Utilities
Indian Electric Utilities
Equity – India

# Indian utilities

## Rising interest rates – a smooth ride for utilities

- **The Indian utilities are protected from rises in interest rates as they can pass on higher interest costs to consumers**
- **For proposed plants, the rising interest cost is not a major threat as long as they contain the costs of funding to benchmarks set by regulators**
- **Tata Power and NTPC are our top picks in the sector, with Overweight ratings and target prices of INR724 and INR176 respectively**

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## Rise in interest cost not to affect utilities

Interest rates in India for term lending of 10-year tenor are up by 3% over last 6 months. Our house view is that the reference rates should rise by another 1% by end-FY08. Rising interest rates should not affect the earnings of Indian utilities as they enjoy the pass-through mechanism for interest and fuel cost. Power sector regulators have set State Bank of India (SBI) prime lending rate as a benchmark for calculating interest cost. For existing plants, utilities pay interest on long term loans as well as working capital loans, which can be passed on to consumers, provided these are below the set benchmarks.

Specialised financial institutions like Power Finance Corporation (PFC) and Rural Electrification Corporation (REC) have disbursed cINR272bn in 2006 and multilateral agencies like Asian Development Bank (ADB) and Japanese Bank for International Cooperation (JBIC) have increased their assistance to the Indian power sector to cINR65bn in 2006. We expect INR2.3tn to be funded by specialised and multilateral agencies during the $11^{th}$ five-year plan. For the proposed projects, which are to be set up over next 4-5 years, the utilities can pass on the higher cost of funding to consumers as regulators generally allow higher interest during construction on the back of increase in interest rate. For projects won through bidding, we expect utilities to have various innovative structures to reduce interest during construction.

Going by the earlier experience of NTPC and Tata Power for raising loans overseas, we are confident that both companies should be able to raise the funds for their aggressive expansion at comfortable rates with a proper mix of domestic and overseas debt. We expect the cost of funds for NTPC and Tata Power to be 9.5% and 8.4%, respectively, for the next year. We maintain our Overweight on NTPC and Tata Power with target price of INR176 and INR724 respectively.

# Interest cost for existing power projects

## Term loans with floating interest rates

The utilities had borrowed c80% portion of the borrowing in fixed interest rates, so there is no major risk of interest cost for most of the projects. For some projects, Indian utilities have raised funds in overseas markets with interest reset clause or floating rates, based on the USD 6 month LIBOR. As USD 6 month LIBOR has been stable at c5.2% over the past 12 months, rise in interest cost was already factored in their tariffs last year. As per the regulatory structure in India, the interest cost can be entirely passed on to consumers. So there we see no risk for existing projects that have borrowed at floating interest rates.

## Working capital loans: not a concern if not significantly above SBI PLR

The utilities have been granted nearly 20-25% of annual sales as working capital requirement by regulators. Most of the Indian utilities under our coverage manage their working requirement below the mandated levels through 100% collection of dues in 5-10 days of raising bills. The interest on working capital loans is benchmarked at SBI prime lending rate. So as long as utilities have controlled their working capital requirement and the interest cost below the set benchmarks, the interest cost can be fully passed on to consumers.

# Interest cost for proposed projects

## Regulator-approved projects: should be able to pass on the costs

Term lending rates for power projects have gone up by c3% over the past six months. Our house view is that the reference rate for India would rise further by 1% by end of FY08. The utilities have to get regulators' approval for capital expenditure for projects; the increased interest during construction may be passed on to consumers. In most of the cases, where interest during construction has been higher, the increase in interest during construction costs were passed on. Projects that have achieved financial closure should not face any interest rate threat as they have fixed interest liability for the next three years. Projects which have applied for long term loans may face pressure due to rising interest rates. The impact could be minimised through a proper mix of fixed and floating interest rates. As per our analysis, rise in interest cost by 1% could affect the tariff of proposed power project by INR0.045/kWh. Given the rise in interest rates by 3%, the impact on the consumers also could be as low as 3-4% rise in power tariff.

