7 September 2010 | 11 pages

Adani Power (ADAN.BO)

Equity

Buy: 16% Custom Duty on SEZ-Based Power Plants Removed

- **The Notification** — Ministry of Finance in a notification issued on 6 September 2010 has replaced 16% duty on sale of electricity from power projects situated in SEZ to domestic tariff area (DTA) or non processing areas of SEZ, with a much lower duty of Rs100 per1000kwh (for imported coal) and nil for domestic coal (details on page 3).

- **Removes Uncertainty** — The replacement of provision of the 16% duty with a much lower duty structure is a big positive for sentiment and removes uncertainty on valuations of APL. APL had contested the earlier provision of 16% duty and our target price of Rs159 assumes that APL would not be required to pay the same.

- **Some questions still remain** — There is still some uncertainty regarding (1) whether 5% custom duty on imported coal will also be removed to avoid double taxation on both input and output; (2) For sale of power under long-term PPA, whether the new duty on sale of electricity would qualify for "change in law" provision and hence be a pass-through in PPA. We analyze various scenarios in the note to asses the impact of various permutation and combinations.

- **Scenario 1 - Impact on target price** — Our target price declines to Rs153 in worst case (no pass-through in PPA and non-removal of custom duty on imported coal) and to Rs158 in the best case (pass-through in PPA and removal of custom duty on imported coal).

- **Scenario 2 - Impact on valuations if we factor in adverse judgment in GUVNL case** — If APL accepts the GERC order and does not get coal from GMDC, our target price would go down to Rs149 from Rs159 currently. If we take Rs149 as base price and examine the impact of notification, our target price declines to Rs143 in the worst case (no pass-through in PPA and non-removal of custom duty on imported coal) and to Rs148 in best case (pass-through in PPA and removal of custom duty on imported coal).

- **Maintain Buy** — Replacement of the 16% custom duty with a lower duty structure is positive for sentiment, though already factored in valuations. Adani Power's stock performance would largely be governed by the pace of capacity additions, milestone achievements on 7.2GW of pipeline projects and short-term swings in merchant prices. Lanco Infratech (LAIN.BO; Rs69.90; 1M), Adani Power, Tata Power (TTPW.BO; Rs1,270.05; 1L) are our top picks in that order of preference.

Buy/Low Risk	**1L**
Price (07 Sep 10)	Rs137.05
Target price	Rs159.00
Expected share price return	16.0%
Expected dividend yield	0.0%
Expected total return	**16.0%**
Market Cap	Rs298,774M US$6,420M

Price Performance (RIC: ADAN.BO, BB: ADANI IN)

