

Natural Resources & Energy
Electric Utilities
 Equity – India

Overweight (V)

Target price (INR)	1,525.00
Share price (INR)	1,213.15
Potential total return (%)	25.7

Performance	1M	3M	12M
Absolute (%)	-5.5	-10.3	70.4
Relative ^A (%)	-7.1	-6.2	-10.7

Index^A BOMBAY SE IDX

RIC TTPW.BO
 Bloomberg TPWR IN

Market cap (USDm) 6,239
 Market cap (INRm) 287,888

Enterprise value (INRm) 435,397
 Free float (%) 67

Note: (V) = volatile (please see disclosure appendix)

03 March 2010

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Tata Power

OW(V): Higher coal production partially offset higher cost

- **3QFY10 earnings conference call highlight the recurring impact of mining cost to be not very negative, as previously perceived**
- **Higher mining cost (6%) likely to be recurring; this to be partially offset by higher production (c3% above our forecast)**
- **Reduce our earnings by c3% for FY10-11e, and TP to INR1,525 (from INR1,585); maintain OW(V)**

3QFY10 Consolidated Result: Tata Power's 3QFY10 result was impacted by higher stripping costs that resulted in lower coal profitability. The company indicated on its conference call that this mining cost (USD1.48/t) as well as staff costs will be recurring. However, the company has clarified that higher coal production volumes (higher by 3%) are expected to partially offset the cost increase. This increase in production and reserves is a modest positive, in our view.

Mining costs higher than expected: The coal mining costs were higher due to: a) INR3.7bn of deferred stripping costs charged in 3Q10 (including prior period write-off of INR3.2bn), b) a one-time expense of INR450m for a prior contractor payment; c) INR700m booked for coal imported for the Trombay power plant, and d) higher staff costs (INR300m).

Tata Power to ramp up coal production by 2011e: Tata Power expects to ramp-up coal production to 75m tonnes (c10% CAGR over 2009-11). Based on this revised outlook, we increase our volume estimates by c3% for FY10-12. This volume increase only partially offsets the higher mining cost. We reduced our FY10-11e earnings estimates by c3%.

Valuation: Based on our revised estimates, we have derived our new target price of INR1,525 (from INR1,585). This is based on the average of three valuation methods (INR1,440) – DCF at INR1,562, PB at INR1,346, and SOTP at INR1,410 – and adding INR85 per share of value from projects under development. Tata Power is currently trading at 15.7x FY11e EPS. We believe that as Tata Power expands its power and coal portfolio, the multiple will expand to 18.3x FY12 EPS. We maintain our Overweight (V) rating. **Risks include:** execution delays, higher mining cost, increased interest rates and unfavourable regulatory changes (India and Indonesia).

We prefer Tata Power for: a) well laid out capacity expansion, b) fuel and funding ties, and c) improved visibility for projects under development for c4.4GW (of c6.2GW).

Table 1 : Tata Power consolidated financial summary (INRbn)

Year	Revenues	EBITDA	Net profit	ROEs	P/E	P/B	EV/EBITDA
FY10e	184.6	41.9	17.2	17.0%	16.7	2.5	10.4
FY11e	209.7	46.9	18.3	14.7%	15.7	2.2	10.2
FY12e	227.3	52.9	20.5	13.9%	14.6	1.8	9.2

Source: HSBC

Clarity from the management post conference call

Higher stripping costs to be partially offset by higher volumes

Tata Power's 3QFY10 consolidated profit was impacted by the INR3.7bn of deferred stripping costs charged in 3Q10 (including prior period write-off of INR3.2bn). On the conference call, the management increased clarity on the concerns that we highlighted in our 26 February 2010 report, [*Tata Power, OW\(V\): Disappointing results due to coal mine write-offs, few concerns need to be addressed.*](#)

- ▶ **a) New resource estimates:** The management has not divulged the details of the new resource estimates, however, it has indicated that the production estimates will be higher than the earlier planned production. Tata Power expects to ramp-up the production to 75m (c10% CAGR over 2009-11).
- ▶ **b) Lower profitability of coal business:** The EBIT margins for the coal business were impacted by
 - a) INR3.2 (of total INR3.7bn) deferred stripping cost charge offs related to prior periods in 3QFY10,
 - b) one time settlement of INR0.45bn for dispute with mining contractors, c) INR700m for coal imports for the Trombay power plant booked in the coal segment instead of power segment, and d) INR0.3bn on account of higher staff costs.
- ▶ **c) Is this higher mining costs recurring?:** The management indicated that some of these costs (staff costs and stripping expense) are recurring in nature. Hence, the mining costs have increased by cUSD1.48/ton due to the increase in stripping ratio, as determined by the recent assessment report. The previous assessment was carried out about three years ago.

