

DECEMBER 23, 2010
UPDATE

Coverage view: **Attractive**

Price PFC/REC (Rs): **323 / 300**

Target price PFC/REC (Rs):
325 / 300

Margin pressure on power finance companies. We believe that rising bulk borrowings rates will put pressure on margins of PFC and REC in the medium term. Capacity addition in the generation segment will likely drive better traction for PFC while loan growth will likely be somewhat lower for REC. Power finance companies (PFC and REC) have underperformed on the back of likely margin pressure and slower loan growth, we retain negative stance on both the stocks.

Company data and valuation summary

PFC

Stock data

52-week range (Rs) (high,low)	385-228
Market Cap. (Rs bn)	370.6

Shareholding pattern (%)

Promoters	89.8
FII	3.8
MFs	2.1

Price performance (%)

	1M	3M	12M
Absolute	(5.9)	(5.2)	27.1
Rel. to BSE-30	(7.3)	(5.8)	9.6

Forecasts/Valuations

	2010	2011E	2012E
EPS (Rs)	20.5	24.1	28.7
EPS growth (%)	54.0	17.5	19.1
P/E (X)	15.7	13.4	11.2
NII (Rs bn)	29.9	37.8	46.0
Net profits (Rs bn)	23.6	27.7	33.0
BVPS	110.5	127.9	148.9
P/B (X)	2.9	2.5	2.2
ROE (%)	19.0	19.3	19.8
Div. Yield (%)	1.4	1.5	1.8

Company data and valuation summary

Rural Electrification Corp.

Stock data

52-week range (Rs) (high,low)	414-205
Market Cap. (Rs bn)	295.9

Shareholding pattern (%)

Promoters	66.8
FII	20.4
MFs	3.1

Price performance (%)

	1M	3M	12M
Absolute	(13.3)	(11.4)	24.1
Rel. to BSE-30	(14.6)	(12.0)	7.0

Forecasts/Valuations

	2010	2011E	2012E
EPS (Rs)	20.3	25.7	30.0
EPS growth (%)	23.2	26.7	16.9
P/E (X)	14.8	11.7	10.0
NII (Rs bn)	25.2	32.8	38.5
Net profits (Rs bn)	20.0	25.4	29.7
BVPS	112.1	128.8	148.3
P/B (X)	2.7	2.3	2.0
ROE (%)	22.0	21.3	21.7
Div. Yield (%)	2.2	2.6	3.0

Rising bulk borrowing rates put pressure on margins

The current liquidity squeeze in the system has put significant pressure on bulk borrowing rates, primarily in the shorter end on the yield curve - interest rates below one year are up by about 4% from April 2010 levels. NIMs for PFC and REC have been in sweet spot over the past few quarters supported by excess liquidity and lower borrowings cost - the decline in lending rates by these companies was lower than the reduction in borrowings cost. We are reducing REC's margins by about 10-20 bps to factor lower margins over the next few quarters.

- ▶ In FY2011E, about Rs100 bn of REC's loan assets are due for re-pricing as compared to Rs50-60 bn of borrowings - favorable re-pricing of assets as compared to liabilities supported REC's spreads, the benefit is unlikely to extend in FY2012E.
- ▶ Higher share of private sector business (in the XII 5- year Plan) will likely increase competition for these companies and put pressure on margins. In case of PFC, about 23% of approvals are driven by private players as compared to 7% share in the current loan book.

Generation companies growing at a faster clip

We believe that PFC will likely deliver about 27% loan growth over the next two years, significantly higher than 22% loan book CAGR between 2007 and 2010, on the back of strong growth in the generation segment. REC has reported loan growth of about 25% YTD and loan growth will likely remain moderate as compared to 27% loan growth CAGR between 2007 and 2010. We are now modeling about 23% loan growth for REC in FY2011E and FY2012E as compared to 26% CAGR factored earlier.

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NPLs remain a risk

PFC and REC currently have negligible NPLs. Strong collections from state utilities despite the latter's poor financials remain a residual risk for these companies. Financial losses reported by state utilities have increased over the years though the asset quality performance of power finance companies remains strong likely due to their nodal agency role and central Government ownership. Government's impetus on power sector provides comfort in this regard. Nevertheless, we would like to highlight that unlike other NBFCs (like IDFC) and banks, PFC and REC have not made any provisioning buffers for any likely slippages.

