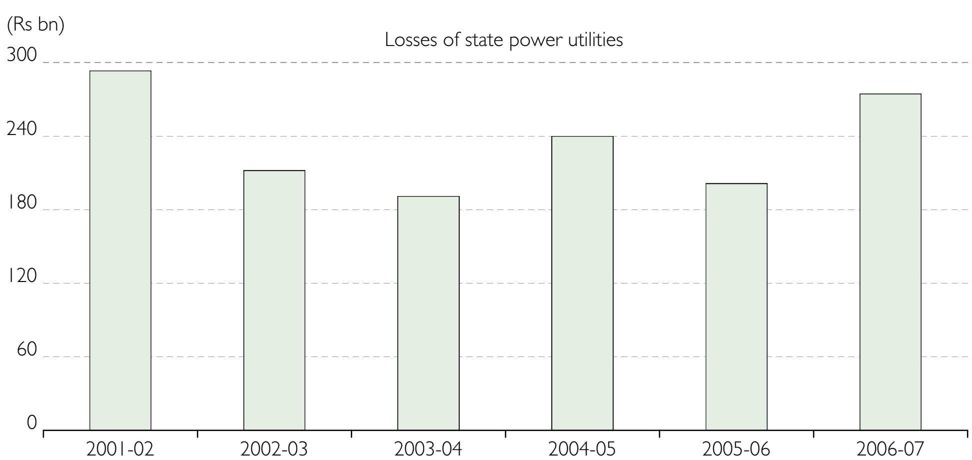
## ❑ …despite a huge exposure to state power utilities

Bulk of PFC's book is exposed to state power utilities (72% of the total as of March 2009). However, financial position of the SPUs has remained weak over the years owing to deficiencies in the T&D framework. As per PFC's report on financial position of SPUs, out of 89 utilities, 45 had negative RoE and 29 had negative net worth in FY07. Aggregate cash losses of all SPUs (without accounting for subsidies) increased to Rs74.8bn in FY07 from Rs19.5bn in FY05. 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.

*…help PFC check delinquencies*

Despite the weak financial position of SPUs, PFC has managed to keep its delinquencies in check with negligible NPAs. This can be attributed to its focus on generation sector, a sound recovery mechanism, loans being secured by charge on assets, irrevocable state government guarantees and payment through default escrow accounts.

**Exhibit 11: Financial position of SPUs – losses have stabilized over the past few years**




*Source: Company*

*PFC maintains a collateral of 1.15-1.25x and escrow payment mechanism on almost all loans*

### ❑ Escrow mechanism aids asset quality preservation

Typically, PFC maintains a collateral of 1.15-1.25x and an escrow payment mechanism is formulated in almost all loans. Under this mechanism, all revenue receipts of borrowers are routed through an escrow account with a bank. As a result, in case of a default, PFC has the right to divert the flow of funds towards itself to clear the dues. While the lender has not had to enforce this mechanism for the past 6-7 years, it facilitates timely payment of advances.

### ❑ Credit appraisal processes in place

Each state has an in-charge, who sends a duly completed application form from an IPP to the centralized entity appraisal unit and another copy to the project appraisal unit. Both the units assign a credit rating after interacting with the borrower, which is then communicated to the state in-charge. Subsequently, depending on the loan amount approval is taken from either the Chairman, Executive Committee of Directors, Loan Committee of Directors (includes a Ministry of Power nominee) or Board of Directors.

*PFC recognizes NPAs on 180-day basis against the 90-day norm for banks*

### ❑ Internal NPA recognition norms

PFC is exempt from RBI prudential norms for NPA recognition. The company follows its internal norms of 180-day basis for recognizing NPAs against the 90-day norm followed by banks. Also, NPAs are recognized on a loan-wise basis for state entities, as against the standard norm of identifying NPAs borrower-wise, which banks and most financial entities follow. PFC has submitted a roadmap to conform to the RBI norms, with a decision still pending. Given the low level of NPAs, provisioning expenses remain negligible.

**Exhibit 12: NPA recognition norms**

| | Definition | Provisioning norm |
|---|---|---|
| NPA recognition | Interest/ principal is overdue for months | |
| Sub-standard | Interest/ principal is overdue for 6 -18 months | 10% |
| Doubtful | Interest/ principal is overdue for greater than 18 months | Up to 1 year – 20%<br>1 -3 years – 30%<br>More than 3 years – 100%<br>Unsecured – 100% |
| Loss | Assessed to be a loss asset of has been a doubtful asset for greater than 36 months | Written-off |

*Source: Company*

## WELL PLACED TO LEVERAGE THE GROWTH PROSPECTS

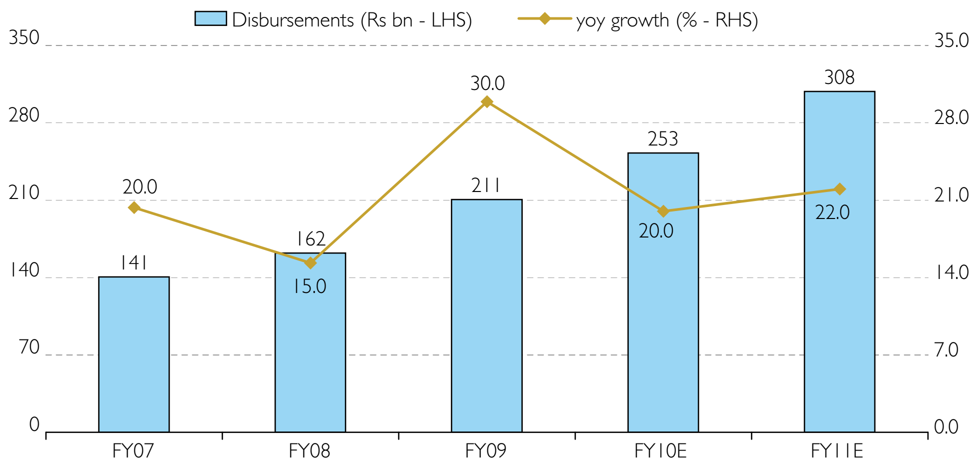
A huge unaddressed financing requirement, robust sanctions pipeline and adequate capital are likely to accelerate PFC's disbursements. We expect 21% CAGR in PFC's disbursals over FY09-11. Competitive funding costs, coupled with a sharp decline in wholesale borrowing rates, is likely to help sustain margins at current levels, which in turn would propel NII momentum. Operating leverage benefits would continue as the balance sheet gains scale, while credit costs remain subdued. Led by improved operations, we expect RoA to remain elevated at 2.6%. We expect 10% CAGR in PFC's earnings over FY09-11 with an average RoE of 17%.

***Outstanding sanctions of Rs1.3tn provide high growth visibility over the next few years***

## ❑ Disbursements to remain robust

We expect sustained traction in disbursals by PFC given the huge investments being channeled into the power sector. As of June 2009, PFC has outstanding sanctions of Rs1.3tn which provides high growth visibility over the next few years. We expect PFC to register a 21% CAGR in disbursals over FY09-11, driven by robust sanctions over the last few years. Loan repayments will remain in the 13-15% range, lower than the average rate of 19% over FY04-09, owing to longer-term loans disbursed in the last few years. We consequently expect a 24% CAGR in loan book to Rs990bn by FY11.

**Exhibit 13: Disbursements to remain strong with outstanding sanctions at Rs1.3tn**




*Source: Company, IDFC-SSKI Research*

## ❑ Interest margins to remain largely intact

***While PFC is currently lending at 11-12%,, its incremental cost of borrowings has come off to 8-9%***

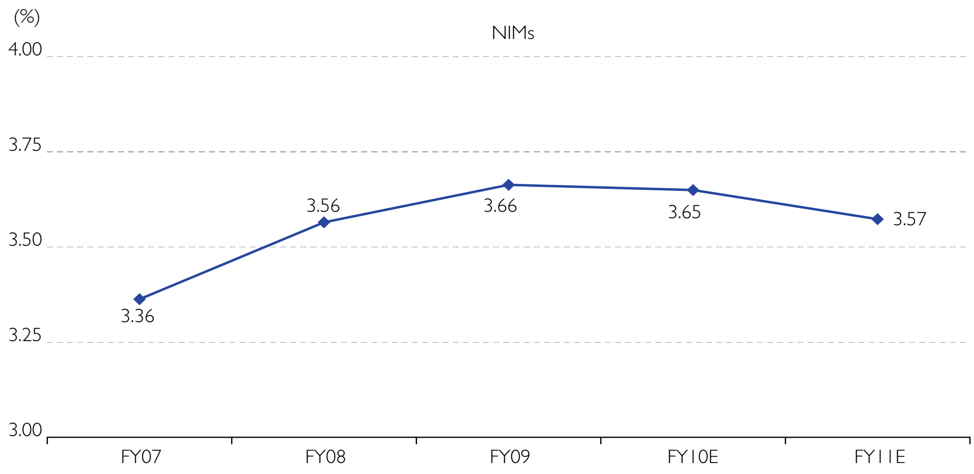
With average duration of 3.98 years, 81% of PFC's liabilities are fixed in nature. On the assets side (maturity of 5.7 years), 15% of the loan book is fixed and 85% floating – of which ~65% has a 3-year re-set and ~15% a 10-year re-set period.

PFC is currently lending at 11-12% whereas with the recent softening in interest rate, its incremental cost of borrowings has come off to 8-9%. 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 was earlier reset or disbursed at a lower rate. Consequently, we expect PFC's margins (calculated on average balances) to sustain at 3.6% in FY10.

***Access to tax-free bonds would help PFC maintain its interest spreads***

Both PFC and REC may get access to tax-free bonds to mobilize 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.

**Exhibit 14: NIMs to remain largely steady**



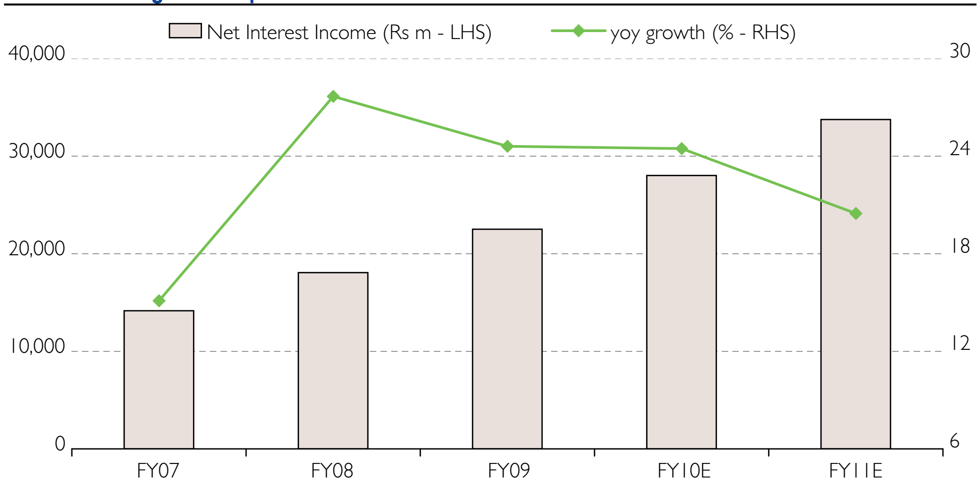

*Source: Company, IDFC-SSKI Research*

## ❑ NII momentum to be sustained

***We expect PFC to register 22% CAGR in NII over FY09-11***

PFC has shown a consistently healthy expansion in NII (26% CAGR over the past two years), driven by a growing balance sheet and margin expansion. We expect the company to register 22% CAGR in NII over FY09-11 on the back of sustained momentum in disbursals and largely steady margins.

