

CESC

Q3FY10/ Target price change

25 January 2010

Buy

Target Price: Rs518

CMP: Rs422*

Upside: 23%

*as on 22 January 2010

Capacity addition gaining momentum

We maintain our Buy rating on CESC with a revised target price of Rs518 (earlier Rs417), primarily because of the significant progress in new capacity addition projects (the Dhariwal project has achieved financial closure) and the stock's attractive valuation of 1.3x P/BV.

- **Results below expectation:** Q3 net revenue grew 4.5% YoY to Rs8bn (vs our estimate of Rs9.7bn) on the back of lower-than-expected PLF and lesser incentives booked. Reported PAT increased 4.1% YoY to Rs1bn (our estimate: Rs1.3bn). However, we believe the company would achieve our FY10E PAT of Rs4.3bn.
- **Dhariwal project achieves financial closure:** Dhariwal Infrastructure's 600MW thermal power plant project in Chandrapur, Maharashtra, has achieved financial closure. CESC would eventually hold 100% stake in Dhariwal Infrastructure. We estimate the value addition from this project at Rs25/share. We believe Haldia project will also achieve financial closure before the end of FY10.
- **Maintain Buy, core business available at just 1.7x FY11E P/BV:** We maintain our Buy rating with a revised target price of Rs518 (earlier Rs417). Our Buy is premised on the momentum building up on capacity addition. Moreover, the stock trades at ~50% discount to peers and is available at mere 1.3x FY11E P/BV. We have not factored in the value from Dumka coal-block in Jharkhand into our valuations, a key trigger to the stock.

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Key Data

Bloomberg Code	CESC IN
Reuters Code	CESC.BO
Current Shares O/S (mn)	124.9
Diluted Shares O/S(mn)	124.9
Mkt Cap (Rsbn/USDbn)	51.2/1.1
52 Wk H / L (Rs)	452/180
Daily Vol. (3M NSE Avg.)	222,902
Face Value (Rs)	10

1 USD = Rs46.8

One year Indexed Stock Performance



Price Performance (%)

	1M	6M	1Yr
CESC	4.7	40.5	79.4
NIFTY	(2.7)	10.2	88.0

Source: Bloomberg, Centrum Research
*as on 22 January 2010

Y/E Dec (Rsmn)	Q3FY10	Q3FY09	YoY (%)	Q2FY10	QoQ (%)	Q3FY10E	Variance (%)
Net sales	7,970	7,630	4.5	9,640	(17.3)	9,700	(17.8)
Consumption of RM	4,030	2,990		5,180		5,190	
% of sales	50.6	39.2	1,138 bp	53.7	(317) bp	53.5	(294) bp
Employee costs	950	940		900		905	
% of sales	11.9	12.3		9.3		9.3	
Other expenditure	1,110	2,080		1,310		1,315	
% of sales	13.9	27.3		13.6		13.6	
Operating profit	1,880	1,620	16	2,250	(16.4)	2,290	(17.9)
OPM (%)	23.6	21.2	236 bp	23.3	25 bp	23.6	(2 bp)
Dep and amortisation	490	430		490		490	
Interest	420	360		460		470	
EBT	970	830	16.9	1,300	(25.4)	1,330	(27.1)
Other income	260	280		210		215	
PBT	1,230	1,110	10.8	1,510	(18.5)	1,545	(20.4)
Provision for tax	210	130		250		265	
-effective tax rate	17.1	11.7		16.6		17.2	
PAT (reported)	1,020	980	4.1	1,260	(19.0)	1,280	(20.3)
Exceptional item (post tax)	-	-		-		-	
PAT (adj for deferred tax)	1,020	980	4.1	1,260	(19.0)	1,280	(20.3)
NPM (%)	12.8	12.8	(5) bp	13.1	(27) bp	13.2	(40) bp