## Plants won through bidding

The plants won through bidding have to control the cost of borrowing to protect their margins as they can not pass on the rising cost to the consumers. We have seen the large utilities like NTPC and Tata Power have the ability to raise USD500m-USD2, 500m in overseas borrowings. We expect Tata Power to raise most of its debt in overseas borrowings as the interest rates in India are rising by leaps and bounds. Overseas institutions like International Finance Corporation, Washington and leading investment banks have already talked about the willingness to fund ultra mega power projects. Recently, NTPC has raised USD100m at LIBOR linked rate from KFW of Germany with a 10-year tenor. The slowdown in US due to sub-prime market may make overseas borrowings slightly costlier. Based on our discussion with market participants, there is enough appetite for the Indian debt in overseas credit market. As leading private equity players have planned USD5bn infrastructure funds for long-term financing needs of infrastructure projects, we believe getting long term funding should not be a problem for utilities.

# Sector-specific financers

## Power Finance Corporation and Rural Electrification Corporation

PFC and REC together have disbursed cINR272bn in 2006, this shows the higher demand from the power projects can be met with higher disbursements from these specialised institutions. Although REC and PFC are primarily funding state-owned utilities, they are increasing their exposure to private utilities. PFC has been funding various independent power projects (IPPs) for several years. We expect these institutions to continue their growth in funding in coming years as a majority of their funds come from special bonds or external borrowings. We expect them to disburse INR2,310bn during the 11th five- year plan, which is equivalent to a CAGR of 17% in their disbursement over the next 5 years.

## Multi-lateral agencies: World Bank, ADB may lead in financing power

Multi-lateral agencies are increasing their exposure to funding Indian power projects. They have increased their exposure by 153% from INR18.4bn in 2005 to INR64.9bn in 2006. We expect these agencies to fund Indian power projects to the tune of INR470bn over next five years. ADB is a leader among multi-lateral agencies, and has disbursed INR31.5bn in 2006 to two power projects, followed by JBIC, which financed transmission and hydro generation projects of INR15.5bn. The World Bank has also taken exposure of INR15.4bn in Power Grid Corporation of India's project. We have not considered the exposure of IFC, Washington in funding of INR470bn during the 11th five-year plan.

**Funding to power sector (INRm)**

| Funding agency | Disbursement in 2006 | Disbursement over FY07-12 |
|---|---|---|
| PFC | 135,120 | 1,080,960 |
| REC | 136,610 | 1,229,490 |
| **Specialised institutions** | **271,730** | **2,310,450** |
| ADB | 31,500 | 220,500 |
| World bank | 18,000 | 126,000 |
| JBIC | 15,450 | 123,600 |
| **Multi-lateral agencies** | **64,950** | **470,100** |

Source: HSBC, Ministry of Power

# Impact on companies

## NTPC: to raise USD15bn over the next five years

NTPC has aggressive expansion plans. Over the next five years, it needs to raise over USD15bn in debt to fund its capacity expansion of 21GW. We expect most of the funding to be raised through long-term bonds and term loans. It may also go for raising external commercial borrowing to the tune of USD5bn over the next five years. It has a revolving credit facility of USD3bn sanctioned by various overseas lenders. NTPC has recently signed an agreement for a term loan of USD100m with KFW of Germany, where KFW has directly provided a term loan to NTPC. It is a loan with a tenor of 10 years without sovereign guarantee. Earlier in February 2006, it had drawn the first tranche of USD300m out of its USD1bn medium term note (MTN). This facility was arranged at 5.875% coupon for 10 years. Going by this, we do believe that funding 21GW of projects would not be a problem for NTPC.

### Tata Power: to raise USD5bn over the next five years

Tata Power has plans to quadruple its capacity to 10GW by 2012. To fund this aggressive expansion, it needs to raise USD5bn in domestic and overseas debt markets. As it already has all necessary approvals for the Mundra UMPP, we expect it to raise most of its debt overseas with average interest cost rate of 6.5%. IFC and other multilateral agencies should be the main lenders to this project. International Finance Corporation had financed a part of Tata Power's Bhutan-India transmission project. They have also raised USD200m through foreign currency convertible bonds (FCCB) with 1% coupon and 5-year tenor. Such hybrid instruments may help the company in saving interest during construction and in turn would reduce capital cost per MW. We expect the average cost of funding for Mundra UMPP to be 8.5%.