Losses have increased across states

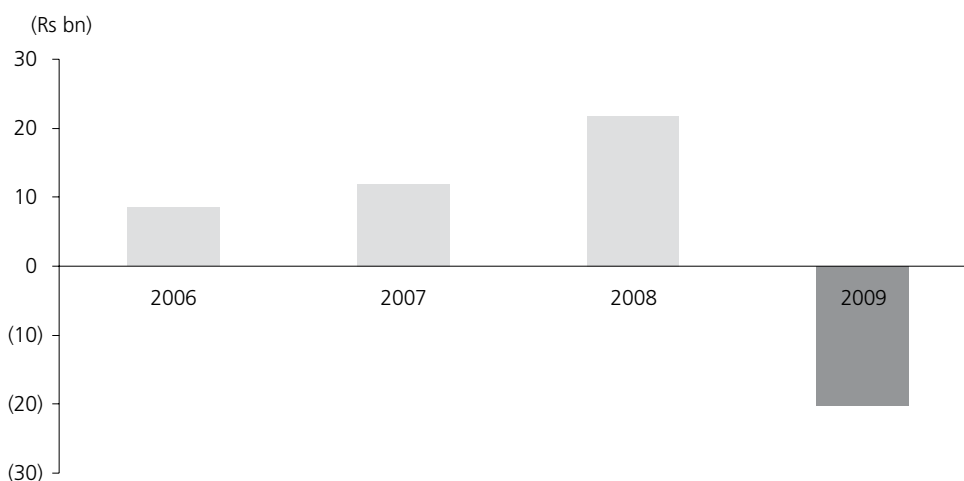
Accounting and cash loss of all state utilities (including distribution companies- Rs bn)

	2007		2008		2009	
	Loss	Cash loss	Loss	Cash loss	Loss	Cash loss
TN, UP, MP, Haryana and Karnataka	(65)	(56)	(102)	(75)	(195)	(199)
All other states	(66)	(9)	(24)	(1)	(34)	(85)
Total	(131)	(65)	(125)	(76)	(229)	(284)

Source: PFC

Generation and transmission companies also reported losses

Aggregate profits (losses) of generation, transmission and trading companies (Rs bn)

