

CESC

FY10 update

23 June 2010

Hold

Target Price: Rs414

CMP: Rs386*

Upside: 6.5%

*as on 22 June 2010

Retail losses mounting

Losses incurred by CESC's retail subsidiary, Spencer's, in FY10 increased 57% YoY due to lower-than-expected cost reduction. In our opinion, Spencer's may not turn positive even in FY12. Going forward, CESC is likely to spend another Rs6bn in the retail business, much more than what we had factored previously. We downgrade our rating to Hold from Buy and reduce our target price to Rs414 (earlier: Rs518).

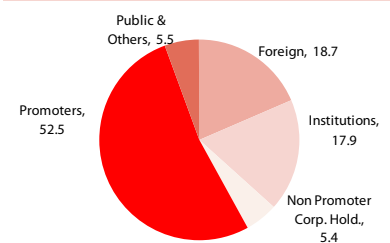
- **Cost reduction lower-than-expected:** Due to lower-than-expected reduction in O&M expenses, Spencer's loss at the operating level in FY10 at Rs2.4bn was 53% higher than our estimate. As a result, net loss at Rs2.8bn was 91.6% higher than our estimate.
- **Signs of improvement in other operational parameters:** Sales per sq ft increased 14.9% YoY to Rs9,620. Gross margin expanded 200bp to 17.3% and was 30bp higher than our estimate due to better product mix. Employee cost per sq ft declined 14.2% to Rs1,044 due to the company's cost rationalization activities.
- **Turnaround not likely possible by FY11; expect Rs6bn more to be spent on retail business:** We expect the turnaround in the retail business to take more time than the previously envisaged FY11. Further, CESC is likely to be spent a further Rs6bn in the retail business over next 3 years, which would drag the core business valuations.
- **Downgrade to Hold, target price cut to Rs414:** We have downgraded the stock to Hold from Buy on account of the more-than-expected losses in the retail business and the expected delay in the turnaround. We have also cut our target price to Rs414 (vs. earlier Rs518).
- **Visibility on power projects improving:** Construction work on the 600MW Dhariwal project is likely to begin soon and is expected to be commissioned before end of FY13. The BTG order for the 600MW Haldia project is likely to be placed by next quarter. However, the 1000MW Dumka project is likely to be delayed due to political instability in Jharkhand.

Key Data

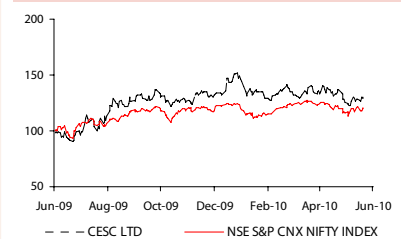
Bloomberg Code	CESC IN
Reuters Code	CESC.BO
Current Shares O/S (mn)	124.9
Diluted Shares O/S(mn)	124.9
Mkt Cap (Rsbn/USDbn)	48.3/1
52 Wk H / L (Rs)	452/260
Daily Vol. (3M NSE Avg.)	203,583
Face Value (Rs)	10

1 USD = Rs46.2

Shareholding Pattern (%)

As on 31st March 2010

One year Indexed Stock Performance



Price Performance (%)

	1M	6M	1Yr
CESC	4.9	0.1	31.9
NIFTY	7.8	6.6	25.5

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

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Y/E Mar (Rsmn)	Rev	YoY (%)	EBITDA	EBITDA (%)	Adj PAT	YoY (%)	Fully DEPS	RoE (%)	RoCE (%)	P/E (x)	P/BV(x)
FY08	27,750	11.7	6,016	21.7	3,037	(6.7)	24.2	12.3	9.5	16.0	1.6
FY09	30,313	9.2	6,125	20.2	3,919	29.0	31.2	12.4	9.4	12.4	1.4
FY10E	33,650	11.0	8,220	24.4	4,330	10.5	34.5	12.1	9.4	11.2	1.3
FY11E	33,978	1.0	9,497	27.9	4,281	(1.1)	34.1	10.9	9.2	11.3	1.2
FY12E	35,680.3	5.0	9,957	27.9	4,441	3.7	35.4	10.3	8.0	10.9	1.1