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	nm	175.6	26.0	6.0	5.6
EV/EBITDA adjusted (x)	nm	151.3	22.9	5.9	4.9
P/BV (x)	11.1	5.2	4.3	2.5	1.7
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (Rs)					
EPS adjusted	-0.01	0.78	5.26	22.71	24.54
EPS reported	-0.01	0.78	5.26	22.71	24.54
BVPS	12.35	26.50	31.77	54.47	79.02
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (RsM)					
Net sales	0	4,349	29,461	119,773	166,537
Operating expenses	-28	-2,264	-11,885	-41,807	-72,486
EBIT	**-28**	**2,085**	**17,576**	**77,966**	**94,051**
Net interest expense	0	-377	-3,289	-12,207	-22,517
Non-operating/exceptionals	0	319	0	-652	348
Pre-tax profit	**-28**	**2,027**	**14,287**	**65,107**	**71,882**
Tax	0	-327	-2,814	-12,826	-14,161
Extraord./Min.Int./Pref.div.	2	1	0	-2,780	-4,215
Reported net income	**-26**	**1,701**	**11,472**	**49,501**	**53,506**
Adjusted earnings	-26	1,701	11,472	49,501	53,506
Adjusted EBITDA	-28	2,438	19,073	84,076	105,095
Growth Rates (%)					
Sales	na	na	577.5	306.5	39.0
EBIT adjusted	61.3	nm	743.1	343.6	20.6
EBITDA adjusted	61.3	nm	682.3	340.8	25.0
EPS adjusted	89.3	nm	574.4	331.5	8.1
Cash Flow (RsM)					
Operating cash flow	**-1,170**	**3,501**	**9,883**	**60,231**	**79,959**
Depreciation/amortization	0	353	1,497	6,110	11,044
Net working capital	-1,142	1,131	-5,727	-7,962	-6,887
Investing cash flow	**-44,085**	**-86,702**	**-94,316**	**-101,150**	**-54,165**
Capital expenditure	-44,618	-86,702	-94,316	-101,150	-54,165
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**48,215**	**88,829**	**79,485**	**61,567**	**33,613**
Borrowings	39,785	55,808	82,126	71,369	51,694
Dividends paid	0	0	0	0	0
Change in cash	**2,960**	**5,627**	**-4,948**	**20,648**	**59,407**
Balance Sheet (RsM)					
Total assets	**78,962**	**179,280**	**261,805**	**396,044**	**515,951**
Cash & cash equivalent	5,585	11,654	9,727	40,186	109,182
Accounts receivable	0	2,563	1,574	5,258	9,812
Net fixed assets	69,213	155,562	248,382	343,422	386,542
Total liabilities	**55,516**	**120,477**	**191,530**	**273,488**	**335,674**
Accounts payable	5,620	14,652	557	1,335	2,238
Total Debt	49,897	105,705	187,831	259,201	310,893
Shareholders' funds	**23,446**	**58,803**	**70,276**	**122,556**	**180,277**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	na	56.1	64.7	70.2	63.1
ROE adjusted	-0.1	4.2	18.1	52.7	36.8
ROIC adjusted	-0.1	1.6	7.3	21.5	21.0
Net debt to equity	189.0	159.9	253.4	178.7	111.9
Total debt to capital	68.0	64.3	72.8	67.9	63.3

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Scenario Analysis

- **Scenario 1 –** Impact of the notification on target price of Rs159.

Figure 1. Impact of the notification on CIRA target price of Rs159

(Rs/share)	Custom duty on imported coal is removed	Custom duty on imported coal is not removed
Custom duty on sale of electricity is allowed to pass-through in PPA	158	157
Custom duty on sale of electricity is not allowed to pass-through in PPA	156	153

Source: Citi Investment Research and Analysis

- **Scenario 2 –** Earlier GERC had requested the Government of Gujarat to ask APL to withdraw the termination notice of the PPA with GUVNL to supply 1,000 MW of power for 25 years at a rate of Rs2.35/kWh. Our discussion with the APL management suggests that it is yet to decide on what legal course it is likely to resort to: (1) Accept the decision or (2) Appeal in the appellate tribunal of electricity (ATE). Under the circumstance that APL accepts the order and does not get coal from GMDC, our EPS estimates would be lower by 1-6% over FY12E-15E and our target price would go down to Rs149 from Rs159 currently (~6% downside). In the following table we examine the impact of the latest custom notification to replace 16% duty with a much lower duty structure on Rs149 value per share of APL.

Figure 2. Impact of the notification on Rs149 value per share of APL.

(Rs/share)	Custom duty on imported coal is removed	Custom duty on imported coal is not removed
Custom duty on sale of electricity is allowed pass-through in PPA	148	148
Custom duty on sale of electricity is not allowed pass-through in PPA	147	143

Source: Citi Investment Research and Analysis

The Details of Notification

- The notification applies on electrical energy removal from a SEZ into Domestic Tariff Area or non processing areas of SEZ.