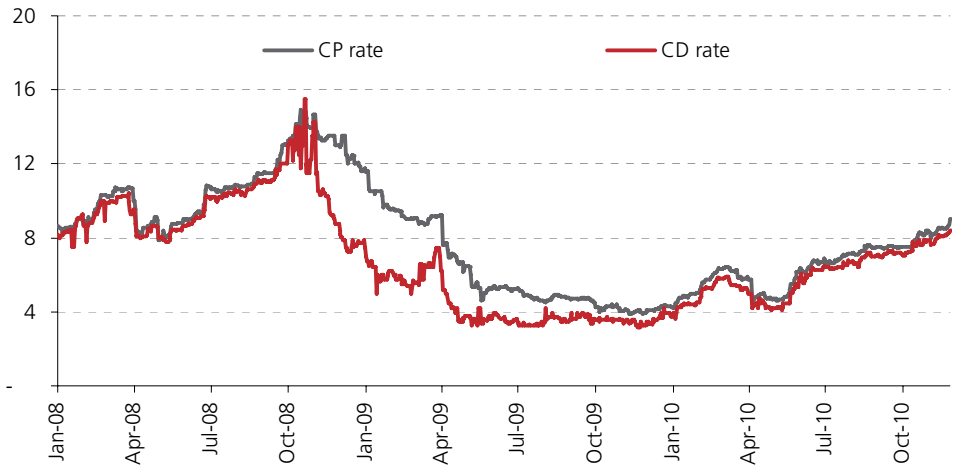


Source: PFC

Retain negative stance on PFC and REC

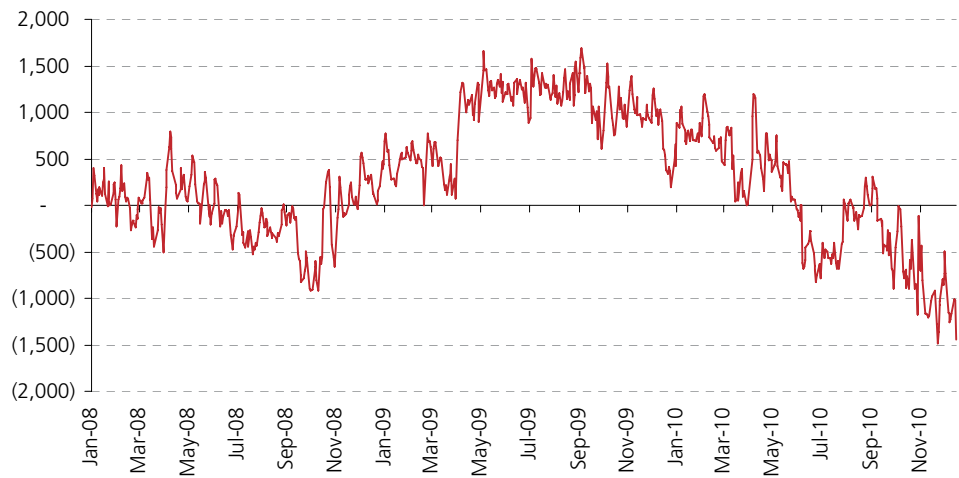
PFC and REC have underperformed the markets significantly over the last one month. We believe that stock performance will likely remain under pressure as NIM compression is more visible. We are revising down our estimates on REC to factor somewhat lower loan growth and margins. Retain REDUCE rating with price target of Rs300 (Rs350 earlier). PFC is relatively better placed due to higher growth traction though margins remain at a risk. The stock is trading closer to our target price, we revise rating to REDUCE from SELL, retain target price of Rs325.

Short-term rates have seen a rise in past few months
 CP and CD rates, 2008-2011 (%)



Source: Bloomberg

Liquidity has tightened significantly
 Net Reverse Repo amount (net of Repo) outstanding, 2008-2011 (Rs bn)



Source: Bloomberg

Loan growth trends for PFC and REC

	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
MOM loan growth (%)									
PFC		4	7	3	4	6	10	7	3
REC		13	4	7	7	8	4	5	5
YOY loan growth (%)									
PFC					19	20	24	29	28
REC					34	29	29	27	25
Loan book (Rs bn)									
PFC	579	604	644	662	687	724	798	856	879
REC	437	492	514	548	587	636	665	698	735

Source: Company

PFC and REC: Margins in sweet spot for past few quarters
NIM (KS estimates), September 2008-September 2010 (%)

	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
PFC	3.9	3.8	4.1	4.3	4.3	4.2	4.0	4.2	4.1
REC	4.4	4.1	4.2	4.4	4.5	4.3	4.7	4.7	4.7

Source: Company, Kotak Institutional Equities estimates

Loans for generation growing rapidly

Disbursements for REC and PFC, 1Q10-2Q10 (Rs mn)

	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11
REC						
Total	36,180	55,040	60,240	59,860	46,440	55,470
Generation	19,930	20,290	18,170	25,100	32,390	27,590
T&D	12,250	22,950	22,970	31,760	12,050	19,880
Short term loan	4,000	11,800	19,100	3,000	2,000	8,000
Share in total (%)						
Generation	55	37	30	42	70	50
T&D	34	42	38	53	26	36
Short term loan	11	21	32	5	4	14
PFC						
Total	43,460	45,170	64,930	104,530	81,270	57,901
Generation	34,370	34,820	48,110	79,520	46,980	41,480
Transmission	3,340	1,420	2,020	3,780	4,300	611
Distribution	2,230	740	720	2,620	3,090	3,500
R APDRP (A)		3,740	3,700	3,810	170	
R APDRP (B)				1,960	1,950	6,250
Others	3,520	4,450	10,380	12,840	24,780	6,060
Share in total (%)						
Generation	79	77	74	76	58	65
Transmission	8	3	3	4	5	1
Distribution	5	2	1	3	4	6
R APDRP (A)	—	8	6	4	0	—
R APDRP (B)	—	—	—	2	2	10
Others	8	10	16	12	30	10

Source: Company

REC, old and new estimates

March fiscal years 2011-2013E (Rs mn)