Sources: Company, Centrum Research Estimates

Spencer's losses more-than-expected

CESC has announced its consolidated results for FY10. We have derived Spencer's numbers by deducting the standalone (there is no other material business in CESC's consolidated numbers). Accordingly, Spencer's sales in FY10 amounted at Rs9.6bn, which was 10.2% lower YoY and was in line with our estimation. Sales per sq ft rose 14.9% YoY to Rs9,620, inline with our estimate. Gross profit margin expanded 200bp YoY to 17.3%, 30bp higher than our estimate due to better product mix like more private labels. Due to lower-than-expected reduction in operation and maintenance (O&M) expenses, operating loss at Rs2.4bn was 53% higher than our estimate, but registered 18.7% YoY improvement.

Personnel expenses per sq ft declined 14.2% YoY to Rs1,190, but were still 5.1% higher than our estimate of Rs1,044. O&M expenses remained same at Rs2,553 per sq ft and were 22.5% higher than our estimate. Due to an extraordinary item of expense and lower EBITDA, net losses increased 56.9% YoY to Rs2.8bn, and were and 91.6% higher than our estimate.

Exhibit 1: Spencer's FY10 review

Spencer's numbers	FY09	FY10	Growth (%)	FY10E	Variance (%)
Income					
Total operating income	10,714	9,620	(10.2)	9,634	(0.1)
<i>Sales per (sq.ft)</i>	<i>8,371</i>	<i>9,620</i>	<i>14.9</i>	<i>9,491</i>	<i>1.4</i>
Cost of Goods sold	9,078	7,960	(12.3)	7,996	(0.4)
Cost of Goods Sold as a %age of Sales (Gross)	85%	83%		83%	
Gross Profit	1,636	1,660	1.5	1,638	1.4
Gross Margin	15.3%	17.3%	200 bps	17.0%	30 bps
Gross margin per sq.ft	1,344	1,456		1,614	
Personnel Expenses	1,481	1,190	(19.6)	1,117	6.5
Personal Expenses per sqft (in mn)	1,216	1,044	<i>(14.2)</i>	1,100	<i>(5.1)</i>
Total O&M Expenses	2,390	2,910	21.7	2,660	9.4
<i>O&M per sq.ft</i>	<i>2,591</i>	<i>2,553</i>	<i>(1.5)</i>	<i>2,084</i>	<i>22.5</i>
EBITDA	(3,000)	(2,440)	18.7	(1,594)	(53.0)
Depreciation	408	450		401	
PBIT	(3,408)	(2,890)	15.2	(1,995)	(44.9)
Interest	244	260		377	
Other Income		100			
PBT before Extra Ordinary items	(3,651)	(3,050)	16.5	(2,372)	(28.6)
Extra Ordinary Expense	766	(430)			
PBT	(2,886)	(3,480)	(20.6)	(2,372)	(46.7)
Taxes	(1,109)	(693)		(917)	
PAT	(1,777)	(2,787)	(56.9)	(1,455)	(91.6)

Note: the above figures have been arrived at after deducting CESC standalone figures from the consolidated numbers

Sources: Company, Centrum Research Estimates

No turnaround possible by FY11; expect additional Rs6bn to be spent on retail

We expect the retail business to take more time to turnaround than previously envisaged FY11. Further, CESC is likely to spend about Rs6bn on this business over the next 3 years, which would drag the core business valuation. The Spencer management has done everything possible to contain losses at both the store and company level. However, going forward, there is not much room left for further cost reductions. It was a broader industry phenomenon last year to reduce the employee cost and rentals by re-negotiating with realtors. But retail companies have now begun to expand and are looking at boosting same-store-sales growth for improving operational performance.

Going forward, Spencer's too has to depend completely on expansion and higher same-store-sales growth for improved performance as the scope of for other cost saving modes are limited. We expect both 10% increase in both retail space and same-store-sales growth. We therefore expect Spencer's to take more than expected time to turnaround, and not before FY13-14. Further, the company has already improved its gross margin by introducing more private label. Gross margin also improved 200bp YoY to 17.3%.