Source: Company, Centrum Research

Y/E Mar (Rsmn)	Rev	YoY (%)	EBITDA	EBITDA (%)	Adj PAT	YoY (%)	Fully DEPS	RoE (%)	RoCE (%)	P/E (x)	P/BV(x)
FY07	24,843	(1.3)	6,750	27.2	3,256	33.9	25.9	18.0	12.1	16.3	2.7
FY08	27,750	11.7	6,016	21.7	3,037	(6.7)	24.2	12.3	9.5	17.5	1.8
FY09E	30,313	9.2	6,125	20.2	3,919	29.0	31.2	12.4	9.4	13.5	1.6
FY10E	33,398	10.2	7,154	21.4	4,268	8.9	34.0	12.0	8.4	12.4	1.4
FY11E	36,227	8.5	9,263	25.6	4,471	4.7	35.6	11.3	8.2	11.9	1.3

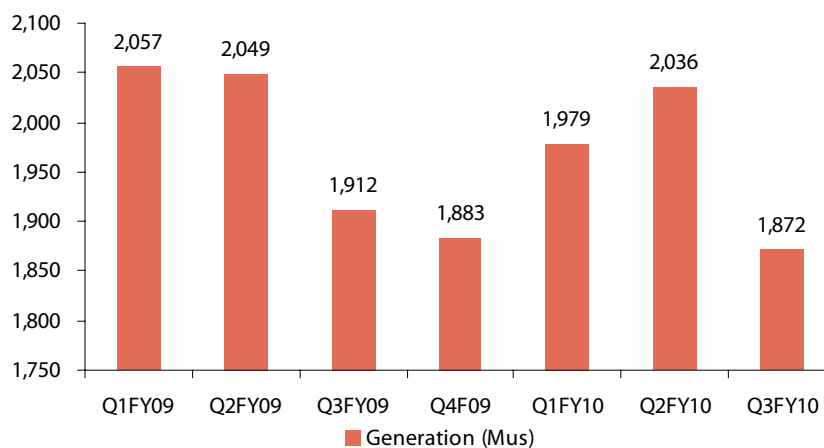
Source: Company, Centrum Research Estimates

Please refer to important disclosures/disclaimers in Appendix A

Q3 below expectations, but CESC likely to achieve our FY10E numbers

Q3 net revenue grew 4.5% YoY (and declined 17.3%) QoQ to Rs8bn (vs our estimate of Rs9.7bn) on the back of lower-than-expected PLF and lesser incentives booked. PLF has declined 100bp YoY and 800bp QoQ to 85%, which would have led to lower incentives. Reported PAT increased 4.1% YoY (down 19% QoQ) to Rs1bn (vs our estimate of Rs1.3bn). However, we expect the company to meet our FY10 PAT estimate of Rs4.3bn as the loss from lower incentives and PLF during Q3 would be recovered in next Q4.

Exhibit 1: Generation declines (MUs)



Sources: Company, Centrum Research

Dhariwal infrastructure project achieves financial closure

Dhariwal Infrastructure's 600MW thermal power plant project in Chandrapur, Maharashtra, has achieved financial closure. CESC would eventually hold 100% stake in Dhariwal Infrastructure. In our opinion, this development brings in more visibility to CESC's capacity addition plans and valuation of its power business. CESC is likely to increase its stake in Dhariwal Infrastructure to 100% from 51% at present through infusion of further Rs1bn in addition to Rs2bn paid earlier. Dhariwal has assets worth Rs1bn and CESC acquired the stake at a 40% premium. It expects to invest further 500bn in the project as equity.

The Dhariwal project is structured in a way that CESC can sell 300MW under PPA and another 300MW under merchant power. The project is located just 500 km from the mine allocated and would therefore have fuel cost of Rs1,250/tonne at the plant level, rising to Rs1,500/tonne by FY13. This would translate into coal cost of roughly Rs1.3/unit at the time of commissioning, at a calorific value of 3,300kCal/kg and SHR assumption of 2,450kCal/kWh. If we add Rs1.1-0.9 per unit of fixed cost, the cost of generation would work out to Rs2.4-2.2 per unit. Even we assume a tariff of Rs3/unit, the project would generate equity IRR of ~24% in the merchant category and 19% for the PPA portion. The PPA would be based on Maharashtra Electricity Regulatory Commission (MERC) rules and regulations.