Figure 3. Notification No. 91/2010-CUSTOMS, Ministry of Finance (Government of India)

For project size >= 1000 MW	
Using imported coal as fuel	Rs100 per 1000kwh
Using domestic coal as fuel	Nil
Using domestic gas as fuel	Rs110 per 1000kwh
For project size < 1000 MW	
Using imported coal as fuel	Rs40 per 1000kwh
Using domestic coal as fuel	Nil
Using domestic gas as fuel	Rs60 per 1000kwh

Source: Ministry of Finance, Citi Investment Research and Analysis

Adani Power

Company description

Adani Power Limited (APL) has five thermal power projects in various stages of development, with combined capacity of 16,500 MW, namely: (i) Mundra Power Project with 4,620MW (ii) Tiroda Power Project with 3,300MW (iii) Kawai Power Project with 1,320MW (iv) Dahej Power Project with a capacity of 2,640MW (v) Chhindwara Power Project with a capacity of 1320MW and (vi) Bhadreshwar with a capacity of 3300MW.

Investment strategy

Adani Power Buy / Low (1L) risk as Adani Power is an interesting case of private sector entrepreneurship at its best, capitalizing on persistent power deficits and exploiting high medium term merchant tariffs before the start of long term PPAs to reduce project payback, using faster-than-BHEL execution time cycles of Chinese equipment suppliers. Impressive progress on 4620MW of capacity at Mundra and 3300MW at Tiroda; and the Adani Group's experience in executing mega projects like the Mundra Ports and SEZ project bolsters the investment case.

APL during its IPO had projects under development of 6,600MW and pipeline projects of 3,300MW. The under development projects have increased to 9,240MW and pipeline projects have increased to 7,200MW.

As the pace of execution in Mundra 4,620MW and Tiroda 3,300MW has been ahead of execution which we observed during our visit to Mundra and from the Tiroda site photographs shared with us by the management. Mundra site currently has ~17,000 workers which include ~300 Chinese workers and execution is currently happening at a frenetic pace.

Purchase of the 100% interest in the Galilee coal tenement though not a short term positive significantly improves fuel supply security to achieve APL’s long term vision of having 20GW of operational capacity by 2020. 30MMTPA of coal can fuel 10.5GW of capacity at 90% PLF using supercritical plants with a heat rate of 2100kcal/kWh assuming coal GCV of 5800kcal/kg and 60MMTPA of coal can fuel 21GW of capacity.

Valuation

Traditional valuation methodologies like P/E and EV/EBITDA multiples can be misleading if used to value pure infrastructure asset holders, as profitability of the projects can be lumpy, primarily on the basis of year of commissioning and the life of the asset. In some years, when projects are commissioned, the company may look attractive on a PE multiple basis, while in another year, when the asset life ends, the stock may appear relatively expensive. Infrastructure assets and more specifically Electric Utilities generate regular and largely predictable cash flow streams for a fixed time period. Therefore, discounted cash flow (DCF) is best-suited to value BOT projects. While applying DCF one can choose free cash flow to the firm (FCF) or free cash flow to equity (FCFE). We prefer FCFE as individual projects are highly geared and gearing changes as debt is rapidly paid off. If we assume APL executes all its projects flawlessly in line with our assumptions we would arrive at a value of Rs159 for the stock.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a Low Risk rating to Adani Power.

Downside risks include: 1) Insufficient quantity of coal in Bunyu to fire the Mundra project; 2) The total reserves of 150mn tonnes have three licenses. While the counterparties of 2 of the 3 mines have procured long-term exploitation licenses the third license has not yet been granted to the counterparty; 3) Regulatory risk in Indonesia; 4) Fuel supply to Mundra Phase IV and Tiroda is contingent on AEL achieving certain milestones and finalizing the coal supply agreements and timely mining; 5) Fuel pricing risk for the Indonesian coal; 6) Merchant tariff risks; 7) Execution risks; 8) Chinese equipment quality risks; and 8) Interest rate risk.

Upside risks include: 1) Better than expected operating parameters; 2) Faster than expected execution; 3) Higher than expected merchant tariffs; and 4) Significant progress on 3300MW of projects now in planning stages.

Lanco Infratech

Valuation

Traditional valuation methodologies like P/E and EV/EBITDA multiples can be misleading if used to value pure infrastructure asset holders, as project profitability can be lumpy, given the year of commissioning and life of the asset. Infrastructure assets, especially electric utilities, generate regular and largely predictable cash flow streams for a fixed period. Therefore, discounted cash flow (DCF) is best suited.