**Exhibit 15: NII growth expected to remain robust**



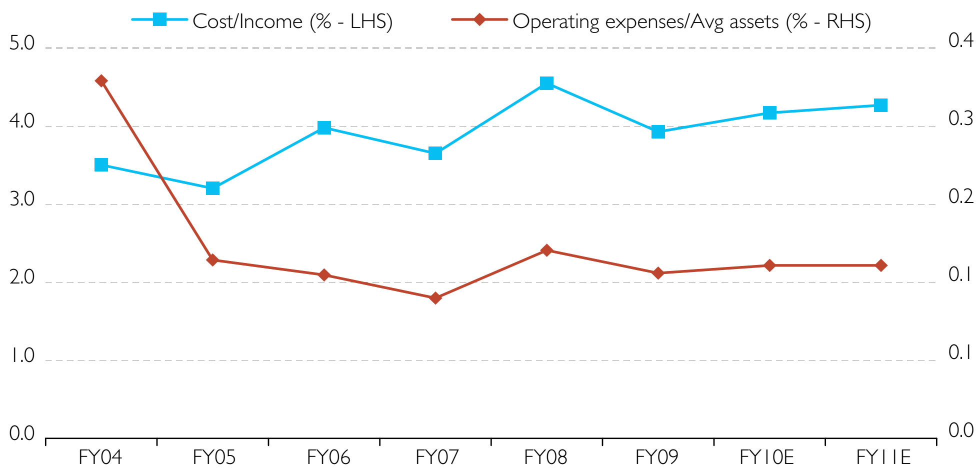

*Source: Company, IDFC-SSKI Research*

## ❑ Operational efficiency to boost profitability

***Cost to income ratio hovers at 4-5%***

As a bulk financier, PFC's cost structure is highly efficient as it does not require a large employee base or distribution network to operate. Consequently, its cost to income ratio hovers in the range of 4-5% while at 0.15% in FY09, operating expenses to assets ratio remains one of the lowest in the industry. We expect the ratio to remain in a similar range over FY09-11.

**Exhibit 16: Operating leverage**




*Source: Company, IDFC-SSKI Research*

## ❑ Robust asset quality to keep provisions low

***Exposure to generation projects in government sector has helped PFC maintain robust asset quality***

Exposure to large generation projects in government sector has helped PFC maintain robust asset quality. Exposure to private sector is low at ~7% of the book as of March 2009, and the company's provisioning expenses remain negligible. Even though our numbers conservatively factor in Gross NPAs increasing 2x to 0.4% in FY11 from 0.2% in FY09, provisioning costs are likely to remain low.

## ❑ Foreign currency fluctuations – no significant impact likely

***Our numbers do not build in any translation losses over FY10-11***

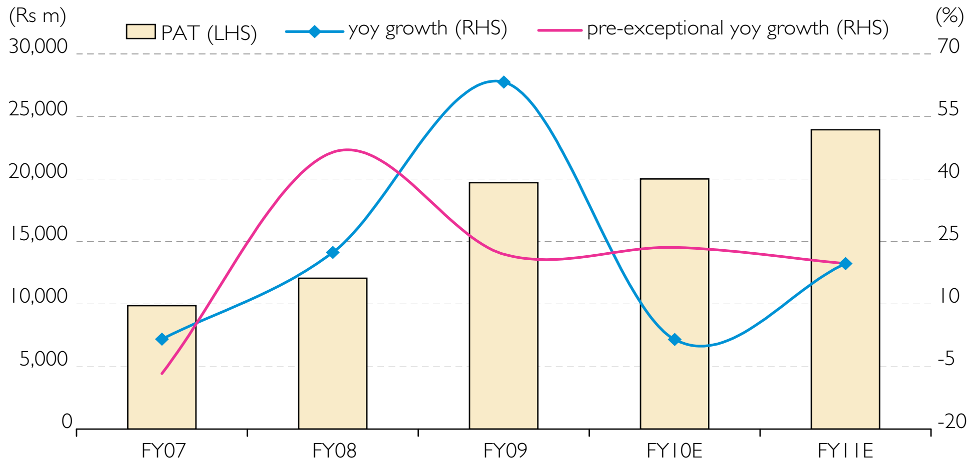
PFC has total foreign exchange borrowings amounting to USD515m, of which ~55% is hedged through either derivative or foreign currency futures. The remaining 45% (~USD230m) is unhedged and has been marked to market at Rs48.3 per USD as of June 2009. Out of the unhedged component, USD180m is due for redemption only in 2017. The management has indicated that ~USD220m of forex borrowings are due for repayment in FY10, primarily in Q2FY10. PFC can keep open forex positions up to 30% of its net worth. Given our currency expectation of Rs47/USD for FY10-11, our numbers do not build in any translation losses over the period.

## ❑ PAT to register 22% CAGR over FY09-11E

We expect 22% CAGR in PFC's comparable net profit over FY09-11 driven by steady growth in NII and contained provisioning expenses (though reported net profit growth is likely to be subdued at 10% over the period due to one-off DTL write-back in FY09). Correspondingly, we expect the lender's RoA to remain elevated at 2.6% over the next two years.

**Steady growth in NII and contained provisioning expenses to drive earnings**

**Exhibit 17: Earnings traction to continue**

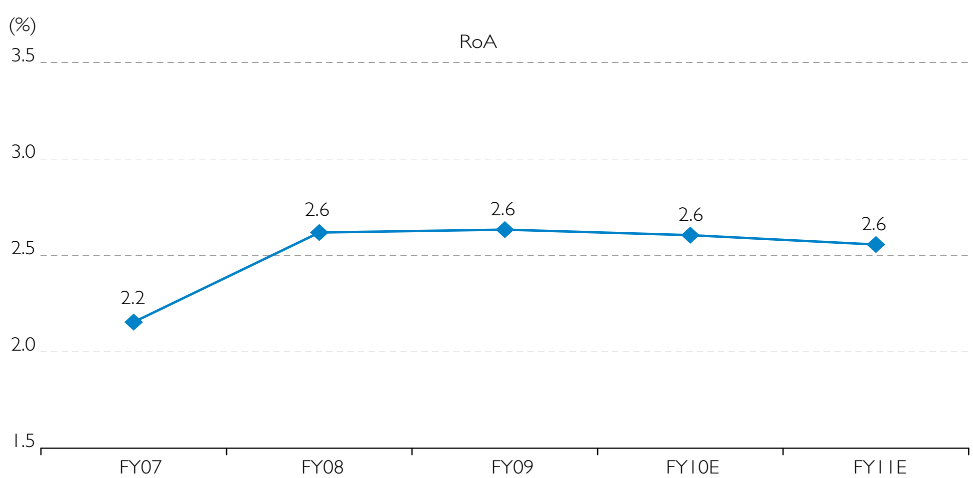



*Source: Company, IDFC-SSKI Research*

## VALUATIONS & VIEW

While PFC currently has a low RoE, we believe that it offers substantially high growth visibility with an estimated Rs7.7tn of debt funding requirement in power sector in the 11th plan period (and a much higher requirement in the 12th plan period). Owing to strong growth in business (24% CAGR in loan book), largely steady margins and 22% CAGR in earnings, RoA is expected to stay healthy at 2.6% over FY09-11E.

**Exhibit 18: RoAs to remain strong***




*Source: Company, IDFC-SSKI Research; *FY09 RoA before write-back of DTL provisions*

**We expect sustainable RoE of 20% over a longer term**

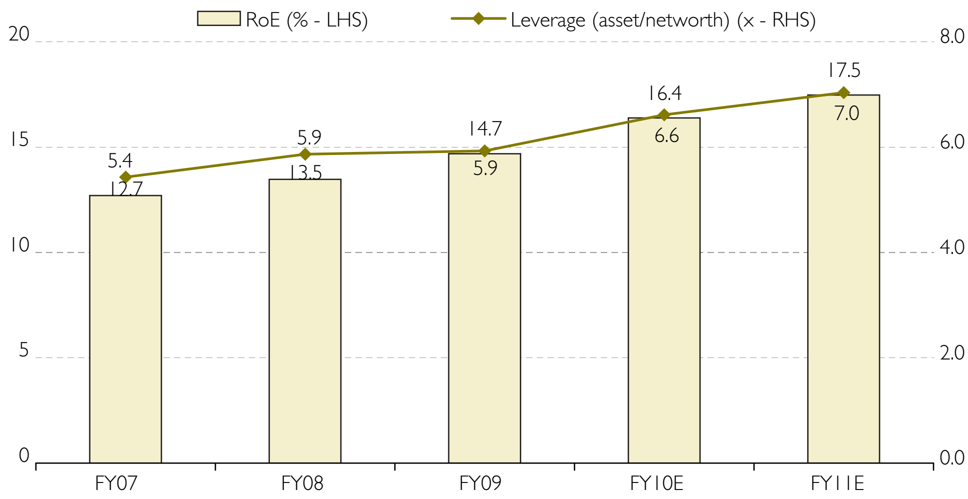
### ❑ Elevated RoA and improving leverage to aid RoE expansion…

Despite robust RoA, low leverage ratio has restricted PFC's RoE at 14-15% over the past five years (elevated at 19% in FY09 due to one-off write-back of DTL[1]). While we expect RoE to hover in the range of 17-18% over FY10-11 (including the DTL

[1] 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, upon transfer of these profits to a special reserve. The aggregate amount of this reserve cannot exceed 2x the paid up share capital and general reserve. However, owing to a difference of opinion with ICAI, the company was providing for tax on this deduction by creating a deferred tax liability till FY08. Consequently, its tax rate stood at 33% instead of 27% for other infrastructure companies. The issue was resolved in FY09 with a favourable outcome for PFC, and the company reversed deferred tax provision of Rs7.5bn through balance sheet and another Rs4.8bn through P&L in FY09, adding Rs12.3bn to net worth.

kicker), a rise in leverage is bound to drive an increase towards higher sustainable levels of 20% (RoA of 2.6% along with 8x leverage) over a longer term. Further, with Tier-I capital adequacy of 17.5%, the lender does not need any capital dilution for the next several years to grow.