We believe the negative impact of higher mining costs is partially offset by higher resource estimates and future production.

Table 2: Tata Power consolidated quarterly results summary

Particulars	3QFY10	3QFY09	yoy	qoq	Comments
Revenue	43,404	46,215	-6.1%	-5.2%	Lower generation in power business and lower realisation in coal business
EBIT	6,880	8,656	-20.5%	-5.2%	Partly offset by INR3.0bn income to be recovered in future tariff
Net profit (recurring)	2,977	5,192	-42.7%	-18.8%	Lower margins from coal business offsetting the strong profits in power business
Net profit (reported)	986	5,192	-81.0%	-73.1%	Lower on account of INR3.17bn write off of deferred stripping costs from its coal business accounted in 3QFY10 relating to prior periods
Segmental					
Power Business					
Revenue	29,094	29,806	-2.4%	-9.0%	Lower generation at standalone level offsetting strong growth at subsidiaries
EBIT	4,455	3,102	43.6%	5.3%	Merchant profits and strong growth at subsidiaries
Standalone					
Capacity	2,815	2,445	15.1%	0.0%	370MW addition: 120MW Haldia, 250MW Unit#8 Trombay
Generation (m units)	3,851	3,848	0.1%	-4.8%	Flat due to unplanned shutdowns for 3 weeks (27% capacity shut for 25% of time)
Sales (m units)	3,714	3,711	0.1%	-5.6%	Lower generation
Revenue	15,412	17,507	-12.0%	-8.6%	Lower fuel costs and unplanned shutdowns
EBIT	2,650	1,797	47.4%	-14.1%	Higher profits from 238MUs merchant sales @ INR5.4-6.2/unit, profit of cINR2/unit
Subsidiaries					
Revenue	13,681	12,300	11.2%	-9.6%	Strong growth at all subsidiaries
EBIT	1,805	1,305	38.3%	57.6%	Strong growth at all subsidiaries
NDPL					
Net Sales	8,309	5,710	45.5%	-19.5%	Higher MUs sold and income recoverable through future tariff increase (INR2.15bn) booked in 3QFY10
PAT	684	452	51.4%	166.5%	
Power Links					
Net Sales	724	560	29.2%	-3.6%	
PAT	344	124	177.7%	66.7%	Higher additional capitalisation and favourable change in CERC norm. Reversal of deferred tax of INR100mn
TPTCL					
Unit traded	1,083	675	60.4%	34.2%	
Net Sales	5,890	5,352	10.0%	30.0%	Higher trading volumes offset by lower price per unit due to lower fuel cost
Per unit (INR)	5.4	7.9	-31.4%	-3.1%	Lower power purchase cost
PAT	15	13	12.0%	-8.0%	Increase in volumes
Coal Business					
Volumes (m tons)#	17.1	13.6	25.9%	14.4%	
Realisation (USD/ton))	60.0	80.0	-25.0%	3.6%	Drop in global coal prices
Revenue	12,593	14,568	-13.6%	11.4%	Lower realisation per ton and exchange rate variation offsetting increase in volumes
EBIT	2,608	5,746	-54.6%	-23.4%	Lower realisation and higher stripping cost
Margins %	20.7%	39.4%	-1,873	-939	Higher stripping costs during 3QFY10

Note: TPTCL = Tata Power Trading Co. Ltd, NDPL = North Delhi Power Ltd, #Volumes represents 100% for the coal mines. Tata Power stake is 30% in the two coal mines

Source: Company data., HSBC

Estimate changes

Accordingly, we increase our volume estimates for coal production by c3% for FY10-12 and factor in the increase in stripping costs by USD1.48/ton (c6% of additional cost). This results in a c3% decline in earnings for FY10-11e.