Downgrade to Hold, target price reduced Rs414

The more-than-expected losses in the retail business coupled with a further delay in its turnaround have compelled us to downgrade our rating to Hold from Buy and also cut our target price to Rs414 (earlier: Rs518). We value the core power business at 2.0x P/BV after adjusting the book net worth by Rs15.9bn which is the amount invested and to be invested in to retail business. CESC has already spent ~Rs9.8bn in Spencer's till FY10 and is further expected to spend ~Rs6bn over next 3 years. We reduce this amount from the FY11E net-worth of Rs40.1bn and accordingly arrive at Rs193/share of book value. Assigning a multiple of 2.0x, we arrive at core business value of Rs387, which is equivalent to CMP. We have valued the retail business at Rs20 per share based on 0.4x EV/sales and Rs7 for property business. SOTP value accordingly comes to Rs414.

Exhibit 2: SOTP valuation for CESC

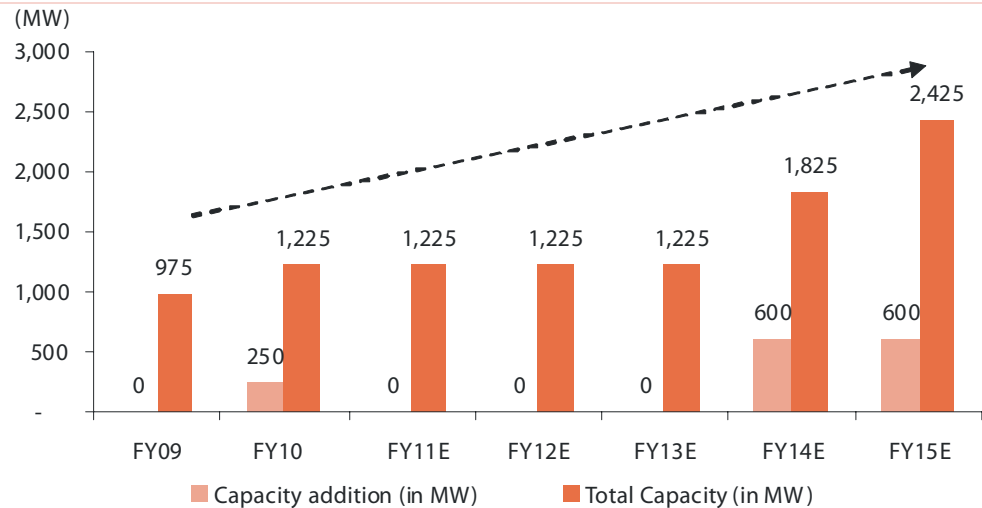
Power valuation (Rsmn)	
Book value	40,177
Less: Investment in Spencer's & other businesses	15,887
Net network	24,290
Net book value per share (Rs)	193
Multiple assigned (x)	2
Value of core business (Rs)	387
Valuation to retail and property business (Rs)	27
SOTP value (Rs)	414

Sources: Centrum Research Estimates

Visibility on power projects improving

Construction work on the 600MW Dhariwal construction is likely to begin soon and is expected to be commissioned by 2014. The BTG order for the 600MW Haldia project is likely to be placed during next quarter. Dehkanal project land acquisition is over and is likely to proceed towards getting coal linkage and financial closure. However, the 1000MW Dumka project is likely to be delayed due to political instability in Jharkhand, any significant improvement in visibility for this project is likely to be trigger for the stock as it is based on captive coal block and 50% merchant. Although the company has plans to add ~5GW of capacity upon its existing 1225MW, but momentum has picked up only in 600MW Dhariwal project.