**Exhibit 19: RoE to expand in line with rise in leverage***




*Source: IDFC - SSKI Research; * FY09 RoE on a pre-exceptional basis*

## ❑ ….driving premium valuations

***We believe the stock deserves to quote at 2.4x FY11E book***

We are bullish on PFC given the good growth prospects (supported by policy thrust), a strong liability franchise and sound asset quality. With leverage (assets/ net worth) of just 6x, strong asset quality and high growth visibility, PFC's cost of equity should be lower than the average cost of equity for most PSU banks. Assuming the cost of equity at 11.6%, sustainable RoE of 20% and sustainable growth rate of 5.5%, we believe the stock deserves to quote at 2.4x FY11E book. We are initiating coverage on PFC with an Outperformer rating and a 12-month price target of Rs300 – 30% upside from here.

**Exhibit 20: Historical PE band**


**P/B band chart**

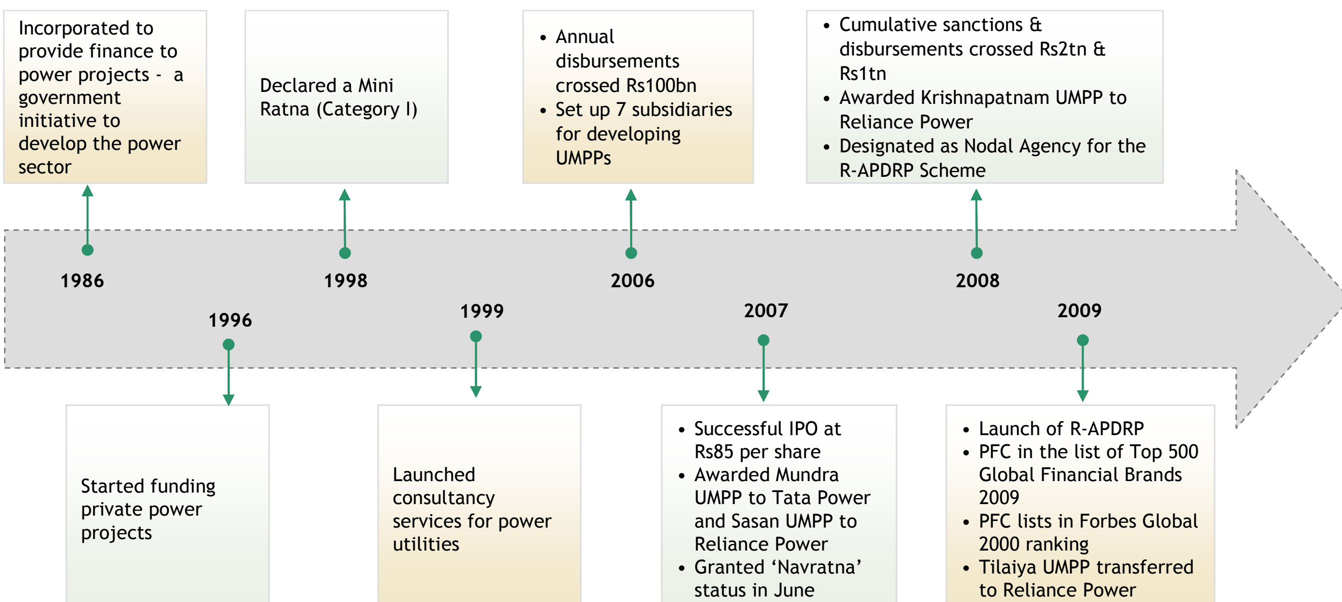

*Source: IDFC - SSKI Research, Bloomberg*

## BRIEF HISTORY

Incorporated in 1986, 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 of June 2009, loans to state and central power utilities comprised 87% of its total loan assets whereas private sector utilities constituted 7% (remaining from joint ventures).

PFC has witnessed strong traction in loan sanctions over FY05-09 given the policy thrust on boosting India's power generation capacity and improving T&D infrastructure. The company has sanctioned loans worth Rs1.9tn over FY05-09 and has outstanding sanctions of over Rs1.3tn to be disbursed in the next few years. Loan assets have clocked 22% CAGR over FY05-09 to Rs644bn. The company is the preferred lender to generation projects (while REC garners a higher share of T&D projects), which constitute ~82% of the total loan book as of June 2009.

**Exhibit 21: Key milestones**




*Source: Company, IDFC-SSKI Research*

## Earnings model

| Year to 31 March (Rs m) | FY07 | FY08 | FY09 | FY10E | FY11E |
|---|---|---|---|---|---|
| **Net interest income** | **14,149** | **18,065** | **22,510** | **28,018** | **33,863** |
| *yoy growth (%)* | *15.1* | *27.7* | *24.6* | *24.5* | *20.9* |
| Other income | 358 | 720 | 670 | 532 | 554 |
| *yoy growth (%)* | *38.5* | *101.2* | *(6.9)* | *(20.6)* | *4.2* |
| **Net revenue** | **14,507** | **18,785** | **23,180** | **28,550** | **34,417** |
| *yoy growth (%)* | *15.6* | *29.5* | *23.4* | *23.2* | *20.6* |
| Operating expenses | 529 | 855 | 910 | 1,190 | 1,457 |
| *yoy growth (%)* | *6.0* | *61.4* | *6.5* | *30.8* | *22.4* |
| Provisions | (49) | (105) | 40 | 154 | 282 |
| **PBT** | **14,026** | **18,035** | **22,230** | **27,206** | **32,679** |
| *yoy growth (%)* | *16.1* | *28.6* | *23.3* | *22.4* | *20.1* |
| Provision for tax | 5,254 | 5,809 | 200 | 7,210 | 8,660 |
| **PAT** | **9,861** | **12,068** | **19,700** | **19,996** | **24,019** |
| *yoy growth (%)* | *1.6* | *22.4* | *63.2* | *1.5* | *20.1* |
| Pre -exceptional PAT | 9,061 | 13,268 | 16,180 | 19,996 | 24,019 |
| *yoy growth (%)* | *(6.7)* | *46.4* | *22.0* | *23.6* | *20.1* |

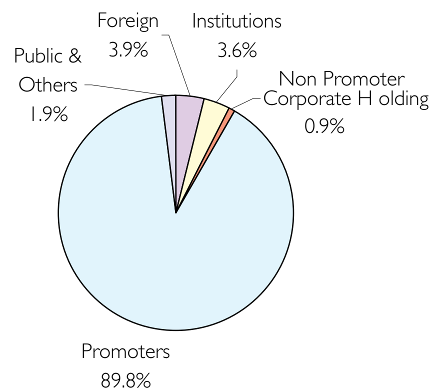
## Balance sheet

| Year to 31 March (Rs m) | FY07 | FY08 | FY09 | FY10E | FY11E |
|---|---|---|---|---|---|
| Loan book | 515,683 | 644,290 | 811,805 | 990,403 | 1,218,195 |
| *yoy growth (%)* | *17.5* | *24.9* | *26.0* | *22.0* | *23.0* |
| Total assets | 547,005 | 682,090 | 853,385 | 1,026,051 | 1,257,408 |
| Networth | 93,299 | 115,080 | 129,078 | 145,891 | 166,866 |
| Borrowings | 406,478 | 521,600 | 676,241 | 838,481 | 1,047,666 |
| Gearing (no of times) | 5.43 | 5.86 | 5.93 | 6.61 | 7.03 |
| Leverage (no of times) | 3.91 | 4.36 | 4.53 | 5.24 | 5.75 |

## Ratio analysis

| Year to 31 March (%) | FY07 | FY08 | FY09 | FY10E | FY11E |
|---|---|---|---|---|---|
| Net int. margin/avg assets | 3.36 | 3.56 | 3.66 | 3.65 | 3.60 |
| Non-fund rev./avg assets | 0.09 | 0.14 | 0.11 | 0.07 | 0.06 |
| Operating exp./avg assets | 0.13 | 0.17 | 0.15 | 0.16 | 0.16 |
| Cost/Income | 3.65 | 4.55 | 3.93 | 4.17 | 4.23 |
| Prov./avg assets | (0.01) | (0.02) | 0.01 | 0.02 | 0.03 |
| PBT/Average assets | 3.33 | 3.56 | 3.62 | 3.54 | 3.48 |
| RoA | 2.34 | 2.38 | 3.21 | 2.60 | 2.56 |
| RoE | 12.70 | 13.47 | 18.91 | 16.38 | 17.47 |
| Tax/PBT | 34.76 | 32.50 | 1.01 | 26.50 | 26.50 |
| Gross NPA | 0.10 | 0.03 | 0.02 | 0.03 | 0.04 |
| Net NPA | 0.06 | 0.01 | 0.01 | 0.00 | 0.00 |

## Shareholding pattern




*As of June 2009*

# REC

Rs212
OUTPERFORMER

## *'Gen' Next*

Mkt Cap: Rs181bn; US$3.7bn

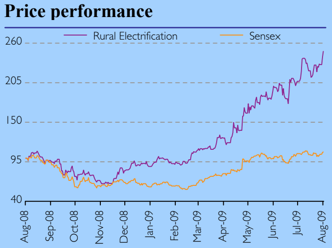
Initiating coverage

26 August 2009

BSE Sensex: 15770

| Stock data | |
|---|---|
| Reuters | RURL.BO |
| Bloomberg | RECL IN |
| 1-yr high/low (Rs) | 213/53 |
| 1-yr avg daily volumes (m) | 1.49 |
| Free float (%) | 18.2 |

**Price performance**




**Performance (%)**

| | 3-mth | 6-mth | 1-yr | 3-yr |
|---|---|---|---|---|
| REC | 53.2 | 165.0 | 149.7 | - |
| Sensex | 16.1 | 76.1 | 8.9 | 36.3 |

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**Rural Electrification Corporation (REC) is well-placed to capitalize on the huge investments planned in India's power sector with a robust sanctions pipeline of Rs1.8tn providing long-term growth visibility. High government ownership and access to capital gains tax exemption bonds fortify the liability franchise and impart competitiveness. Increasing exposure to generation projects over the last three years against the historic focus on T&D segment has lent credence to REC's growth prospects. Despite the subsequent stellar ~140% outperformance vis-à-vis Sensex in the last 12 months, valuations of 2.2x FY10E and 1.9x FY11E book appear attractive in view of the 29% CAGR in earnings over FY09-11E. Initiating coverage with Outperformer rating and a 12-month price target of Rs260 (2.3x FY11E book).**

**Robust growth prospects:** REC is well-poised to capitalize on the enormous demand-supply gap in power financing. Its rich sanctions pipeline (Rs1.8tn – adequate to sustain disbursements for ~11 years at the current run rate) offers high growth visibility. With incremental growth largely driven by upstream projects as against T&D projects earlier, concerns on asset quality are fading.