Exhibit 2: Details of Dhariwal project in which CESC holds 51% stake

Promoted by	Dhariwal Steel
Location	Chandrapur, Maharashtra
Installed Capacity	600 MW
Unit Configuration	2 x 300 MW
Fuel	Coal linkage obtained
Water Requirement	State Water Resource Deptt. on 16.9.2008 has certified that 19.27 MCM of water is available for proposed power project at 90% dependability.
Main Plant Award	To be done along with Haldia 600 MW project
Financial Closure	Completed
Scheduled Commissioning	Unit-I - June 2011 Unit-2 - March 2012
Consent of State Government	Signed MoU with Chhattisgarh State Govt.
Environment clearance	Done
Water Allocation	State Water Resource Department on 16 September 2008 has certified that 19.27 MCM of water is available for its proposed power project at 90% dependability.
Land Acquisition	Completed: Maharashtra Industrial Development Corporation on 22.2.2008 has allocated 200 ha of land at Chandrapur (Tadli) industrial area

Sources: Company, Centrum Research

Haldia project to achieve financial closure before the end of FY10

CESC has acquired 80% of the land (vs 75% till Q2FY10) for the 600MW Haldia power project and is confident of achieving financial closure before the end of FY10. The project is being set up under a regulated PPA model. The company has obtained NOC for water and would process the equipment procurement along with Dhariwal project. We estimate a minimum upside of Rs19/share on a NPV basis from this project.

Company to generate enough cash to fund more 5GW of projects

The Dumka project is in a stalemate with no progress in land acquisition. Moreover, its Bhagalpur and Dhenkanal projects too have no visibility and we therefore have not considered these for our base case valuation. However, we are confident that the company would generate enough cash post FY12 to fund another set of 5GW projects. Probably, Dumka project which has got 110mt captive coal block allocated to it, might see progress by year end. Any momentum in the project would bring significant upside to our target price of Rs518.

Exhibit 3: Cash flows and funding ability

(Rsmn)	FY10E	FY11E	FY12E	FY13E	FY14E	FY15E
Cash flow from operations	4,802	9,047	7,156	13,814	19,739	20,320
Less: repayments, interest, dividend	(2,289)	(1,039)	(3,844)	(7,471)	(7,810)	(5,655)
Internal accruals	2,513	8,008	3,312	6,344	11,929	14,665
Capex	(21,127)	(17,390)	(23,904)	(6,227)	(3,000)	(3,002)
Less: Debt	9,687	9,183	18,822	4,238	1,855	1,855
Net Requirement	(11,441)	(8,207)	(5,081)	(1,990)	(1,145)	(1,147)
Net Cash available	(8,927)	(199)	(1,769)	4,354	10,784	13,518
Cash in hand	3,583	3,384	1,615	5,969	16,753	30,271

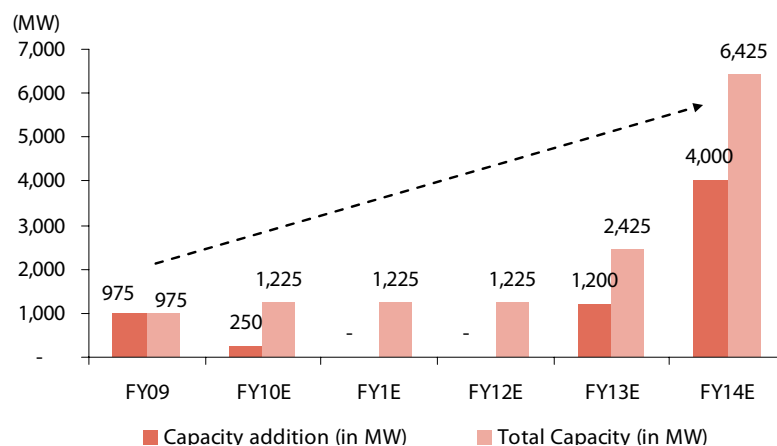
Sources: Centrum Research Estimates

Exhibit 4: Capacity addition plans

Location / Project	Purpose	Size (in MW)	Cost (Rsbn)	Commissioning	Remarks
Budge Budge	License Area	250 MW	12	FY10 (Q4)	Test synchronization achieved on 14 July 2009. Commissioning in Sep 2009
Haldia Phase - 1	License Area	600 MW	26	FY12-13	75% land acquired; long term linkage obtained; environmental clearance received and financial closure in Q3FY10
Chandrapur, Maharashtra	Merchant	600 MW	28	FY12-13	450 acres of land in possession; coal linkage obtained; environmental clearance at an advanced stage; other major clearance received; financial closure in Q3 - Q4FY10
Dumka, Jharkhand	Merchant	1000 MW	45	FY13-14	110 MT coal block allocated; MOU signed with Jharkhand government; land acquisition process initiated; mining prospecting license obtained
Dhenkanal, Orissa	Merchant	1000 MW	53	FY13-14	Land acquisition process at an advanced stage; awaiting coal linkage
Bhagalpur	Merchant	2000 MW	80	FY13-14	Merchant 2000MW 80 2013-14; MoU signed with Bihar government for the Pirpainty project