	Old estimates			New estimates			% change		
	2011E	2012E	2013E	2011E	2012E	2013E	2011E	2012E	2013E
Net interest income	33,910	40,846	48,574	32,805	38,531	44,811	(3)	(6)	(8)
Loan growth (%)	26	26	25	25	23	23			
NIM (%)	4.5	4.3	4.1	4.4	4.1	3.9	(2.8)	(3.8)	(4.0)
NPL provisions	3	3	4	3	3	4	—	—	—
Other operational income	2,927	3,362	3,870	2,927	3,362	3,870	—	—	—
Other income (forex etc)									
Operating expenses	1,678	1,943	2,252	1,678	1,943	2,252		—	—
Employee	1,323	1,522	1,750	1,323	1,522	1,750	(0)	—	—
Others	355	422	502	355	422	502	(0)	—	—
PBT	35,156	42,261	50,189	34,051	39,946	46,425	(3)	(5)	(7)
Tax	8,965	10,882	13,049	8,683	10,286	12,071	(3)	(5)	(7)
PAT	26,191	31,379	37,140	25,368	29,660	34,355	(3)	(5)	(7)

Source: Kotak Institutional Equities

REC : Key ratios, March fiscal year-ends, 2008-2013E (%)

	2008	2009	2010E	2011E	2012E	2013E
Growth in key parameters (%)						
Interest income	28.5	32.6	37.9	29.8	27.5	18.9
Interest costs	17.5	39.8	35.0	29.5	34.0	20.4
Net interest income	48.5	22.4	42.5	30.2	17.5	16.3
PAT	30.3	47.9	57.3	26.7	16.9	15.8
Disbursements	19.3	34.0	24.9	19.2	17.0	21.5
Loans	22.5	30.7	29.3	25.4	23.0	22.8
Borrowings	13.2	31.1	24.5	26.6	23.7	23.5
Shareholders funds	33.8	15.3	79.0	14.9	15.1	15.2
Key ratios (%)						
Interest yield	9.85	10.29	10.92	11.14	11.45	11.08
Interest cost	6.42	7.31	7.75	7.99	8.56	8.35
Spreads	3.43	2.97	3.16	3.15	2.88	2.73
NIMs	4.05	3.90	4.28	4.38	4.15	3.92
Tax rate	29	26	24	26	26	26
Debt/ equity+DTL (X)	5.5	6.3	5.1	5.6	6.0	6.4
Du Pont analysis						
(% of average assets)						
Net interest income	3.7	3.6	4.0	4.1	3.9	3.7
Other income	0.1	0.5	0.4	0.4	0.3	0.3
Credit costs	0.1	0.0	—	—	—	—
Operating expenses	0.3	0.2	0.2	0.2	0.2	0.2
PBT post extraordinary	3.3	3.9	4.2	4.3	4.1	3.9
1-tax rate	0.7	0.7	0.8	0.7	0.7	0.7
RoA	2.2	2.6	3.1	3.2	3.0	2.9
Average assets / average equity (X)	8.4	8.6	7.4	6.7	7.2	7.6
RoE	18.3	22.0	23.2	21.3	21.7	21.8

Source: Company, Kotak Institutional Equities estimates

REC : Income statement and balance sheet, March fiscal year-ends, 2008-2013E (Rs mn)

	2008	2009	2010E	2011E	2012E	2013E
Income statement (Rs mn)						
Interest income	35,174	46,650	64,309	83,460	106,388	126,538
Interest costs	(20,728)	(28,970)	(39,112)	(50,655)	67,857	81,727
Net interest income	14,447	17,680	25,197	32,805	38,531	44,811
Other income	202	2,660	2,768	2,927	3,362	3,870
Fees	177	1,740	1,189	1,427	1,712	2,055
Net total income	14,649	20,340	27,965	35,731	41,893	48,680
Provisioning expenses	(400)	(20)	(2)	(3)	3	4
Net income (post provisions)	14,249	20,320	27,962	35,729	41,890	48,677
Operating expenses	(1,119)	(1,120)	(1,470)	(1,678)	1,943	2,252
PBT before extraordinaries	13,130	19,200	26,492	34,051	39,946	46,425
Extraordinary income	(6)	—	—	—	—	—
PBT post extraordinaries	13,124	19,200	26,492	34,051	39,946	46,425
Tax	(3,749)	(5,070)	(6,473)	(8,683)	10,286	12,071
Provision for DTL	(774)	(1,410)	(5)	-	-	1
PAT	8,602	12,720	20,014	25,368	29,660	34,354
PAT (add. back DTL)	9,376	14,130	20,019	25,368	29,660	34,355
EPS (adding back DTL) (Rs)	11	16	20	26	30	35
BVPS (adding back DTL) (Rs)	72	83	112	129	148	171
ABVPS (adding back DTL) (Rs)	69	83	112	129	148	171
Balance sheet (Rs mn)						
Assets						
Loans	393,165	513,810	664,520	833,540	1,025,565	1,259,018
Investments	11,474	10,060	9,100	9,100	9,100	9,100
Fixed assets	779	810	900	1,035	1,190	1,369
Current assets	23,725	34,890	37,876	42,419	47,791	54,151
Total assets	429,143	559,570	712,396	886,094	1,083,647	1,323,637
Liabilities						
Borrowings	342,828	449,360	559,480	708,270	876,440	1,081,974
Deferred tax liability	8,170	9,570	(70)	(70)	(70)	(69)
Current liabilities and provisions	24,468	38,740	42,186	50,623	60,747	72,897
Total liabilities	375,466	497,670	601,596	758,823	937,117	1,154,802
Share capital	8,586	8,586	9,874	9,874	9,874	9,874
Reserves and surplus	45,090	53,314	100,926	117,397	136,656	158,961
Shareholders funds	53,676	61,900	110,800	127,271	146,530	168,835