## Valuation and ratings

### Tata Power: target price of INR724, Overweight

Tata Power's share price has gone down by 8.8% y-t-d. At INR510.35, it is trading at 12.9x FY08 earnings, much below the Asian utilities average of 14.4x.

Our target price for the company is INR724, which is based on the average of our two valuation methods – DCF analysis (with a cost of equity of 12.7% and terminal growth rate of 5%), which values the company at INR771 and sum-of-the-parts valuation, which valuates generation, distribution and investments on various parameters at INR677. We also expect Tata Power to trade at a premium to its regional peers given its strong earnings growth potential and good project execution skills.

### NTPC: target price of INR176, Overweight

NTPC's share price has gone up 6.5% y-t-d. At INR145.3, it is trading at 13.2x FY08 earnings, much below the Asian utilities average of 14.4x.

Our target price for the company is INR176, which is based on the average of our two valuation methods – DCF analysis (with a cost of equity of 12.7% and terminal growth rate of 5%), which values the company at INR181 and sum-of-the-parts valuation, which valuates generation, distribution and investments on various parameters at INR171. We also expect NTPC to trade at a premium to its regional peers given its huge capacity expansion and good project execution skills.

## Risks to our call

### Overseas borrowings may not come easy

We have considered that the majority of the borrowing for the projects won through bidding will come from external commercial borrowings. This exposes the company to the currency risk as well as floating interest rate risk. Any event changing the rating of the country may affect the exchange rate as well as interest rate for the company; this would have adverse impact on the earnings of the company. As NTPC and Tata Power are expanding their capacity very aggressively, any delay in the execution of the projects could affect their earnings in a big way.

# Disclosure appendix

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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| | | |
|---|---|---|
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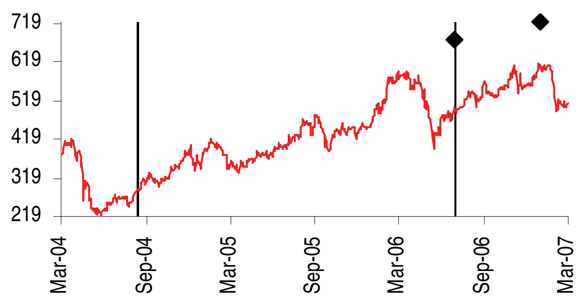
| **Neutral (Hold)** | 35% | (15% of these provided with Investment Banking Services) |
| **Underweight (Sell)** | 20% | (12% of these provided with Investment Banking Services) |

## Share price and rating changes for long-term investment opportunities

**Tata Power Share Price performance INR Vs HSBC rating history**



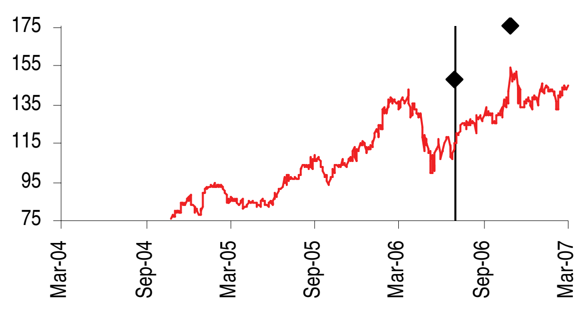

Source: HSBC

**Recommendation & price target history**

| From | To | Date |
|---|---|---|
| Add | N/A | 08 September 2004 |
| N/A | Overweight | 28 July 2006 |
| **Target Price** | **Value** | **Date** |
| Price 1 | 679.10 | 28 July 2006 |
| Price 2 | 724.00 | 30 January 2007 |

Source: HSBC

NTPC Share Price performance INR Vs HSBC rating history




Source: HSBC

Recommendation & price target history

| From | To | Date |
|---|---|---|
| N/A | Overweight | 28 July 2006 |
| **Target Price** | **Value** | **Date** |
| Price 1 | 148.10 | 28 July 2006 |
| Price 2 | 175.80 | 24 November 2006 |

Source: HSBC

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**Disclosure checklist**

| Company | Ticker | Recent price | Price Date | Disclosure |
|---|---|---|---|---|
| NTPC | NTPC.NS | 145.50 | 29-Mar-2007 | 5 |
| TATA POWER | TTPW.NS | 510.65 | 29-Mar-2007 | 5 |

Source: HSBC

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