Sources: Company, Centrum Research

Exhibit 5: Capacity addition plans



Sources: Company, Centrum Research Estimates

Visibility on Dumka 1GW captive coal block based project increases

CESC has been jointly allocated a coal block of 110mt in Jharkhand and plans to set up a 1,000MW merchant power plant. With a new government having been formed, the company expects to overcome hurdles associated in land acquisition in a year's time and move towards achieving financial closure and approval for mining. In our opinion, power projects with captive coal-blocks deserve higher valuation on account of (1) secure fuel supplies and (2) cheap source of fuel. A captive coal block plant's generation cost is not expected to be more than Rs1.5/unit. Therefore, any realization over Rs3/unit should return 100% ROE. A rough cut value on a conservative 1.5x P/BV for the Dumka project gives a potential upside of Rs120 per share which is 20% upside to our current valuation.

Spencer's showing signs of revival

CESC claims that Spencer's has saved around Rs700mn cash during the last 9 months from its cost-saving exercise at distribution and corporate level. CESC spent around Rs3.2bn on its retail business during FY09 and is likely to invest close to Rs2.1bn in FY10 and Rs1.7bn in FY11E as per our estimate. The management claims Spencer's sales/sq ft/month has increased 20% from Rs660 in March 2009 to ~Rs793 in Oct 2009 and further to Rs854 in Dec 2009. We see these as early signs of revival and have therefore included the value of Spencer's in our SOTP based target price. We have valued Spencer at a 50% discount to Shoppers Stop's EV/sales multiple at 0.5x FY11E. Accordingly, we arrive at value of Rs2.6bn (as against Rs6.3bn invested till FY09 in Spencer's) and value per share of Rs21 per share for CESC.

Mall project construction to begin, adds Rs7 to our target price

CESC has got huge land bank due to closure of its age old plant at Mulajore and office spaces in and around Kolkata. The company has a land bank of 35 acres after closing down its Mulajore plant, which it intends to develop as a commercial or residential property in the future. It has got another 3 acres of land in central Kolkata in which it is planning to construct a 400,000 sq ft mall. Recently, it awarded the contract of construction to L&T. For valuing the mall we have assumed a conservative rental of Rs70 per sq ft per month, occupancy rate of 80% and a capitalization rate of 12%. Accordingly, the value of the mall property comes to a net asset value (NAV) of Rs1.3bn, which translates to Rs7 per share after considering a 30% share to power consumers.

Core business available at just 1.7x P/BV

At current valuations, after removing the value of other businesses, CESC core power business is available at just 1.7x P/BV FY11E, which we feel is compellingly cheap. Considering the momentum in its power capacity addition projects, we believe the power business deserves a valuation of at least 2.0x P/BV. Based on our DCF methodology, we arrive at a value of Rs490 for the power business, which translates into 2.0x FY11E P/B/V. Spencer's and Mall project bring in an value of Rs28/share to our target price.

Exhibit 6: Implied valuation of power segment

Power valuation – Relative	FY10E	FY11E	FY12E
Book value	36,338	40,183	44,020
Less: Investment in Spencer's & other businesses	6,187	8,287	9,987
Net-worth net of investments in other business	30,152	31,896	34,033
Net book value per share	240	254	271
CMP less value of other business	394	394	394
Implied multiple	1.6	1.6	1.5

Sources: Centrum Research Estimates

Exhibit 7: SOTP value of Rs518

	Rsmn	Per share value
Enterprise value - Power business	81,271	
Less: Net debt	19,683	
Equity value - Power business	61,588	490
Power Business	61,588	490
Spencer's valuation	2,580	21
Property business valuation	941	7
Target Price	65,108	518

