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POWER

Rising interest rates to hurt non-regulated projects

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Rising interest rates to hurt capex-oriented companies

In the last few months, the PLR of all large banks have gone up 50-100bps. We believe in the next few quarters, owing to pressure on banks (on account of increasing CRR and repo rate), the PLR may further move upwards. In the increasing lending rate scenario, companies with high leverage are likely to be adversely affected.

Generally, power projects are highly leveraged, and are 70-80% debt-funded. Hence, the sector is highly susceptible to rising interest rates, especially in the current scenario when all major players are undergoing expansion. Rising interest rates, beyond a certain point can hurt these players' financials adversely; the impact could range from increase in overall project cost due to increase in interest during construction (IDC) to increment in annual interest cost.

Regulated entities unlikely to bear the brunt

Movement in interest rates is unlikely to affect profitability of operational regulated projects due to the pass-through element in their tariffs. In case of projects that have already achieved financial closure or are in the process of attaining it, project costs could increase with rising interest costs. However, we believe that regulators will allow this increase; hence, regulated entities will not bear the brunt of increased costs.

Merchant and competitive-bid projects to be adversely impacted

In case of competitive-bid based projects, the rising interest costs will have a dual impact. First, in the form of increased project costs, and second, rise in annual interest costs. If companies have submitted their bids, wherein, the interest cost is a part of the non-escalable component, there will be direct impact on financials and value of the project. In a similar scenario for merchant power projects, the impact of higher project and interest costs will be fully borne by the developer.

RoE could be lower by 1.5% for merchant and competitively-won projects

We believe rise in interest rates by 100bps could reduce companies' RoE by ~1.5%. This is largely applicable for projects won under competitive bids and those to be built on merchant basis. Competitive bids can still play safe, in case they quoted an escalable component in capacity charges. Merchant power projects would, however, be totally exposed to such a risk. As merchant rates are market determined, we believe the impact of increased interest cost will depend more on the demand supply gap and merchant price.

Lanco to be impacted most, followed by Reliance Power

We believe players with large portfolio of power assets, either under merchant or competitive bid basis will be impacted the most. Lanco, with ~77% of its planned portfolio under these two categories will be most affected, followed by Reliance Power that has ~65% of its planned portfolio under these two categories.

Companies adopt various strategies to mitigate interest rate risks

To mitigate interest rate risks, companies are increasingly entering into loan agreements with reset clause of 3-5 years. Such clause insulates the company from rise in interest rates for that particular period. Further, companies are increasingly looking at foreign debt markets to reduce exposure to high domestic interest rates.

Rising interest to hurt capex-oriented companies

In the last few months, the PLR of all large banks have gone up 50-100bps. We believe in the next few quarters, owing to pressure on banks (on account of increasing CRR and repo rate), the PLR may further move upwards. In the increasing lending rate scenario, companies with high leverage are likely to be adversely affected.

Increase in PLR of leading Indian Banks since April

Month	Banks	Increase	Before	After	Remarks
Apr-08	SBI	75bps	12.0	12.8	PLR increase
May-08	SBI	(50)bps	12.8	12.3	PLR decrease
Jun-08	SBI	50bps	12.3	12.8	PLR increase
Jul-08	Canara Bank	50bps	12.8	13.3	PLR increase
Jun-08	Punjab National Bank	50bps	12.5	13.5	PLR increase
Jul-08	Allahabad Bank	50bps	13.0	13.5	PLR increase
Jun-08	HDFC Bank	25bps	15.0	15.3	PLR increase
Jul-08	HDFC Bank	75bps	15.3	16.0	PLR increase
Jun-08	Yes Bank	50bps	15.5	16.0	PLR increase
Jul-08	ICICI Bank	75bps	14.0	14.8	PLR increase

Source: Edelweiss research

The table above clearly shows that all major banks in India have increased their PLR, following repo rate and CRR movement from 7.75% to 8.5% and 7.5% to 8.75%, respectively, in the last six months.

Generally, power projects are highly leveraged, and are 70-80% debt-funded. Hence, the sector is highly susceptible to rising interest rates, especially in the current scenario when all major players are undergoing expansion. Rising interest rates, beyond a certain point can hurt these payers' financials adversely; the impact could range from increase in overall project cost due to increase in interest during construction (IDC) to increment in annual interest cost.

Only select power projects to be affected

Power projects can be broadly classified into the following three categories:

- Regulated projects: Here, the long-term interest costs and interest on working capital are a part of the tariff structure, and hence, can be passed through.
- Competitive bid-based projects: Only escalable components are pass-through. Often, capital costs servicing is non–escalable.
- Merchant projects: In this category, the developer is exposed to all project-related risks such as higher project or interest costs, and offtake risk.

Most power projects in India are currently in category one. There are only select projects operating under the merchant and competitive-bid categories. Ultra mega power projects (UMPPs) fall under the second category.

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However, considering that merchant power plants normally have higher profit margins than competitively-bid projects, we believe the impact would be lower in merchant plants.

RoE could be lower by 1.5% for merchant and competitively-won projects

Assuming a project built on capital cost of INR 45 mn/MW, funded with 70:30 debt-equity with a 10-year debt repayment schedule, 11% interest cost, and RoE of 16%, a 1% increase in interest costs would increase costs by ~INR 0.08 per kwh in the first year of tariff. In terms of profitability, the rise in interest rate could result in a ~1.5% reduction in RoE, hurting projects won under competitive bids and merchant basis. We have assumed 100% debt from the domestic market and full tax for the project. Competitive bids can still play safe, in case they quoted an escalable component in capacity charges.