Exhibit 3: Capacity addition



Sources: Company, Centrum Research Estimates

Financials

Exhibit 4: Income Statement

Y/E March (Rsmn)	FY08	FY09	FY10	FY11E	FY12E
Revenues	27,750	30,313	33,650	33,978	35,680
Growth in revenues (%)	11.7	9.2	11.0	1.0	5.0
Cost of fuel and power	12,440	13,572	17,140	15,607	16,405
% of Revenue	44.8	44.8	50.9	45.9	46.0
Employee cost	3,378	3,702	3,790	4,054	4,257
% of Sales	12.2	12.2	11.3	11.9	11.9
O&M expenses	5,915	6,914	4,500	4,821	5,062
% of Sales	21.3	22.8	13.4	14.2	14.2
EBITDA	6,016	6,125	8,220	9,497	9,957
EBITDA Margin	21.7	20.2	24.4	27.9	27.9
Depreciation	1,685	1,749	2,060	2,271	2,430
Other Income	475	1,479	840	172	147
PBIT	4,807	5,855	7,000	7,398	7,674
Interest expenses	1,363	1,410	1,780	2,263	2,339
PBT before extra-ord. items	3,444	4,445	5,220	5,135	5,335
Extra-ordinary income/ (exp)	585.3	203.7	-	-	-
PBT	4,029	4,649	5,220	5,135	5,335
Provision for tax	476	550	890	855	894
Effective tax rate (%)	11.8	11.8	17.0	16.6	16.8
PAT before extra-ord. items	3,554	4,099	4,330	4,281	4,441
Extra-ordinary income/ (exp)	516	180	-	-	-
Adjusted PAT	3,037	3,919	4,330	4,281	4,441
Growth in PAT (%)	(6.7)	29.0	10.5	(1.1)	3.7
PAT margin	10.9	12.9	12.9	12.6	12.4

Source: Company, Centrum Research Estimates

Exhibit 5: Balance Sheet

Y/E March (Rsmn)	FY08	FY09	FY10E	FY11E	FY12E
Share Capital	1,256	1,256	1,256	1,256	1,256
Reserves	44,609	47,573	51,297	54,978	58,797
- Revaluation Reserve	16,183	14,906	14,906	14,906	14,906
Shareholders' fund	45,865	48,829	52,553	56,234	60,053
Debt	16,288	23,981	21,241	27,182	40,212
Deferred Tax Liability	-	-	-	-	-
Advance against depreciation	1,980	3,376	4,467	5,454	4,714
Capital Contributions & Grants	7,422	8,212	9,002	9,792	10,582
Total Capital Employed	71,554	84,398	87,262	98,662	115,561
Total Fixed Assets	58,292	68,824	72,850	81,146	97,799
Investments	5,697	3,104	3,104	3,104	3,104
Inventories	1,762	2,120	2,941	2,181	2,195
Debtors	3,152	3,889	4,428	4,471	4,695
Other Current Assets	287	422	422	422	422
Cash and bank balances	9,864	12,510	10,322	12,056	11,060
Loans and Advances	4,551	10,327	13,327	16,027	17,827
Total current assets	19,616	29,268	31,439	35,157	36,199
Current liabilities & provisions	12,137	16,876	20,209	20,823	21,621
Net current assets	7,480	12,391	11,229	14,333	14,579
Misc. Expenditure	86	79	79	79	79
Total Assets	71,554	84,398	87,262	98,662	115,561