Sources: Centrum Research Estimates

Trades at significant discount to peers

Exhibit 8: Peer comparison

Company	Rating	BPS		P/E (x)		P/BV (x)		ROE (%)	
		FY10E	FY11E	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
NTPC	Sell	75.3	81.6	21.2	19.0	3.0	2.7	22.8	24.0
Power Grid	Hold	37.4	41.1	22.4	17.3	3.1	2.8	14.1	16.7
Tata Power	Hold	483.3	545.8	21.8	16.5	2.8	2.4	14.4	15.7
Reliance Power	Accumulate	60.6	64.1	88.5	34.2	2.5	2.3	2.8	7.0
CESC	Buy	301.8	332.4	12.0	11.9	1.4	1.3	12.3	11.2
PTC	Buy	70.0	71.9	75.6	31.5	1.6	1.6	2.4	5.0

Note: CESC's book value is adjusted for revaluation reserve in the book.

Source: Centrum Research Estimates

Financials (Standalone)

Exhibit 9: Income Statement

Y/E March (Rsmn)	FY07	FY08	FY09	FY10E	FY11E
Revenues	24,843	27,750	30,313	33,305	36,227
Growth in revenues (%)	(1.3)	11.7	9.2	9.9	8.8
Cost of fuel and power	11,106	12,440	13,572	14,990	15,607
% of Revenue	44.7	44.8	44.8	45.0	43.1
Employee cost	3,078	3,378	3,702	3,745	4,054
% of Sales	12.4	12.2	12.2	11.2	11.2
O&M expenses	3,910	5,915	6,914	7,224	7,304
% of Sales	15.7	21.3	22.8	21.7	20.2
EBITDA	6,750	6,016	6,125	7,346	9,263
EBITDA Margin	27.2	21.7	20.2	22.1	25.6
Depreciation	1,579	1,685	1,749	1,853	2,271
Other Income	198	475	1,479	1,265	358
PBIT	5,368	4,807	5,855	6,758	7,351
Interest expenses	1,679	1,363	1,410	1,569	2,263
PBT before extra-ordinary items	3,690	3,444	4,445	5,190	5,088
Extra-ordinary income/ (expenses)	(282.6)	585.3	203.7	-	-
PBT	3,407	4,029	4,649	5,190	5,088
Provision for tax	400	476	550	793	648
Effective tax rate (%)	11.7	11.8	11.8	15.3	12.7
PAT before extra-ordinary items	3,007	3,554	4,099	4,397	4,440
Extra-ordinary income/ (expenses)	(249)	516	180	-	-
(+/-) Minority Int. & sha. of associates					
Adjusted PAT	3,256	3,037	3,919	4,397	4,440
Growth in PAT (%)	33.9	(6.7)	29.0	12.2	1.0
PAT margin	13.1	10.9	12.9	13.2	12.3

Source: Company, Centrum Research Estimates

Exhibit 10: Balance Sheet

Y/E March (Rsmn)	FY07	FY08	FY09	FY10E	FY11E
Share Capital	850	1,256	1,256	1,256	1,256
Reserves	37,302	44,609	47,573	51,244	55,088
- Revaluation Reserve	18,360	16,183	14,906	14,906	14,906
Shareholders' fund	38,152	45,865	48,829	52,500	56,344
Debt	17,983	16,288	23,981	30,927	40,164
Deferred Tax Liability	-	-	-	-	-
Advance against depreciation	1,005	1,980	3,376	4,467	5,454
Capital Contributions and Grants	6,521	7,422	8,212	9,002	9,792
Total Capital Employed	63,660	71,554	84,398	96,896	111,754
Total Fixed Assets	55,558	58,292	68,824	86,060	99,479
Investments	2,414	5,697	3,104	3,104	3,104
Inventories	1,673	1,762	2,120	2,907	3,215
Debtors	4,151	3,152	3,889	4,395	4,767
Other Current Assets	515	287	422	422	422
Cash and bank balances	7,314	9,864	12,510	3,583	3,384
Loans and Advances	1,770	4,551	10,327	12,427	14,127
Total current assets	15,424	19,616	29,268	23,733	25,915
Current liabilities and provisions	9,829	12,137	16,876	16,081	16,823
Net current assets	5,596	7,480	12,391	7,653	9,092
Misc. Expenditure	93	86	79	79	79
Total Assets	63,660	71,554	84,398	96,896	111,754