Table 3: Change in estimates summary

INRM	New			Old			Change (%)		
	FY10e	FY11e	FY12e	FY10e	FY11e	FY12e	FY10e	FY11e	FY12e
Sales	184,593	209,709	227,330	181,823	206,229	223,384	1.5%	1.7%	1.8%
Net profit	17,187	18,284	20,501	17,799	18,787	20,400	-3.4%	-2.7%	0.5%
EPS (fully diluted) (INR)	72.8	77.4	83.4	75.3	79.5	83.0	-3.4%	-2.7%	0.5%

Source: HSBC estimates

Valuation and risks

Based on our new estimates, we derive a new target price of INR1,525 per share (earlier INR1,585). We use a combination of three valuation approaches to value Tata Power (see table 4) and derive a fair value of INR1,440 (earlier INR1,495). To this fair value, we have added the value of projects under development (c4.4GW) at INR85.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below the hurdle rate for Indian stocks of 10.5%. For Tata Power, this translates into a Neutral rating band of 0.5-20.5%. Our target price implies a potential total return of 26.6% including dividend yield; therefore, we maintain our Overweight (V) rating on the stock.

Downside risks to our rating include delays in project execution, higher mining cost, interest rate risk and unfavourable regulatory changes. Business risks include equity funding for the other 6.2GW capacity expansion in the pipeline.

Table 4: Tata Power Valuation Summary

INR/Share	New	Old	New basis	Old basis
DCF	1,562	1,690	WACC of 10.5% (CoE - 12%, CoD - 10%, growth rate - 5%)	WACC of 10.4% (CoE - 12%, CoD - 10%, growth rate - 5%)
PB	1,346	1,370	P/B multiple 2.4x on BV 2011 (RoE 20%, COE 10.5%, g 5%)	P/B multiple 2.4x on BV 2011 (RoE 20%, COE 10.5%, g 5%)
SOTP	1,410	1,425	<ul style="list-style-type: none"> Parent company: INR496/share, DCF WACC of 10.3% Subsidiaries: INR200/share, DCF WACC of 10.3%, for Mundra 12.9% Stake in KPC and Arutmin: INR378/share, WACC of 12.9% Investments and others: INR336/share 	<ul style="list-style-type: none"> Parent company: INR550/share, DCF WACC of 10.3% Subsidiaries: INR210/share, DCF WACC of 10.3%, for Mundra 12.9% Stake in KPC and Arutmin: INR310/share, WACC of 12.9% Investments and others: INR355/share
Average of the above	1,440	1,495		
Projects under development	85	89	4.4GW operational by FY16	4.4GW operational by FY16
Target Price	1,525	1,584		

Source: HSBC estimates

Financials & valuation

Financial statements

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Profit & loss summary (INRm)				
Revenue	175,875	184,593	209,709	227,330
EBITDA	36,496	41,926	46,931	52,932
Depreciation & amortisation	-6,565	-8,802	-9,418	-10,355
Operating profit/EBIT	29,931	33,123	37,513	42,577
Net interest	-8,129	-9,202	-10,438	-11,808
PBT	23,025	27,625	30,470	33,811
HSBC PBT	23,025	27,625	30,470	33,811
Taxation	-9,764	-9,177	-10,575	-11,178
Net profit	12,186	17,187	18,284	20,501
HSBC net profit	12,567	17,187	18,284	20,501

Cash flow summary (INRm)

Cash flow from operations	30,551	26,853	29,005	33,016
Capex	-53,349	-79,867	-66,874	-50,924
Cash flow from investment	-54,158	-79,867	-66,874	-50,924
Dividends	-2,915	-3,111	-3,111	-3,520
Change in net debt	44,141	39,951	40,980	7,328
FCF equity	-23,746	-56,427	-40,960	-20,631

Balance sheet summary (INRm)