**Strong liability profile to support NIM:** REC has a competitive funding franchise owing to (i) regulatory dispensations in the form of access to tax exempted bonds, (ii) high government ownership leading to sovereign credit rating, and (iii) no reserve requirements. While redemption of ~50% of capital gains exemption bonds will exert pressure on margins in FY10, we expect NIM to be steady on lower incremental costs and assets re-pricing at higher yields.

**Attractive valuations; Outperformer:** We expect robust disbursements and steady margins to drive ~29% CAGR in REC's net profit. While RoA would improve from 2.6% to an average 2.9% over FY09-11E, RoE will be subdued given the imminent capital raising (our estimates do not factor in the same) with sustainable RoE of ~20%. Despite a marked outperformance in the last 12 months, the stock is attractively valued at 1.87x FY11E book. Initiating coverage with an Outperformer rating and a 12-month price target of Rs260.

**Key valuation metrics**

| As on 31 March | FY07 | FY08 | FY09 | FY10E * | FY11E |
|---|---|---|---|---|---|
| Disbursements (Rs bn) | 107.3 | 129.5 | 171.6 | 223.0 | 278.8 |
| Net profit (Rs m) | 6,603 | 8,601 | 12,722 | 20,477 | 21,183 |
| yoy growth (%) | 3.6 | 30.3 | 47.9 | 61.0 | 3.4 |
| Shares in issue (m) | 780.6 | 858.7 | 858.7 | 858.7 | 858.7 |
| EPS (Rs) | 8.5 | 10.5 | 14.8 | 23.8 | 24.7 |
| EPS growth (%) | 3.6 | 24.1 | 41.2 | 61.0 | 3.4 |
| PE (x) | 24.9 | 20.1 | 14.2 | 8.8 | 8.5 |
| Book value (Rs/share) | 51.4 | 62.5 | 72.1 | 97.4 | 112.2 |
| P / BV (x) | 4.1 | 3.4 | 2.9 | 2.2 | 1.9 |
| RoAE (%) | 16.1 | 18.3 | 22.0 | 28.1 | 23.5 |

** Profit includes Rs3bn of deferred tax reversal through P&L. Pre-exceptional profit growth of 36%*

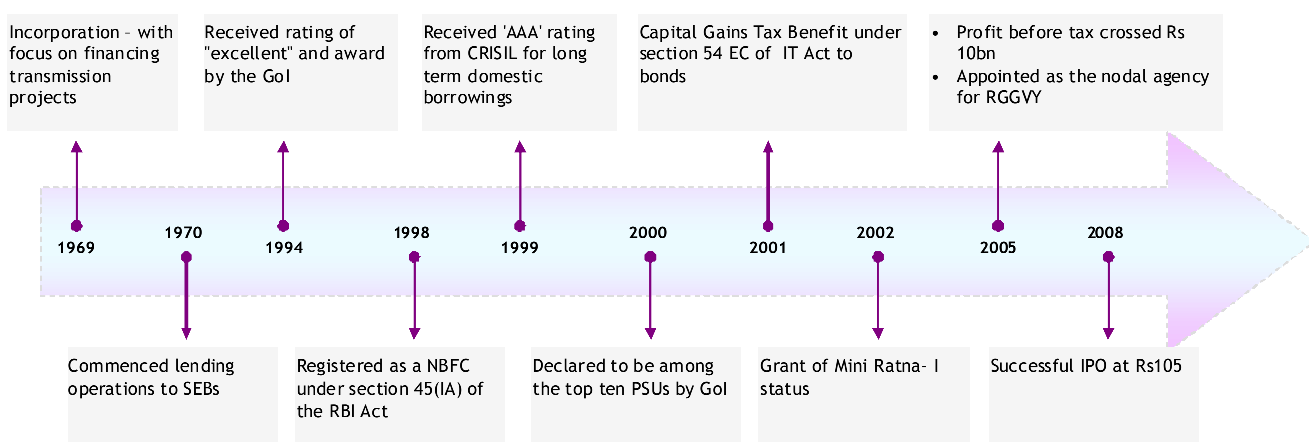
# INVESTMENT ARGUMENT

**With presence across the value chain, REC is among the top financiers to the power sector in India. Accordingly, we see the company well-placed to grow its disbursements at a robust pace of 27% over FY09-11E. Focus on increasing exposure to upstream projects and a consequent improvement in asset quality, suitable exposure norms, substantial government ownership and a lean operating structure offer a structural competitive edge. With growth remaining strong, traction in core profitability will be augmented by steady NIMs and low operating costs, driving 30% earnings CAGR over FY09-11. Owing to a high debt-equity ratio (8.5x in FY10E), REC intends to raise ~Rs30bn of equity capital. Currently, our estimates do not factor in the planned capital raising. At 1.9x FY11E book, we believe valuations are attractive considering the high growth visibility. We initiate coverage with an Outperformer rating.**

## RURAL ELECTRIFICATION CORPORATION: SPREADING WINGS

Rural Electrification Corporation (REC) was incorporated in 1969 for extending credit to the power sector, predominantly government entities such as state electricity boards. Further to its revised mandate in FY02 from the Government of India to finance power projects across the value chain, REC has steadily increased exposure to generation assets (which was up until then the preserve of Power Finance Corporation), particularly over FY06-09. Historically, REC has been focused on funding transmission & distribution projects (T&D).

**Exhibit 1: Key milestones**




*Source: Company, IDFC-SSKI Research*

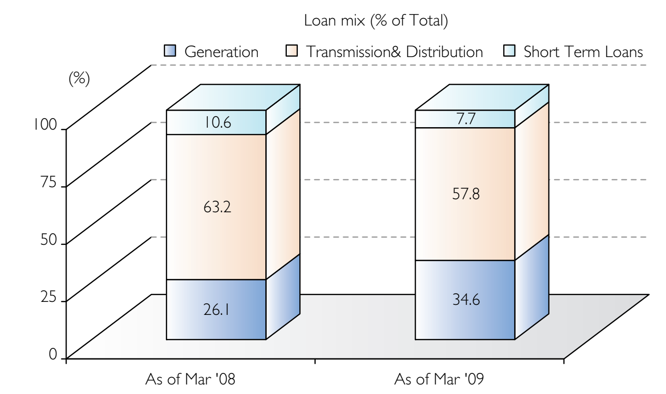
***Generation projects comprised 46% of REC's disbursements in March 2009; 33% a year ago***

### ❑ Morphing itself into a 'power value chain' financier

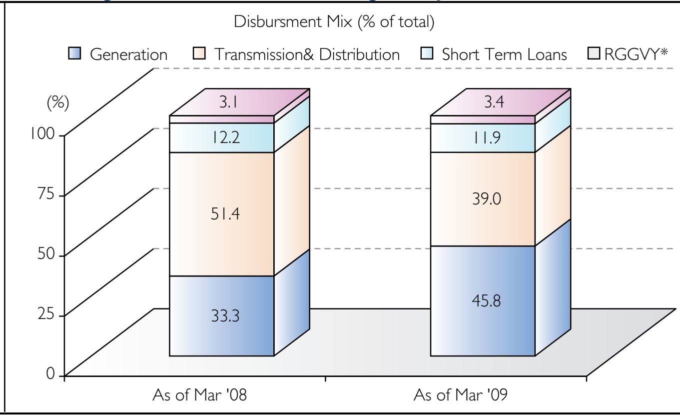
As in the past, REC's loan book continues to be dominated by T&D assets, comprising 58% of the total as of June 2009. Notably, generation projects comprise an increasing proportion of the disbursement pie (at 46% in March 2009 as against 33% a year ago), and thereby outstanding loans. While generation assets and/or T&D assets are similar from an IRR perspective for REC, we believe the increasing proportion of generation projects in disbursements could yield the following benefits:

- *Higher growth visibility and better growth prospects:* While the potential across the power value chain is immense given the demand-supply gap, financing requirements are higher for generation projects. The management has indicated that generation assets may rise to 50-60% of outstanding loan book over the next couple of years owing to (i) a larger ticket size; and (ii) increased focus.
- *Augurs well for asset quality:* The T&D asset bias exposed REC's asset quality to the risk of payment and execution delays. The risk is somewhat mitigated by the changing product mix in favour of upstream projects.

**Exhibit 2: A more diversified loan book…**




**…generation disbursements gather pace**




*Source: Company, IDFC-SSKI Research*

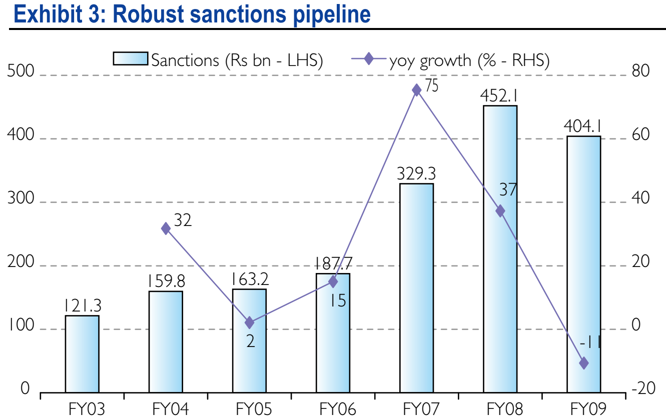
** RGGVY includes government subsidy*

***Disbursements in FY10 and FY11 are only 12% and 15% of cumulative sanctions***

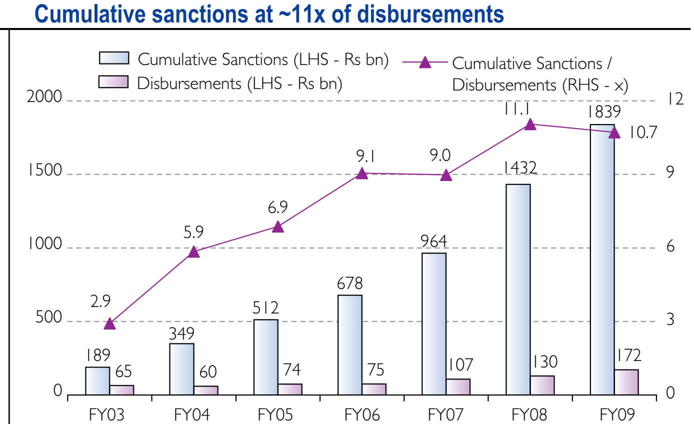
## ❑ High growth visibility – robust sanctions pipeline

Comfort around REC's growth prospects, and thereby profitability, stems from its swell sanctions pipeline. While investor concerns do exist over the ~11% yoy decline in sanctions in FY09 to Rs404bn, we draw comfort from the fact that disbursements in FY10 and FY11 are only 12% and 15% of cumulative sanctions of Rs1,839bn as of March 2009. Typically, generation projects have a gestation period of 4-5 years, while it is 2-3 years for T&D projects.