Source: Company, Centrum Research Estimates

Exhibit 11: Cash flow

Y/E March (Rsmn)	FY07	FY08	FY09	FY10E	FY11E
Cash flow from operating					
Profit before tax	3,407	4,029	4,649	5,062	5,125
Depreciation	1,579	1,685	1,749	1,791	2,271
Interest expenses	1,679	1,363	1,410	1,569	2,263
Other Non operating (income)/exp.	285	(437)	891	(737)	(20)
Operating profit bef. WC change	6,951	6,640	8,698	7,685	9,639
Working capital adjustment	4,162	3,437	2,980	(2,089)	63
Gross cash from operations	11,112	10,077	11,678	5,596	9,702
Direct taxes paid	(480)	(452)	(568)	(794)	(655)
Cash from operations	10,633	9,625	11,110	4,802	9,047
Cash flow from investing					
Capex	(3,645)	(6,152)	(12,500)	(19,027)	(15,690)
Investment - Cash equivalents	(2,057)	(2,373)	(2,889)	(2,100)	(1,700)
Investment - Subsidiary / Strategic					
Other Income	153	(2,214)	375	1,828	1,006
Cash from investment	(5,549)	(10,738)	(15,013)	(19,299)	(16,383)
Cash flow from financing					
Proceeds from share cap & premium	390	5,697	-	-	-
Borrowings/ (Repayments)	(69)	(176)	8,526	7,736	10,026
Interest paid	(1,817)	(1,516)	(1,394)	(1,569)	(2,263)
Dividend paid	(233)	(343)	(582)	(598)	(626)
Cash from financing	(1,729)	3,663	6,549	5,570	7,138
Net cash increase/ (decrease)	3,355	2,550	2,646	(8,927)	(199)
Free Cash Flow	6,988	3,473	(1,390)	(14,225)	(6,643)

Source: Company, Centrum Research Estimates

Exhibit 12: Key Ratios

Y/E March	FY07	FY08	FY09	FY10E	FY11E
Margin ratios (%)					
EBITDA Margin	27.2	21.7	20.2	21.4	25.6
PBIT Margin	21.6	17.3	19.3	19.9	20.4
PBT Margin	14.9	12.4	14.7	15.2	14.1
PAT Margin	13.1	10.9	12.9	12.8	12.3
Growth ratios (%)					
Revenues	(1.3)	11.7	9.2	10.2	8.5
EBITDA	(7.8)	(10.9)	1.8	16.8	29.5
Adjusted PAT	33.9	(6.7)	29.0	8.9	4.7
Return ratios (%)					
ROCE	12.1	9.5	9.4	8.4	8.2
ROIC	12.1	9.5	7.7	7.2	8.1
ROE	18.0	12.3	12.4	12.0	11.3
Turnover ratios (x)					
Asset turnover ratio (x)	0.4	0.4	0.4	0.3	0.3
Inventroy (days)	23.6	21.6	22.6	22.1	22.4
Average Collection period (days)	68.9	48.0	42.4	45.3	46.2
Average payment period (days)	87.7	86.4	85.0	85.8	76.3
Per share ratios (Rs.)					
EPS (Reported)	23.9	28.3	32.6	34.0	35.6
Adjusted EPS	25.9	24.2	31.2	34.0	35.6
CEPS	38.5	37.6	45.1	48.2	53.7
Adjusted Book Value*	157.6	236.3	270.1	299.3	329.9
*Adjusted for revaluation reserve in the book					
Solvency ratios					
Debt/ Equity	0.9	0.5	0.7	0.8	1.0
Interest coverage	3.2	3.5	4.2	4.2	1.0
Valuation parameters (x)					
P/E (Reported EPS)	17.6	14.9	12.9	12.4	11.9
P/E (Adj. EPS)	16.3	17.5	13.5	12.4	11.9
P/ABV	2.7	1.8	1.6	1.4	1.3
EV/ EBITDA	9.4	9.9	10.5	11.2	9.7
EV/ Sales	2.6	2.1	2.1	2.4	2.5

Source: Company, Centrum Research Estimates

Appendix A

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