Source: Company, Kotak Institutional Equities estimates

PFC : Key ratios, March fiscal year-ends, 2008-2013E (%)

	2008	2009	2010	2011E	2012E	2013E
Growth rates (%)						
Net interest income	25.6	32.5	26.2	26.4	21.8	20.8
Loan loss provisions	113.3	(135.0)	(115.6)	(3,289.6)	536.9	27.1
Other income	128.3	(71.2)	(21.5)	635.3	20.0	16.7
Operating expense	64.6	66.0	(21.3)	8.7	26.4	26.7
PBT	18.3	11.3	51.4	24.2	19.1	20.4
PAT	22.3	63.3	19.7	17.5	19.1	20.4
PBT- forex gains	27	26	29	29	19	20
Net loans	17	25	24	28	27	27
Disbursements	15	30	24	38	37	30
Unsecured loans (liabilities)	21	28	29	29	29	29
Net worth	9	23	15	16	16	17
Yield measures (%)						
Yield on earnings assets	9.6	10.4	10.3	10.8	10.9	11.0
Yield on loans	10.1	11.0	10.9	11.3	11.4	11.5
Cost of funds	8.3	8.8	8.3	8.6	8.8	8.9
Spread	1.8	2.2	2.6	2.7	2.6	2.5
Net interest margin	3.7	4.0	4.1	4.1	3.9	3.7
Total provisions/net loans (EoY)	(0.02)	0.01	—	0.02	0.09	0.09
Tax rate	32	1	22	26	26	26
Dividend payout ratio	33	23	22	20	20	20
Profitability measures (%)						
Interest income/total income	96.2	111.0	95.8	97.4	97.5	97.5
Other operating income/total income	3.2	0.8	0.4	2.6	2.5	2.5
Other income / total income	0.6	(11.8)	3.8	—	—	—
Operating expenses/total income	4.4	6.3	3.4	3.0	3.1	3.2
Payout ratio	33.3	23.3	21.9	20.0	20.0	20.0
LT Debt- Equity Ratio (X)	4.4	4.5	5.1	5.6	6.2	6.9
CAR (%)	23.6	17.9	16.6	15.1	13.8	12.7
Loan loss provisions/ ave loan assets	(0.02)	0.01	—	0.02	0.10	0.10
ROA decomposition - % of avg. assets						
Net interest income	3.5	3.9	3.9	3.9	3.8	3.6
Interest restructuring premium	—	—	—	—	—	—
Loan loss provisions	(0.0)	—	—	—	0.1	0.1
Adj. Net interest income	3.5	3.8	3.9	3.9	3.7	3.5
Net other operating income	0.1	—	0.0	0.1	0.1	0.1
Other income	—	(0.4)	0.2	—	—	—
Operating expenses	0.2	0.2	0.1	0.1	0.1	0.1
Other expenses & extraordinaries	(0.0)	—	—	—	—	—
(1- tax rate)	67.5	99.0	78.2	74.0	74.0	74.0
ROA	2.4	3.2	3.1	2.9	2.7	2.6
Average assets/average equity	5.7	5.9	6.2	6.7	7.3	7.9
ROE	13.5	18.9	19.0	19.3	19.8	20.4