**Exhibit 3: Robust sanctions pipeline**




**Cumulative sanctions at ~11x of disbursements**




*Source: Company, IDFC-SSKI Research*

## LIABILITY FRANCHISE: A SOURCE OF STRENGTH

REC's liability franchise is a source of strength on the back of regulatory dispensations and 'AAA' credit rating given the government ownership. Despite the ceiling on issue of capital gains exemption bonds, REC's cost of funds is structurally lower than peer NBFCs, thereby bolstering margins. Being wholesale funded, REC's cost of funds is susceptible to pressure during interest rate cycles. However, the risk is partly mitigated by a 3-year re-set on 75% of the disbursements.

### ❑ Broad-based liability profile; regulatory dispensations an anchor

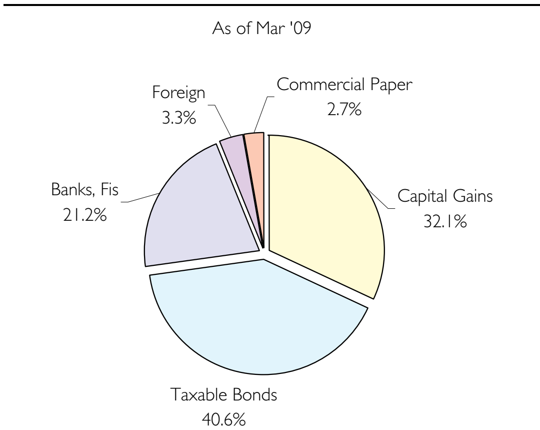
***As of March 2009, capital gains tax exemption bonds comprised 32% of REC's total funding mix***

According to the Finance Act 2006, REC (and NHAI) is entitled to raise money through capital gains tax exemption bonds under Sec 54 EC of the Act. As these bonds give the holder tax concessions, REC is able to price them lower – thereby reducing its cost of capital. As of March 2009, capital gains tax exemption bonds comprised 32% of REC's total funding mix. Typically, these bonds have a maturity of three years.

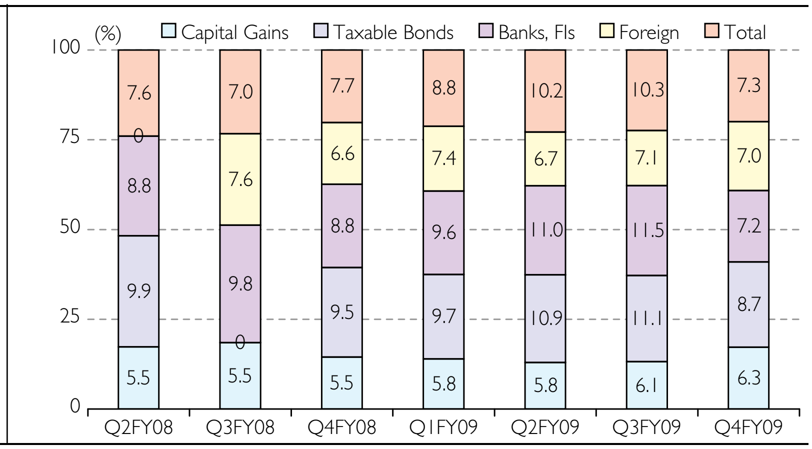
Unlike banks, REC is not required to adhere to reserve requirements like SLR and CRR, which places the company at a competitive funding advantage.

Another 41% of REC's total debt is attributable to taxable bonds, while banks and FII loans constitute ~21% of the total. REC has also raised Rs14.9bn in foreign loans (~3% of the total debt), which bring down the overall cost of capital.

**Exhibit 4: Liabilitites mix**




**Average cost of incremental borrowings**




*Source: Company, IDFC-SSKI Research*

### ❑ Limit on tax exempted bonds, near-term redemptions – a dampener

***A limit of Rs0.5m pa imposed for an entity /individual investing in tax exempted bonds***

Historically, REC has seen large investments from corporate entities in its capital gains tax exemption bonds. Later, the GoI imposed a limit of Rs0.5m per annum for an entity/individual investing in the capital gains exemption bonds. The ceiling in turn has made the bonds unattractive for several corporate investors, thereby acting as a major deterrent.

Also, Rs70bn-75bn of capital gains exemption bonds (~50% of total) are due for redemption in FY10, which would then be replaced by costlier debt. However, 75% of loans disbursed three years ago are also due to re-price at higher rates, thereby softening the impact on NIMs.

**Exhibit 5: Capital Gains Bonds redemption schedule#**

| Rs bn | Redemption | Fresh issue |
|---|---|---|
| **Capital gains exemption Bonds** | | |
| (Average cost: 5.5%-7.5%) | | |
| FY10 | 70-75 | 25 |
| FY11 | 35-40 | 20 |

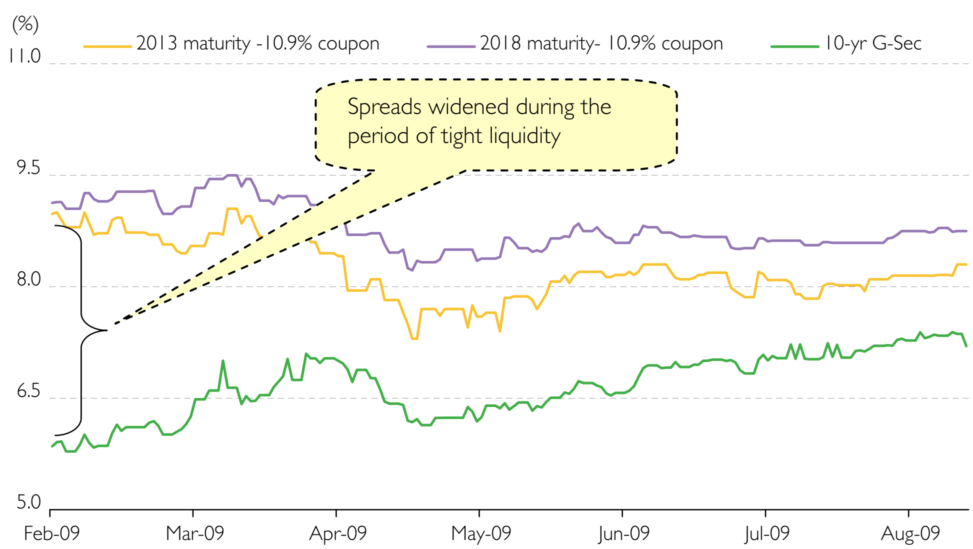
*Source: Company; # approximations*

## ❑ Sovereign credit rating aids costs

*REC's corporate bond yields can be priced due to the lower perceived risk premium*

Given the significant government ownership, REC enjoys the highest possible credit ratings of "AAA/Stable" from CRISIL, 'LAAA' from ICRA, "AAA (ind)" from Fitch and 'AAA' from CARE. Consequently, REC's corporate bond yields can be priced due to the lower perceived risk premium, thereby aiding its cost of capital (spread of 100-150bp on a normalized basis).

**Exhibit 6: REC corporate spreads typically 100-150bp**




*Source: Bloomberg*

## ❑ Strong capital adequacy…

*As of March 2009, REC's CAR stood at ~12%*

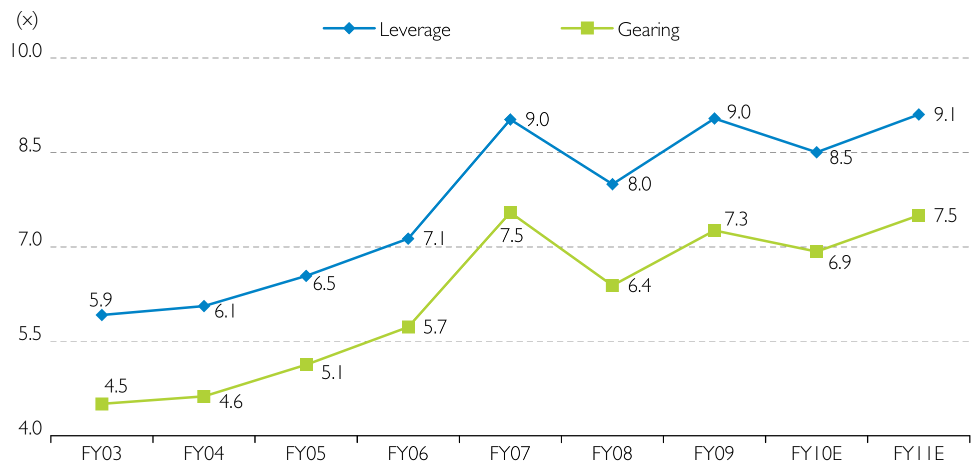
REC is exempt from conforming with the capital adequacy guidelines applicable to other NBFCs. As of March 2009, REC's CRAR ratio stood at ~12%. While REC has submitted a roadmap to the RBI, there is no decided deadline for compliance with the prudential norms (applicable to other NBFCs and banks).

## ❑ …capital raising in the offing as leverage rises

*REC proposes to raise Rs30bn through a follow-on public offer/ QIP issuance*

Optically, REC's debt-equity ratio appears elevated at 9x in FY09, which declines to 8.5x in FY10E after adjusting the reversal of deferred tax liability. In the past, REC's leverage ratio peaked at 9x in FY07. Currently, REC has submitted its proposal to the power ministry to raise Rs30bn through a follow-on public offer/ QIP issuance. While near-term RoE would likely be subdued subsequent to the capital raising, RoA will stay robust at an average of 2.9% over the next two years.

**Exhibit 7: Leverage ratio trend**




*Source: Company, IDFC SSKI Research*

## IMPROVING ASSET QUALITY

### ❑ Asset quality woes behind…

In FY04, REC's Gross NPAs touched 11%, as beleaguered state electricity boards (SEBs) defaulted on payments. Consequently,

*Gross NPAs had spiked to 11% in FY04…*

- REC negotiated bilateral deals (such as waiver of interest for a year, revising interest rates and early settlement discounts) to settle dues.
- Subsequently, REC booked Rs7.6bn of one-off settlement income over FY05-07.
- In the case of Madhya Pradesh, the bilateral settlement involved issue of bonds by the state government, of which Rs9.9bn is still outstanding as of March 2009. These bonds carry a coupon of 8%, and are due to be redeemed in 30 equal half-yearly installments by FY20.