While applying the DCF one can either choose free cash flow to the firm (FCF) or free cash flow to equity (FCFE). We prefer FCFE as individual projects are highly geared and gearing changes as debt is rapidly paid off.

We value Lanco Infratech at Rs80/share with EPC at Rs23/share (11x Dec-11 EPS - 20% discount to mid-cap construction), Power at Rs56.8/share (DCF on FCFE using 13% CoE), Roads at Rs2/share (DCF on FCFE using 13% CoE) and other businesses at Rs(-1.6)/share.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a High Risk rating to Lanco Infratech. However, we believe a Medium Risk rating is more appropriate given the status of projects under implementation, industry-specific risks, financial risk and management risks.

LANCI's Medium Risk rating is more appropriate as: 1) its 6,000MW of capacity under implementation, has fuel, land, off-take arrangement and bulk of financing tied up; 2) The construction on a large part of this capacity is in advanced stage; 3)The power portfolio has ~80% of capacity operating on full/ fuel cost pass-through mechanism. These factors, we believe, reduce risk substantially.

Given that LANCI is a play on both execution and operation of power plants, execution delays would have a bigger impact on numbers and company value. Other downside risks that could prevent the stock from reaching our target price include financial closure delays, fuel supply disruption, equipment quality and lower-than-expected merchant tariffs.

Tata Power

Valuation

Our Rs1,550 target price is based on a sum-of-the-parts approach: 1) The parent business is valued using DCF as of Sept-2010E, using a WACC of 12.3% (risk free rate of 8.5%, market risk premium of 6%, beta of 1.06, D/E of 67%); 2) Tata Power's 51% stake in NDPL is valued at 2.5x FY11E P/BV; 3) Tata Power's stake in Powerlinks is valued at 1.5x FY11E P/BV; 4) Holdings in Tata Teleservices (Maharashtra) and VSNL are valued at a 20% discount to the market price prices; 5) Stake in Tata Teleservices is valued at a 30% discount to the NTT Docomo valuations; 6) Mundra UMPP using FCFE and Cost of Equity = 12.5%; 7) The Maithon project is valued like Mundra UMPP; and 8) 30% stake in KPC and Arutmin coal mines at FCFE and CoE = 14%.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a Medium Risk rating to Tata Power. However, given a significant proportion of its power business works on regulated returns we view a Low Risk rating as more appropriate. Key downside risks to our target price include: 1) Unfavorable judgement in the MERC order petition and standby charges case vs. R-Infra could hit the financials; 2) Power sector is gradually liberalizing, but regulatory and tariff structures still evolving. Companies in the sector are vulnerable to delays, mid-term corrections and dramatic policy changes; under the existing system, litigation following discord may be time-consuming, and a lack of precedents adds to uncertainty; 3) Delays and cost escalation in capacity expansion and an unfavorable interest rate environment; 4) The nature of the Asian coal market means an inability to fill orders or expand capacity in Indonesian coal mines will have a material impact on profitability, as will regional coal prices; and 5) Coal mines rely heavily on contract miners; changing relations could materially affect operations.

Appendix A-1

Analyst Certification

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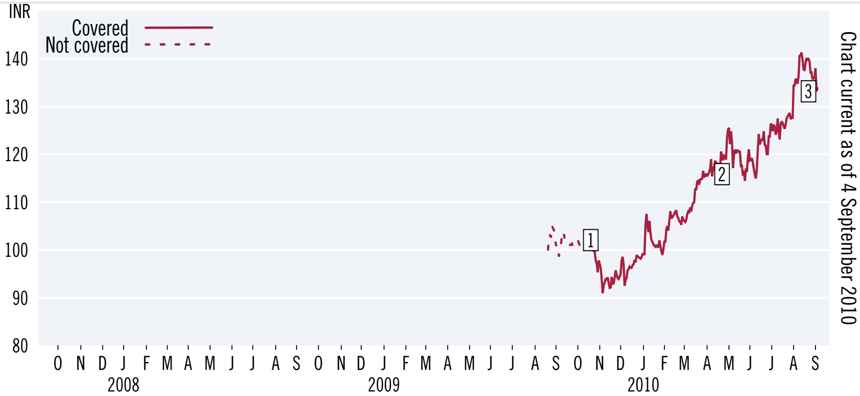
Adani Power (ADAN.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Venkatesh Balasubramaniam
Covered since October 20 2009