Source: Company, Centrum Research Estimates

Exhibit 6: Cash flow

Y/E March (Rsmn)	FY08	FY09E	FY10E	FY11E	FY12E
Cash flow from operating					
Profit before tax	4,029	4,649	5,220	5,135	5,335
Depreciation	1,685	1,749	2,060	2,271	2,430
Interest expenses	1,363	1,410	1,780	2,263	2,339
Other Non op. (income)/exp.	(437)	891	1,091	987	(740)
Op. profit bef. WC change	6,640	8,698	10,151	10,656	9,364
Working capital adjustment	3,437	2,980	1,973	1,331	558
Gross cash from operations	10,077	11,678	12,124	11,986	9,922
Direct taxes paid	(452)	(568)	(890)	(855)	(894)
Cash from operations	9,625	11,110	11,234	11,132	9,028
Cash flow from investing					
Capex	(6,152)	(12,500)	(6,086)	(10,567)	(19,084)
Investment - Cash equivalents	(2,373)	(2,889)	(3,000)	(2,700)	(1,800)
Investment - Subsidiary / Strategic					
Other Income	(2,214)	375	-	-	-
Cash from investment	(10,738)	(15,013)	(9,086)	(13,267)	(20,884)
Cash flow from financing					
Procds from share cap. & premium	5,697	-	-	-	-
Borrowings/ (Repayments)	(176)	8,526	(1,950)	6,732	13,820
Interest paid	(1,516)	(1,394)	(1,780)	(2,263)	(2,339)
Dividend paid	(343)	(582)	(606)	(599)	(622)
Cash from financing	3,663	6,549	(4,337)	3,870	10,859
Net cash increase/ (decrease)	2,550	2,646	(2,189)	1,735	(996)
Free Cash Flow	3,473	(1,390)	5,148	565	(10,055)

Source: Company, Centrum Research Estimates

Exhibit 7: Key Ratios

Y/E March	FY08	FY09E	FY10E	FY11E	FY12E
Margin ratios (%)					
EBITDA Margin	21.7	20.2	24.4	27.9	27.9
PBIT Margin	17.3	19.3	20.8	21.8	21.5
PBT Margin	12.4	14.7	15.5	15.1	15.0
PAT Margin	10.9	12.9	12.9	12.6	12.4
Growth ratios (%)					
Revenues	11.7	9.2	11.0	1.0	5.0
EBITDA	(10.9)	1.8	34.2	15.5	4.8
Adjusted PAT	(6.7)	29.0	10.5	(1.1)	3.7
Return ratios (%)					
ROCE	9.5	9.4	9.4	9.2	8.0
ROIC	9.5	7.6	8.8	9.4	8.1
ROE	12.3	12.4	12.1	10.9	10.3
Turnover ratios (x)					
Asset turnover ratio (x)	0.4	0.4	0.4	0.3	0.3
Inventory (days)	21.6	22.6	22.1	22.4	22.2
Average Collection period (days)	48.0	42.4	45.1	47.8	46.9
Average payment period (days)	86.4	85.0	83.7	78.0	89.4
Per share ratios (Rs)					
EPS (Reported)	28.3	32.6	34.5	34.1	35.4
Adjusted EPS	24.2	31.2	34.5	34.1	35.4
CEPS	37.6	45.1	50.9	52.2	54.7
Adjusted Book Value*	236.3	270.1	299.7	329.0	359.5
Solvency ratios					
Debt/ Equity	0.5	0.7	0.6	0.7	0.9
Interest coverage	3.5	4.2	3.9	1.0	2.0
Valuation parameters (x)					
P/E (Reported EPS)	13.6	11.8	11.2	11.3	10.9
P/E (Adj. EPS)	16.0	12.4	11.2	11.3	10.9
P/ABV	1.6	1.4	1.3	1.2	1.1
EV/ EBITDA	9.1	9.8	7.2	6.7	7.8
EV/ Sales	2.0	2.0	1.8	1.9	2.2

*Adjusted for revaluation reserve in the book

Source: Company, Centrum Research Estimates

Appendix A

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Buy: Expected outperform Nifty by >15%, **Accumulate:** Expected to outperform Nifty by +5 to 15%, **Hold:** Expected to outperform Nifty by -5% to +5%, **Reduce:** Expected to underperform Nifty by 5 to 15%, **Sell:** Expected to underperform Nifty by >15%

Centrum Broking Private Limited

Member (NSE, BSE), Depository Participant (CDSL) and SEBI registered Portfolio Manager

Regn Nos

CAPITAL MARKET SEBI REGN. NO.: BSE: INB 011251130, NSE: INB231251134

DERIVATIVES SEBI REGN. NO.: NSE: INF 231251134 (TRADING & SELF CLEARING MEMBER)

CDSL DP ID: 12200. **SEBI REGISTRATION NO.:** IN-DP-CDSL-20-99

PMS REGISTRATION NO.: INP000000456

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