Intangible fixed assets	0	0	0	0
Tangible fixed assets	211,465	282,529	339,985	380,554
Current assets	74,466	89,237	91,983	98,214
Cash & others	11,780	29,488	29,771	34,940
Total assets	318,450	404,576	465,082	512,201
Operating liabilities	56,490	53,444	55,904	57,314
Gross debt	141,434	199,094	240,356	252,853
Net debt	129,655	169,606	210,585	217,913
Shareholders funds	86,189	116,439	131,612	162,693
Invested capital	217,661	288,833	346,293	386,515

Ratio, growth and per share analysis

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Y-o-y % change				
Revenue	61.5	5.0	13.6	8.4
EBITDA	72.0	14.9	11.9	12.8
Operating profit	91.5	10.7	13.3	13.5
PBT	50.4	20.0	10.3	11.0
HSBC EPS	85.3	28.2	6.4	7.7

Ratios (%)

Revenue/IC (x)	1.0	0.7	0.7	0.6
ROIC	9.3	8.7	7.7	7.8
ROE	15.4	17.0	14.7	13.9
ROA	6.6	6.8	6.1	6.2
EBITDA margin	20.8	22.7	22.4	23.3
Operating profit margin	17.0	17.9	17.9	18.7
EBITDA/net interest (x)	4.5	4.6	4.5	4.5
Net debt/equity	135.6	133.4	146.3	123.0
Net debt/EBITDA (x)	3.6	4.0	4.5	4.1
CF from operations/net debt	23.6	15.8	13.8	15.2

Per share data (INR)

EPS reported (fully diluted)	55.04	72.75	77.40	83.36
HSBC EPS (fully diluted)	56.76	72.75	77.40	83.36
DPS	11.50	11.50	11.50	12.50
Book value	389.29	492.89	557.12	661.57

Key forecast drivers

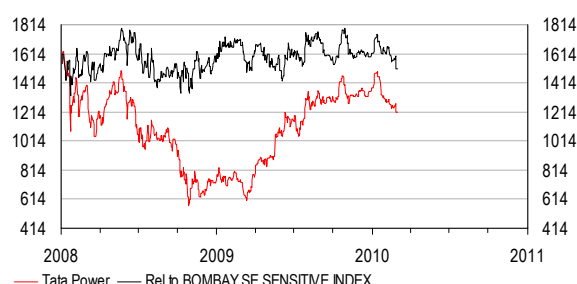
Year to	03/2009a	03/2010e	03/2011e	03/2012e
Capacity Installed (MW)	2,785	3,103	3,628	4,153
Units Sold (MU)	14,703	17,199	20,189	24,801

Valuation data

Year to	03/2009a	03/2010e	03/2011e	03/2012e
EV/sales	2.2	2.4	2.3	2.1
EV/EBITDA	10.8	10.4	10.2	9.2
EV/IC	1.8	1.5	1.4	1.3
PE*	21.4	16.7	15.7	14.6
P/Book value	3.1	2.5	2.2	1.8
FCF yield (%)	-9.0	-21.2	-15.3	-7.7
Dividend yield (%)	0.9	0.9	0.9	1.0

Note: * = Based on HSBC EPS (fully diluted)