Source: Company, Kotak Institutional Equities estimates

PFC : Income statement and balance sheet, March fiscal year-ends, 2008-2013E (Rs mn)

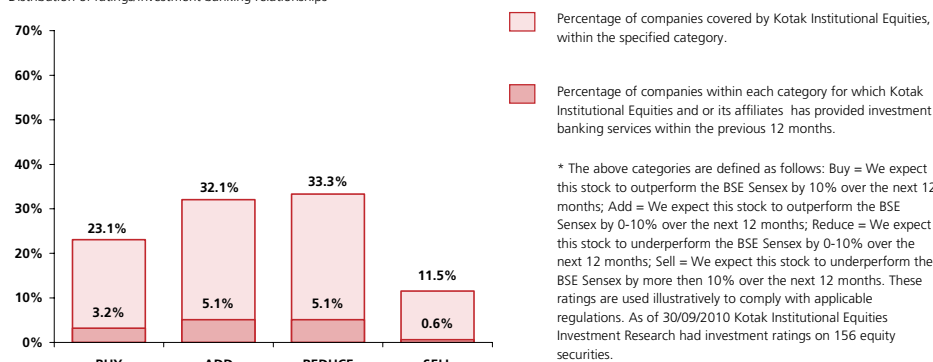
	2008	2009	2010	2011E	2012E	2013E
Income statement (Rsmn)						
Total interest income	48,833	64,534	79,214	104,007	133,191	170,246
Adj. interest (after rebate for timely payment)	48,452	63,965	78,634	103,007	131,941	168,746
Other interest income	381	569	580—	1,000	1,250	1,500
Total interest expense	30,968	40,859	49,324	66,221	87,165	114,639
Net interest income	17,865	23,675	29,890	37,785	46,026	55,607
Loan loss provisions	(105)	37	(6)	182	1,158	1,471
Other operating income	602	173	136	1,000	1,200	1,400
Other income	108	(2,525)	1,184	—	—	—
Net total income	18,574	21,323	31,209	38,785	47,226	57,007
Operating expenses	810	1344	1058	1149	1452	1840
Depreciation	45	38	34	34	34	34
PBT	17,876	19,905	30,134	37,421	44,583	53,662
Tax	5,809	205	6,562	9,729	11,591	13,952
PAT	12,067	19,699	23,573	27,691	32,991	39,710
PAT (incl def tax/normalised)	13,043	15,310	23,573	27,691	32,991	39,710
PBT + provisions-interest on restruction premium	17,771	19,941	29,983	37,602	45,740	55,133
EPS (Rs)	10.5	17.2	20.5	24.1	28.7	34.6
% growth	22.3	63.3	19.7	17.5	19.1	20.4
DPS(Rs)	3.5	4.0	4.5	4.8	5.7	6.9
BPS (Rs)	81.3	100.3	115.5	134.0	156.0	182.5
EPS (incl def tax Rs)	11	13	21	24	29	35
BPS (incl def tax Rs)	92	101	116	134	156	183
ABVPS (Rs)	77	96	110	127	149	0
ABVPS (incl def tax Rs)	88	96	110	128	149	0
Balance sheet (Rs mn)						
Assets						
Fixed Assets (Net)	770	752	745	699	676	654
Total Loan Assets	515,683	644,290	798,558	1,019,527	1,296,199	1,646,571
Total Current Assets, Loans & Advances	29,896	36,686	48,155	47,224	55,997	66,509
Total Assets	547,005	682,086	847,771	1,067,450	1,352,872	1,713,734
Unsecured Loans	406,478	521,602	671,084	864,741	1,119,281	1,442,921
Total current liabilities	12,125	18,606	21,245	22,103	23,005	23,951
Deferred tax liability	12,403	555	469	469	469	469
Interest Subsidy Fund from GOI	10,668	9,089	6,635	6,635	6,635	6,635
Total liabilities	453,706	567,007	715,164	913,628	1,173,775	1,504,216
Paid up capital	11,478	11,478	11,478	11,478	11,478	11,478
Reserves & surplus	81,821	103,601	121,130	142,345	167,619	198,041
Total equity	93,298	115,078	132,608	153,822	179,097	209,518

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of September 30, 2010

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Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

Other ratings/identifiers

NR = Not Rated. The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

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