**Exhibit 8: One-time settlement income received**

| REC - P&L (Rs mn) | Mar '02 | Mar '03 | Mar '04 | Mar '05 | Mar '06 | Mar '07 |
|---|---|---|---|---|---|---|
| One-time Settlement income – (incl. in interest income) | 2,200 | 4,730 | 2,940 | 5,470 | - | - |
| One-time Settlement income – (incl. in other income ) | - | - | - | - | 1,216.8 | 877.7 |

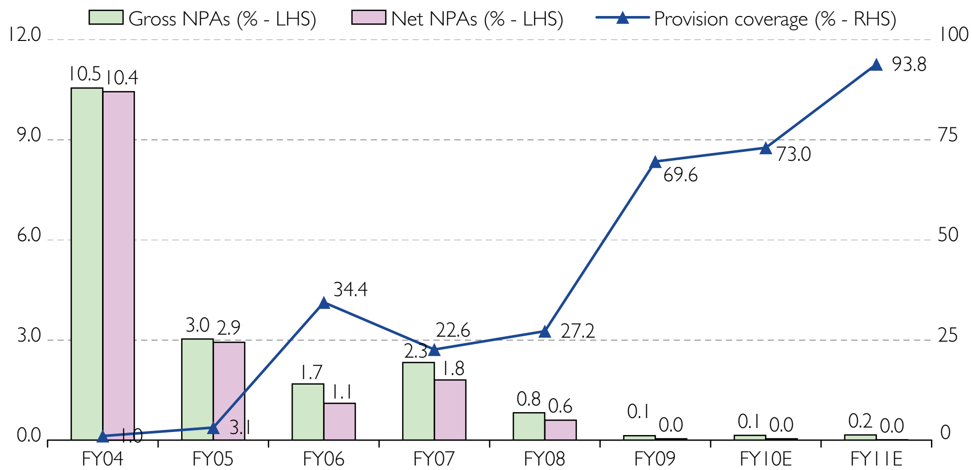
*Source: Company*

### ❑ …on an improving trajectory since then

*…but later declined to ~3% in FY05, partly due to government-aided clean-up*

Further to the government-aided clean-up, REC's Gross NPAs declined by 67% yoy to 3.03% in FY05. Since then, REC's Gross NPAs have been consistently improving on the back of (i) improving financial strength of state electricity boards (in turn a function of de-coupling of value chain projects), and (ii) introduction of an escrow mechanism having a first charge to the sale proceeds credited. Currently, 60-65% of REC's assets are under the escrow mechanism, while 35-40% are backed by government guarantees. So far, REC has invoked government guarantee in case of a few co-operatives.

**Exhibit 9: Gross NPAs on a downtrend as coverage improves**



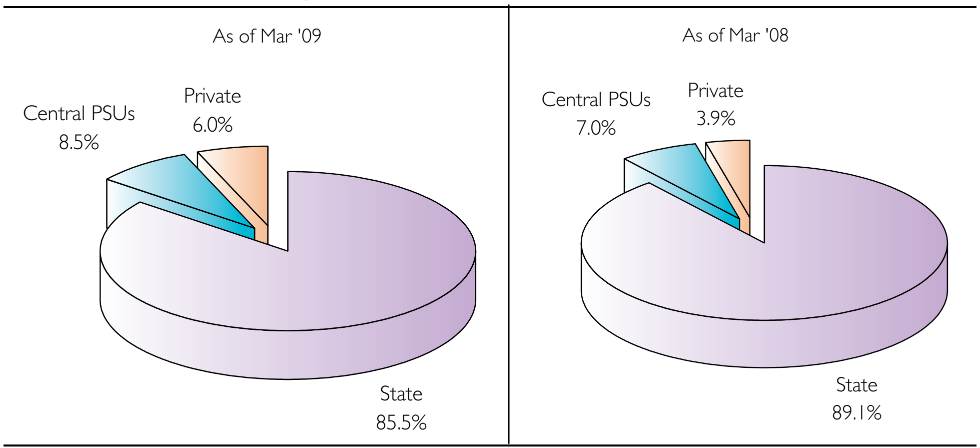

*Source: Company, IDFC-SSKI Research*

## ❑ Loan profile provides comfort

***As of March 2009, ~85% of the loan book is to state government entities***

As of March 2009, ~85% of REC's loan book is to state government entities, with central government comprising another ~9%. While this part of the loan book is subject to the risk of delayed execution, and thereby delayed payments, the sovereign ownership safeguards REC against defaults. By 2011-12, private sector could contribute as much as 15% of the outstanding loan book against ~6% currently. REC charges higher rates to its private borrowers relative to PSU peers. Among PSU borrowers, rate differential varies from 25-50bp depending on the assigned 'credit grade' of the borrower.

**Exhibit 10: A sound borrower profile**




*Source: Company*

## ❑ …stringent norms to assess private borrowers

***For private sector projects, 25-50% equity contribution by the borrower is a pre-requisite before disbursal***

In case of private sector projects, REC ensures that coal linkages have been obtained and power purchase agreements agreed upon prior to sanction. Most significantly, the pre-requisite is that the borrower should bring in 25-50% of the equity contribution before disbursement, depending on the credit rating of the borrower.

## ❑ Prudential norms – similar to RBI's prescription

Unlike peer NBFCs, REC enjoys regulatory forbearance from prudential norms. REC then has its own prudential norms, broadly in line with RBI's prescribed norms. REC has submitted a roadmap to migrate to RBI norms to the ministry, with a verdict still due. Notably, given the low NPAs, provisioning expenses remain negligible.

**Exhibit 11: Prudential norms of NPA recognition and provisioning**

| Type of NPA | Definition | REC's provisioning norm |
|---|---|---|
| Non-performing asset | If interest/ principal is overdue for a period of 6 months or more | NIL |
| Sub-standard asset | An asset which has been an NPA for, not more than 18 months | 10% provision is to be made |
| Doubtful asset | An asset which has been a substandard asset for a period exceeding 18 months | 100% provision to the extent the loan is not realizable<br>Depending on period for which asset has remained doubtful on the realizable portion:<br>Upto 1 year – 20% of provision<br>1- 3 years – 30% of provision<br>> 3 years – 50% of provision |
| Loss asset | To the extent written-off or if the asset remains doubtful for a period exceeding 5 years, whichever is earlier | Entire asset shall be written-off/ 100% provisions made if on books |

*Source: Company*

## ❑ Exposure norms aid risk mitigation

While RBI's prudential norms do not apply, REC follows internal exposure limits in order to mitigate the concentration risk. Currently, lending to a single project is restricted to 25% of REC's net worth and 50% for a Group. On the other hand, REC can lend as much as 100% of its net worth to unbundled generation projects and up to 250% for integrated projects.

**Exhibit 12: REC's exposure norms**

| Type of borrower/ project | Exposure norms (% of REC's net worth) |
|---|---|
| State Power Utility (other than integrated)/ State Government/ Central Government PSUs in Power Sector | Not greater than 100% |
| DISCOM (an integrated one for entire distribution) | Not greater than 200% |
| Integrated SEBs | Not greater than 250% (of which exposure to generation projects would be limited to 100%) |
| Central/ State/ Joint sector borrower other than above | Not greater than 50% |
| Single Group of companies | Not greater than 50% (an additional 5% subject to board approval) |
| In case of T&D projects for exposure beyond 100% | Where AT&C losses are more than 30%, borrower shall undertake to contain losses by 2% per annum<br>Where AT&C losses are between 20-30%, borrower shall undertake to contain losses by 1% per annum |

*Source: Company*

## FEE INCOME: INCREASING CONTRIBUTION

### ❑ Nodal agency for government schemes

The GoI has appointed REC as the nodal agency for several initiatives around the Indian power sector:

- RGGVY – aimed to augment transmission network

*REC lends 10% of the project cost under RGGVY with 90% routed as grant through the company*

The government is implementing the RGGVY (Rajiv Gandhi Grameen Vidyut Yojana) programme to electrify all villages and rural households. The programme envisages a spend of ~Rs160bn over the XIth Plan period, which is a 64% increase over the previous Plan. Under the scheme, the government provides subsidies in the form of grants for 90% of the funding, which is channeled through REC. the company provides the remaining 10% of the funding in the form of long-term loans, which have a 15-year maturity (including 5-year moratorium on principal). From FY08, REC earns 1% of the total project cost as fee for its role as the nodal agency.

**Exhibit 13: Loans disbursed under RGGVY**

| (Rs m) | FY05 | FY06 | FY07 | FY08 | FY09 |
|---|---|---|---|---|---|
| RGGVY * | 494 | 575 | 3,334 | 3,723 | 5,689 |

** Approximations*

- APDRP-II

*REC jointly mandated with PFC to implement the APDRP scheme*

The GoI has jointly mandated REC (with PFC) to implement the APDRP scheme. REC is yet to commence disbursals under the scheme. Subsequently, REC is likely to earn fee revenues of 1% of the amount disbursed (as seen in the case of PFC).

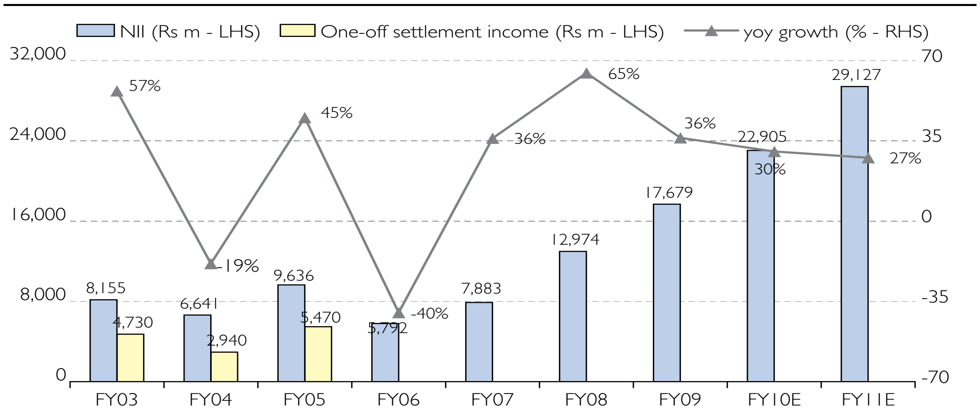
## STRONG EARNINGS TRACTION AHEAD

### ❑ NII on an uptrend…

*We expect REC to post a CAGR of ~28% in NII over FY09-11*

Over FY04-07, REC evidenced a phase of low and volatile NII growth, as the company expurgated its book of NPA assets of state electricity boards. During the period, REC received one-off settlement income from state governments, which was booked under interest income over FY03-05, and under other income in FY06 and FY07. Buoyed by robust disbursement growth and steady margins, we expect REC to post a CAGR of ~28% in NII over FY09-11.