Impact on RoE with increase in interest rate

Interest rate (%)	RoE (%)
11.0	16.0
11.5	15.2
12.0	14.5
12.5	13.7
13.0	12.9

Source: Edelweiss research

Merchant power projects would, however, be totally exposed to such a risk. As merchant rates are market determined, we believe the impact of increased interest cost will depend more on the demand supply gap and merchant price.

Lanco to be impacted most, followed by Reliance Power

Currently, all power plants of National Thermal Power corporation (NTPC),CESC, Gujarat Industries Power Company (GIPCL), Power Grid Corporation of India (PGCIL), and Reliance Infrastructure operate under the regulated scenario, and hence, are unlikely to be affected by rising interest rates. Going forward, CESC plans to have 500 MW of merchant power plant, which we believe, will be affected if the high interest rate scenario prevails. The table below exhibits the break-up of portfolio of assets of major generators as per their medium-term expansion plan.

Break-up of portfolio of major players

Company	MW	Regulated (%)	Competitive (%)	Merchant (%)	Total (%)
NTPC	50,000	100.0	-	-	100.0
Tata Power	13,784	51.0	47.0	2.0	100.0
Reliance Infrastructure	941	100.0	-	-	100.0
Reliance Power	28,200	34.0	28.0	38.0	100.0
CESC	2,825	82.0	-	18.0	100.0
Lanco	7,195	22.0	56.0	21.0	100.0
GIPCL	1,305	100.0	-	-	100.0
JPVL*	2,600	67.0	-	33.1	100.0
Adani Power*	2,620	-	76.0	24.4	100.0

Source: Edelweiss research

Tata Power: Apart from 4,000 MW Mundra UMPP and ~200 MW, all its projects fall under the regulatory category. The Mundra UMPP, won on competitive bidding, is likely to be hurt marginally.

Reliance Power: It intends to have a portfolio of 28,000 MW, out of which, ~38% would be merchant projects. Also, the company has two UMPPs, namely Sasan (4,000 MW) and Krishnapattnam (4,000 MW). We believe all these projects will be adversely impacted in case of rising interest rates.

Lanco Infratech: It has ~4,000 MW of competitive-bid projects under various stages of development. The company has a 3-year reset clause for a large part of its debt. We believe although the earnings might not be affected within these three years, profits would be impacted if high interest rate persists at the time of reset. We believe, with ~77% of its planned portfolio out of the regulated scenario, the company runs a high risk on earnings growth.

For Jaiprakash Power Ventures Limited (JPVL) and Adani Power we have considered units which are either operational or are under construction.

Companies adopt various strategies to mitigate interest rate risks

To check the impact of rise in interest rates, companies are building probabilities of higher project costs in the bidding stage itself after necessary discussions with the lender. However, projects that have been won through competitive bids (assuming a lower interest rate) are exposed to cost overruns and higher annual interest costs. To mitigate risks associated with such projects, companies are increasingly entering into loan agreements with reset clause of 3-5 years. Such a clause insulates the company from rise in interest rates for that particular period. Even after the reset period, the company has flexibility to negotiate interest rates with the lender, depending upon the cash flow from the particular project. Further companies also mitigate the high domestic interest rate by looking into foreign debt market.

Annexure

Typical structure of a loan

We spoke to Power Finance Corporation (PFC) and some other lenders, to have a better understanding of the present structuring of loans for power projects.

Power project loans are generally long term, ranging between ~10-12 years. These loans are typically benchmarked to prevailing interest rates and have reset clause after 3-5 years. Interest rates tend to vary based on the project, equity contribution, project IRR, and developer profile. Further, the interest rate also depends upon whether the lending in done on the company's balance sheet or is developed through a special purpose vehicle (SPV) on account of different risk associated with these projects. Further, the interest rate generally reduces 50bps post commissioning, as the construction-related risks end and projects start generating profits.

Disbursement of loans is dependent upon project milestones and equity infusion by the developer with pari pasu charge on the assets. Amongst different lenders there is flexibility in the loan structure to accommodate exigencies. The table below summarises these aspects.

Loan structure

Description	Structure
Tenure	10 years & above
Interest rate	Fixed / Floating
Principal moratorium	3-4 years
Interest during moratorium period	Floating
Repayment	Quarterly / Six months / Annual
Interest reset clause	3-5 year reset in case of fixed loan
Restructuring	On a case-to-case basis

Source: Edelweiss research

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Coverage group(s) of stocks by primary analyst(s): Power:

CESC, GIPCL, NTPC, Power Grid Corporation, Reliance Infrastructure and Tata Power

Recent Research

Date	Company	Title	Price (INR)	Recos
26-Jun-08	**Neyveli Lignite Corp.**	Regulatory uncertainty easing out; *Visit Note*	116	Not Rated
24-Jun-08	**Tata Power**	Clear visibility *Result Update*	1,118	Accum.
20-Jun-08	**Power Grid Corp.**	Transmission back bone; *Result Update*	87	Accum.
10-Jun-08	**GIPCL**	Waiting for trigger; *Result Update*	88	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	101	62	14	2	188

* 8 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	77	70	41

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period