	Date	Rating	Target Price	Closing Price
1	20-Oct-09	*3M	*88.00	100.15
2	22-Apr-10	3M	*106.00	119.50
3	23-Aug-10	*1L	*159.00	139.95

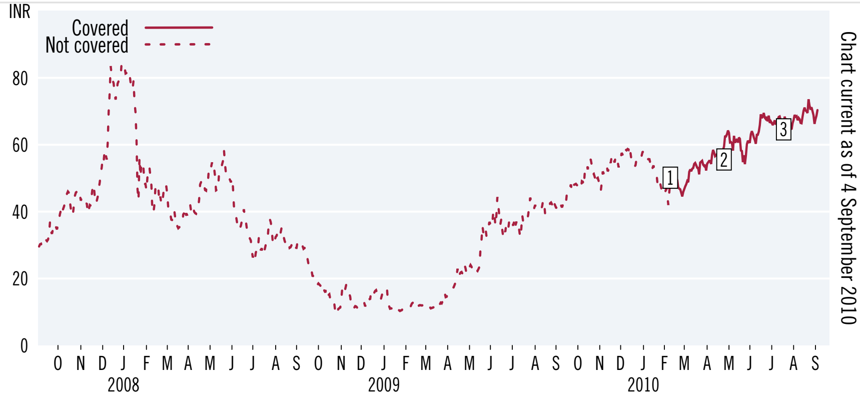
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Lanco Infratech (LAIN.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Atul Tiwari, CFA
Covered since February 9 2010



	Date	Rating	Target Price	Closing Price
1	9-Feb-10	*1M	*60.00	49.20
2	26-Apr-10	1M	*70.00	59.45
3	19-Jul-10	1M	*80.00	66.05

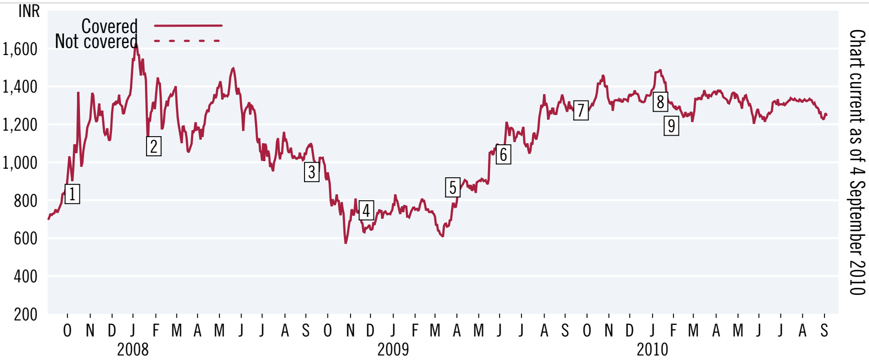
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Tata Power (TTPW.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Venkatesh Balasubramaniam



	Date	Rating	Target Price	Closing Price
1	8-Oct-07	*1L	*1,078.00	900.45
2	30-Jan-08	1L	*1,494.00	1,317.75
3	9-Sep-08	1L	*1,453.00	1,086.50
4	25-Nov-08	1L	*1,027.00	651.00
5	26-Mar-09	1L	*900.00	781.40
6	5-Jun-09	1L	*1,209.00	1,081.35
7	23-Sep-09	*2L	*1,389.00	1,305.35
8	13-Jan-10	2L	*1,564.00	1,488.65
9	28-Jan-10	*1L	*1,550.00	1,318.35

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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