Price relative



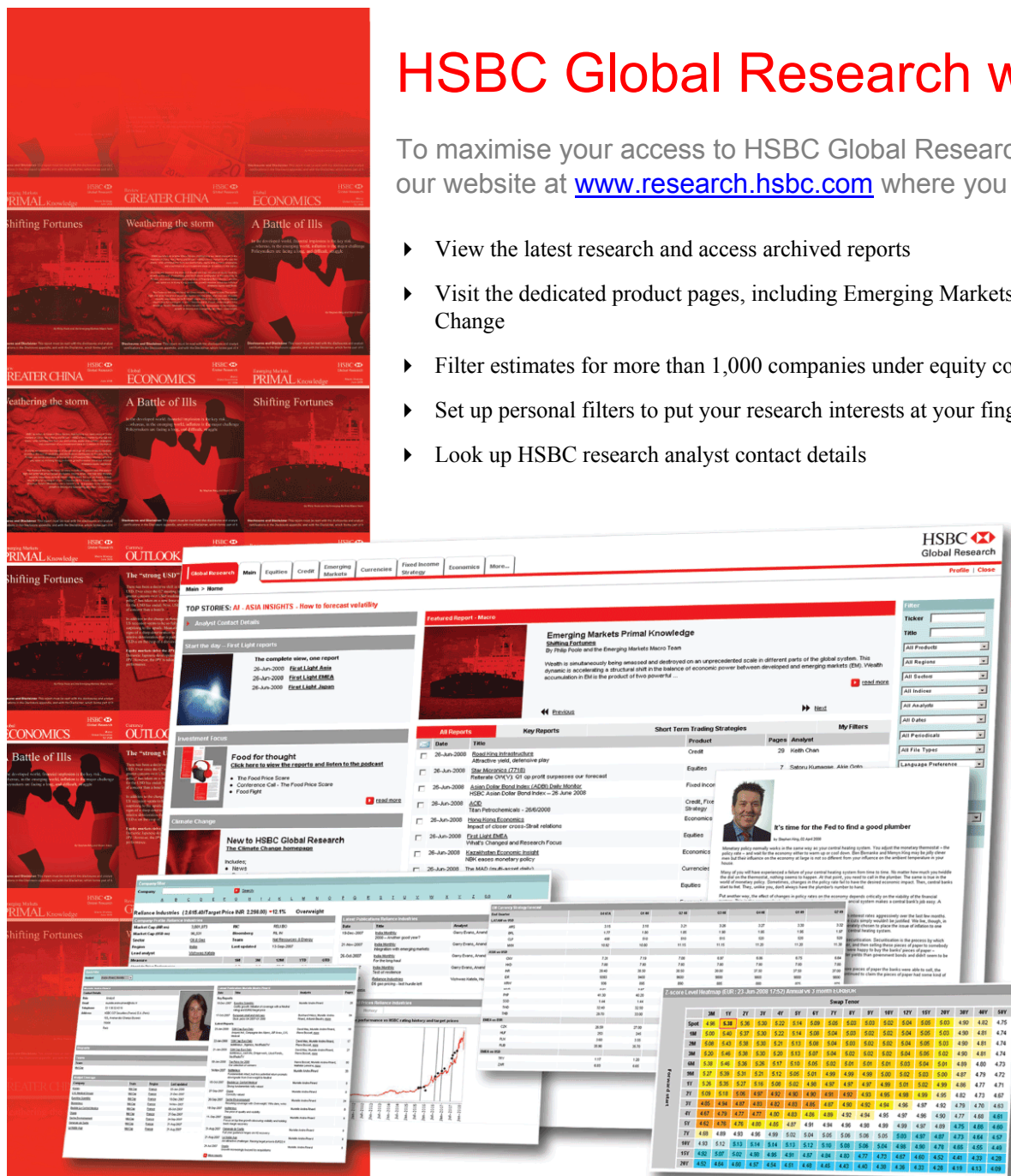
Source: HSBC

Note: price at close of 02 Mar 2010

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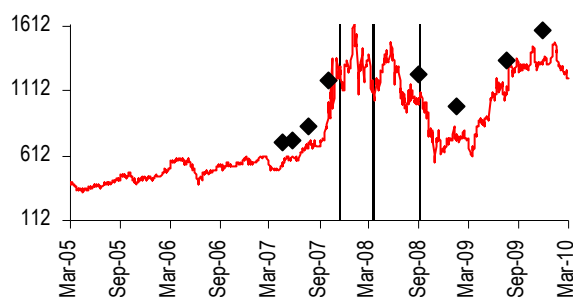
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Share price and rating changes for long-term investment opportunities

Tata Power (TTPW.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Overweight	Underweight	07 November 2007
Underweight	Underweight (V)	17 March 2008
Underweight (V)	Overweight (V)	29 August 2008
Target Price	Value	Date
Price 1	714.00	20 April 2007
Price 2	732.00	23 May 2007
Price 3	843.00	26 July 2007
Price 4	1198.00	04 October 2007
Price 5	1244.00	29 August 2008
Price 6	1000.00	14 January 2009
Price 7	1350.00	21 July 2009
Price 8	1585.00	30 November 2009

Source: HSBC

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Company	Ticker	Recent price	Price Date	Disclosure
TATA POWER	TTPW.NS	1213.15	02-Mar-2010	7

Source: HSBC

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