**Exhibit 14: Volatility behind…NII on an uptrend**



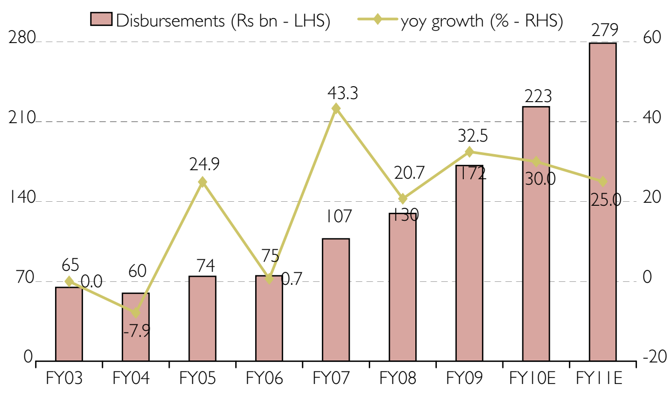

*Source: Company, IDFC-SSKI Research*

*We estimate disbursement CAGR of 27% over FY09-11*

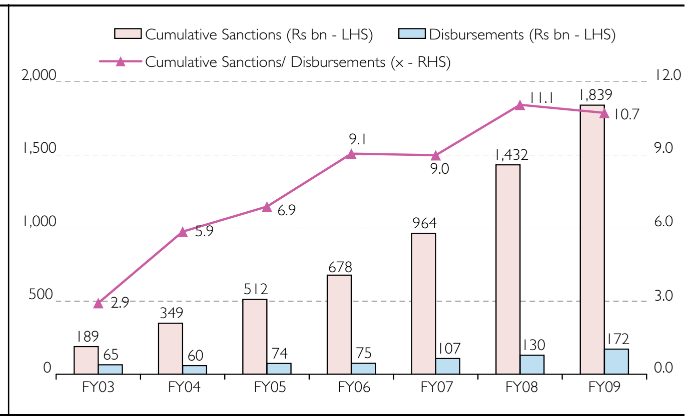
## ❑ …driven by robust volume growth and…

Over FY07-09, REC has posted a CAGR of 26% in disbursements. In our estimates, we are factoring in a disbursement CAGR of 27% over FY09-11. As of March 2009, the cumulative sanctions/ FY09 disbursements ratio stands at ~11x, which is testimony to REC's strong growth prospects.

**Exhibit 15: Strong disbursement growth…**




**…to be fuelled by strong pipeline (cumulative sanctions at ~11x)**



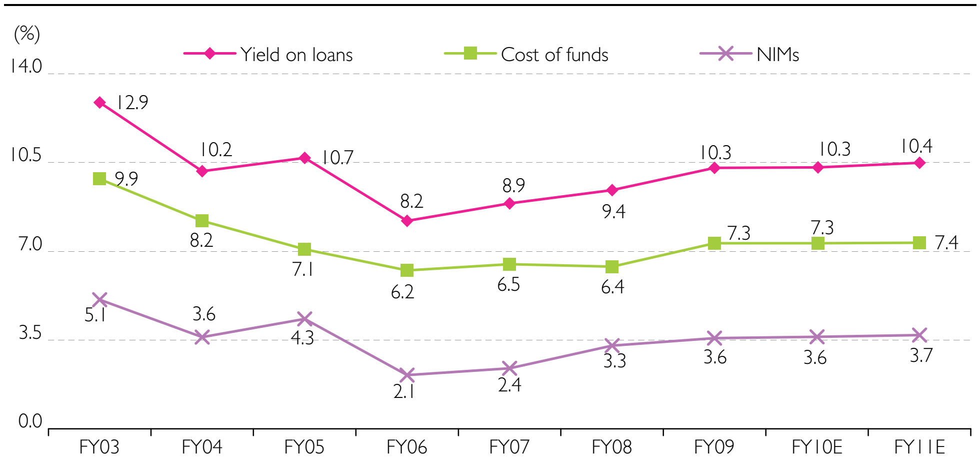

*Source: Company, IDFC-SSKI Research*

*Rredemption of ~50% of outstanding capital gains exemption bonds to exert pressure on margins*

## ❑ … steady margins

In FY10E, redemption of ~50% of outstanding low-cost capital gains exemption bonds is likely to create downward pressure on margins, which would be partly offset by (i) lower-cost of incremental borrowings in the prevailing high liquidity environment, and more significantly (ii) by re-pricing of assets disbursed three years ago at higher yields. In the context of high systemic liquidity, REC's near-term capital raising plan and re-pricing of assets, we are building in a stable margin trend over FY09-11E. The management expects any pressure on net interest income on account of near-term redemptions to be limited to Rs600m-700m.

**Exhibit 16: Some uptick expected margins over FY09-11**



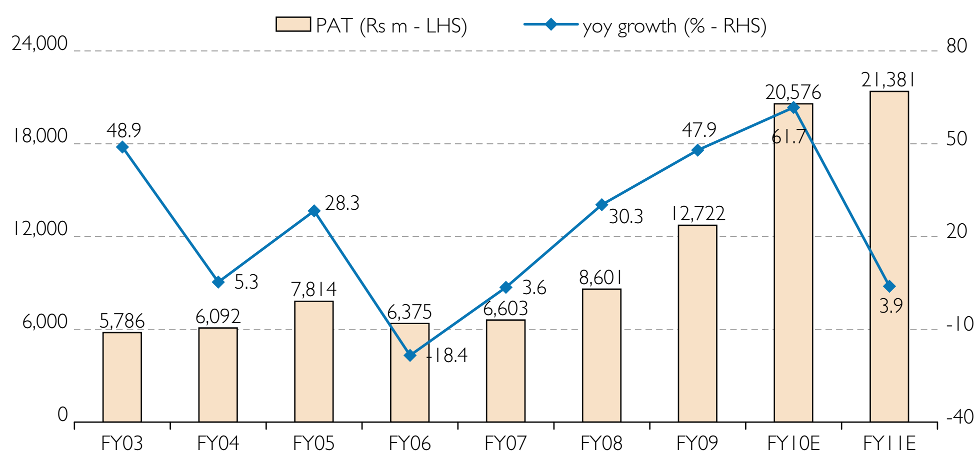

*Source: Company, IDFC-SSKI Research*

*We expect 29% CAGR in REC's net profit over FY09-11*

## ❑ Strong profit growth ahead …

We estimate REC to register a CAGR of 29% in net profit over FY09-11, buoyed by strong disbursement growth and stable margins. As the dispute pertaining to creation of deferred tax liability between ICAI and PFC has been resolved (refer page 25 for details), REC is likely to book Rs3bn of one-off deferred tax reversal through the P&L in FY10. On a pre-exceptional basis, profit growth in FY10E is pegged at 36% yoy.

**Exhibit 17: Strong profit growth ahead**



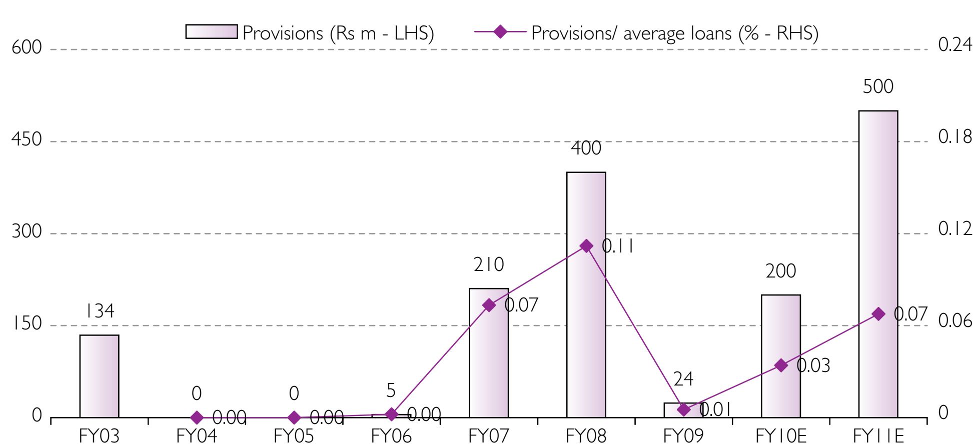

*Source: Company, IDFC-SSKI Research; FY11E profit yoy growth amounts to ~30% on a comparable basis*

*Minimal provisioning expenses on the back of expurgation of book in FY04 and improving financial strength of SPUs*

## ❑ …bolstered by minimal provisioning costs…

While REC adheres to RBI-equivalent provisioning norms, provisioning expenses remain minimal on the back of clean-up of book in FY04 and improving financial strength of state electricity boards (~85% of REC's loan book). Going forward, we are conservatively building in some rise in provisions for REC.

**Exhibit 18: Building in a marginal rise in provisioning costs**

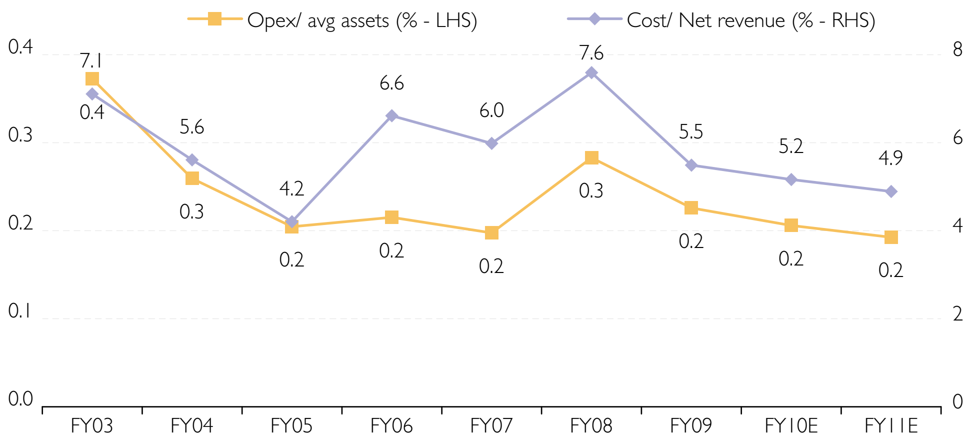



*Source: Company, IDFC SSKI Research*

## ❑ …and low operating expenses

By virtue of the business segment REC operates in, operating expenses are negligible and are expected to remain within the historic range going forward.

**Exhibit 19: Lean operating structure**




*Source: Company, IDFC SSKI Research*

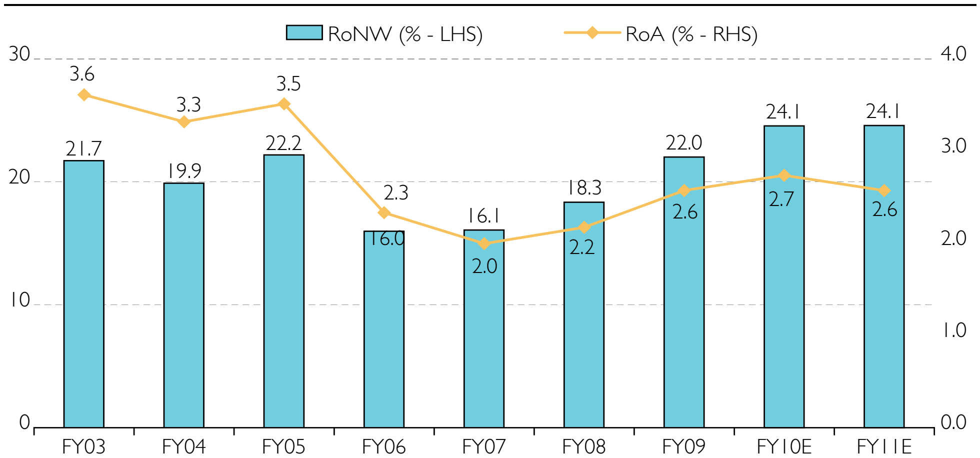
## VALUATIONS & VIEW

### ❑ Return ratios on an uptrend

*Average RoA expected to improve to 2.9% over the period from 2.6% in FY09*

Buoyed by the robust disbursement growth and stable margins, we expect ~30% CAGR in REC's profits over FY09-11. Consequently, average RoA would improve to 2.9% over the period from 2.6% in FY09. While RoE is expected to surge from 22% in FY09 to 28% in FY10 due to one-off reversal of deferred tax of Rs6.4bn in FY10, proposed capital raising would subdue the near-term RoEs. However, core profitability will remain strong with RoA of 2.9% over the next two years. While our current estimates do not factor in the potential capital raising, we expect RoE to stabilize at ~20% on a sustainable basis.

**Exhibit 20: RoA on an uptrend**




*Source: Company, IDFC SSKI Research; FY10E ratios on a pre-exceptional basis*

### ❑ Capital raising – free float to increase

*REC's proposed capital raising of ~Rs30bn to improve free float*

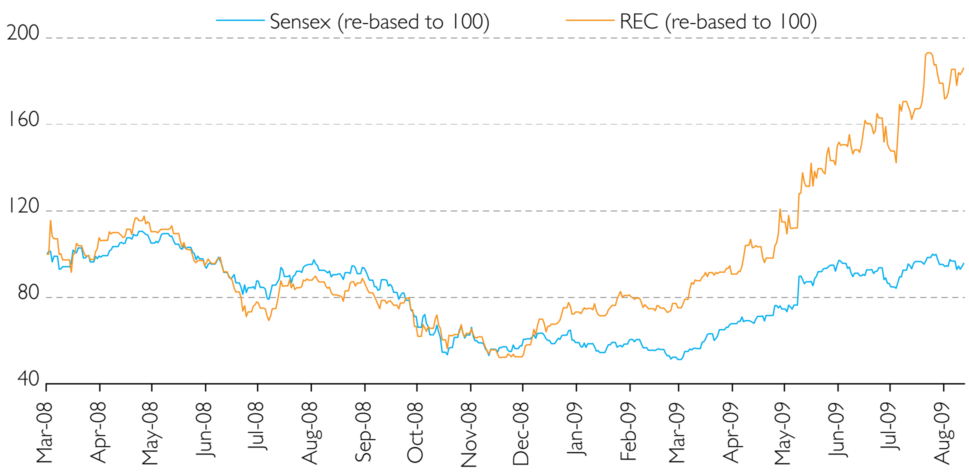
Given the 81.8% holding of government in REC, free float has been limited so far. In this context, REC's proposed capital raising of ~Rs30bn would be a positive. Assuming the capital raising happens at close to the current market price of Rs211, the stock currently trades at attractive valuations of 1.8x FY10E and 1.6x FY11E adjusted book.

*The imminent capital raising and strong underlying business potential to drive further re-rating in the stock*

## ❑ Relative outperformance expected to continue

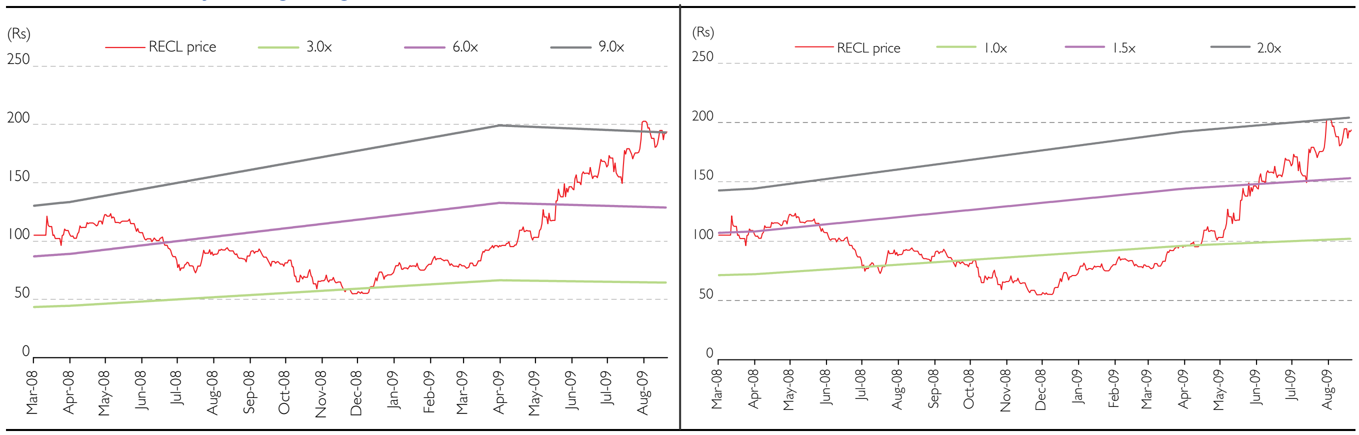
REC has consistently outperformed the Sensex since December 2008 on the back of lower risk premium, sound asset quality profile and positive triggers of ruling of deferred tax in favour of REC and near-term capital raising. While the stock currently trades at the higher end of its historic band, the imminent capital raising and strong underlying business potential would drive a re-rating.

**Exhibit 21: REC has outperformed the Sensex by a wide margin**




*Source: Bloomberg, Company, IDFC-SSKI Research*

**Exhibit 22: Currently trading at higher end of its historic band**




*Source: Bloomberg, Company, IDFC-SSKI Research*

*Buy with a 12-month price target of Rs260*

## ❑ Initiating coverage with an 'Outperformer' recommendation

We are structurally bullish on REC given the strong growth prospects (backed by sharp government focus), and balance sheet strength (both in terms of liability franchise and asset quality). Our estimates do not factor in the imminent capital raising. We have valued REC on a P/BV basis. We initiate coverage with an Outperformer rating and a 12-month price target of Rs260 (2.3x FY11E book and 10.4x FY11E EPS).

## Earnings model

| Year to 31 March (Rs m) | FY07 | FY08 | FY09 | FY10E* | FY11E |
|---|---|---|---|---|---|
| Net interest income | 7,883 | 12,974 | 17,679 | 22,905 | 29,127 |
| *yoy growth (%)* | *36.1* | *64.6* | *36.3* | *29.6* | *27.2* |
| Other income | 3,028 | 1,771 | 2,663 | 2,306 | 1,923 |
| *yoy growth (%)* | *(2.4)* | *(41.5)* | *50.4* | *(13.4)* | *(16.6)* |
| Trading profits | 1,866 | 1,569 | 1,242 | 1,122 | 896 |
| Non trading income | 1,161 | 202 | 1,421 | 1,184 | 1,028 |
| Net revenue | 10,910 | 14,745 | 20,343 | 25,211 | 31,050 |
| *yoy growth (%)* | *22.7* | *35.1* | *38.0* | *23.9* | *23.2* |
| Operating expenses | 653 | 1,119 | 1,117 | 1,309 | 1,532 |
| *yoy growth (%)* | *11.1* | *71.4* | *(0.2)* | *17.2* | *17.0* |
| Provisions | 210 | 400 | 24 | 200 | 500 |
| PBT | 10,047 | 13,226 | 19,202 | 23,703 | 29,018 |
| *yoy growth (%)* | *21.1* | *31.6* | *45.2* | *23.4* | *22.4* |
| Provision for tax | 3,459 | 4,523 | 6,480 | 3,226 | 7,835 |
| PAT | 6,603 | 8,601 | 12,722 | 20,477 | 21,183 |
| *yoy growth (%)* | *3.6* | *30.3* | *47.9* | *61.0* | *3.4* |

** Profit including Rs3bn of deferred tax reversal through P&L. Pre exceptional profit growth of 36%*

## Balance sheet

| As on 31 March (Rs m) | FY07 | FY08 | FY09 | FY10E | FY11E |
|---|---|---|---|---|---|
| Loan book | 320,991 | 393,165 | 513,814 | 659,788 | 819,833 |
| *yoy growth (%)* | *26.7* | *22.5* | *30.7* | *28.4* | *24.3* |
| Total assets | 362,034 | 429,143 | 559,564 | 711,910 | 879,118 |
| Networth | 40,127 | 53,677 | 61,901 | 83,651 | 96,365 |
| Borrowings | 302,810 | 342,828 | 449,360 | 579,838 | 724,648 |
| Gearing (no of times) | 7.5 | 6.4 | 7.3 | 6.9 | 7.5 |
| Leverage (no of times) | 9.0 | 8.0 | 9.0 | 8.5 | 9.1 |

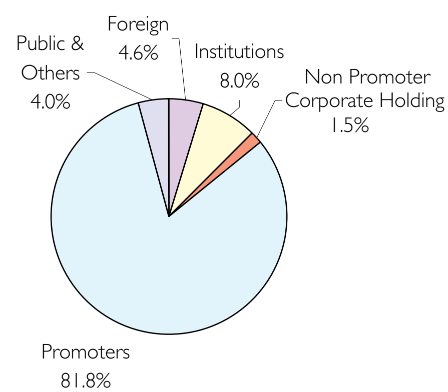
*Source: IDFC - SSKI Research*

## Ratio analysis

| Year to 31 March (%) | FY07 | FY08 | FY09 | FY10E | FY11E |
|---|---|---|---|---|---|
| Net int. margin/avg assets | 2.3 | 3.2 | 3.6 | 3.6 | 3.6 |
| Non-fund rev./avg assets | 0.9 | 0.4 | 0.5 | 0.4 | 0.2 |
| Fees / avg assets | 0.9 | 0.4 | 0.5 | 0.4 | 0.2 |
| Operating exp./avg assets | 0.2 | 0.3 | 0.2 | 0.2 | 0.2 |
| Cost/Income | 6.0 | 7.6 | 5.5 | 5.2 | 4.9 |
| Prov./avg assets | 0.06 | 0.10 | 0.00 | 0.03 | 0.06 |
| Prov./avg loans | 0.07 | 0.11 | 0.01 | 0.03 | 0.07 |
| PBT/Average assets | 3.0 | 3.3 | 3.9 | 3.7 | 3.6 |
| RoA | 2.0 | 2.2 | 2.6 | 3.2 | 2.7 |
| RoE | 16.1 | 18.3 | 22.0 | 28.1 | 23.5 |
| Tax/PBT | 22.8 | 28.6 | 26.5 | 27.0 | 27.0 |
| Gross NPA | 2.33 | 0.82 | 0.13 | 0.14 | 0.15 |
| Net NPA | 1.80 | 0.60 | 0.04 | 0.04 | 0.01 |
| Provisioning coverage | 22.6 | 27.2 | 69.6 | 73.0 | 93.8 |

*Source: IDFC - SSKI Research*

## Shareholding pattern (As of June 2009)




*Source: Company*

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**Explanation of Ratings:**

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

**Disclosure of interest:**

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