RURAL ELECTRIFICATION CORP.

Edelweiss
Ideas create, values protect

Power play

Strong visibility on business growth

Rural Electrification Corporation (REC) plays a strategic role in government's plan for development of the power sector. Over the Eleventh and Twelfth Five Year plans (FY07-17), India targets to add capacity of ~170 GW, creating investment opportunities of ~USD 400 bn across the power value chain. With superior domain knowledge, financing expertise, and government support, REC is well-positioned to leverage this opportunity (in the Tenth Plan, REC met 16-18% of the overall debt requirement of the power sector). We expect disbursement and loan book to post 20% and 24% CAGR over FY10-12E, respectively.

Diversifying and monetising across the power value chain

REC, since inception, has played a leading role in rural electrification and T&D project financing. It ventured into generation projects in 2002 - now constituting 38% of its loan book (plans to take it to >50% in two years). It is also looking to finance activities with linkages to power like coal, fuel supply etc and increase its involvement in consortium lending to capitalise on private sector participation. It acts as a nodal agent for RGGVY and is coordinator for GoI's transmission BOT scheme. This provides strong visibility on its asset growth and fee based income.

Near zero NPLs despite higher perceived risk

REC has reported significant improvement in its asset quality since FY07 due to upgradation/recoveries, with gross NPA declining to near zero levels. Escrow mechanism (for ~75% of loans), government guarantees, and strengthening appraisal/collection process provide comfort on its asset quality, despite higher perceived risk due to large exposure to loss making state utilities.

Outlook and valuations: Power play; initiate coverage with **'BUY'**

We expect REC's net interest margins to come off 25bps, to 4.2%, by FY12E due to limited repricing benefit, and shift in borrowings towards longer tenure bonds/loans (to bridge asset liability maturity gap). The company is also raising money through follow-on public offer (for 15% dilution) and has fixed a floor price of INR 203. Despite this, we believe strong loan growth, higher fee income, further supported by a lean cost structure and stable asset quality, will support 19% earnings growth and RoEs will sustain at ~20%. REC's strategic role will enable it to command premium valuation compared with PSU banks. Considering equity dilution, the stock is trading at 1.4x FY12E book and 7.8x earnings. We initiate coverage on REC with '**BUY'** and recommend investors to subscribe to the FPO. On a relative basis, we rate the stock '**Sector Outperformer'.**

Financials

Year to March	FY08	FY09	FY10E	FY11E
Net revenues (INR mn)	14,745	20,227	26,939	33,187
Net profit (INR mn)	9,627	13,788	19,222	23,176
EPS (INR)	11.2	16.1	19.5	23.5
EPS growth (%)	*13.1*	*43.2*	*21.2*	*20.6*
Book value per share (INR)	72.9	83.8	112.4	128.9
Diluted P/E (x)	19.1	13.3	11.0	9.1
Price/ BV (x)	2.9	2.6	1.9	1.7
ROAE (%)	17.5	20.5	21.0	19.5

February 19, 2010

Reuters : RURL.BO Bloomberg : RECL IN

EDELWEISS 4D RATINGS	
Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Low
Sector Relative to Market	Overweight

Note:
Please refer last page of the report for rating explanation

MARKET DATA		
CMP	:	INR 214
52-week range (INR)	:	274 / 76
Share in issue (mn)	:	858.7
M cap (INR bn/USD mn)	:	183.7 / 3,953.3
Avg. Daily Vol. BSE ('000)	:	1,407.4

SHARE HOLDING PATTERN (%)		
Promoters*	:	81.8
MFs, FIs & Banks	:	6.3
FIIs	:	6.0
Others	:	5.8
* *Promoters pledged shares (% of share in issue)*	:	*NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW BFSI Index
1 month	(17.8)	(7.3)	(6.1)
3 months	(8.2)	(3.3)	(8.0)
12 months	179.5	76.1	104.4

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Investment Rationale

Over the Eleventh and Twelfth Five Year plans (FY07-17), India targets to add ~170 GW, creating huge investment opportunities of ~USD 400 bn

Strong visibility on business growth

Investments of ~USD 400 bn lined up in power sector over next 10 years

Over the Eleventh and Twelfth Five Year plans (FY07-17), India targets to add ~170 GW, creating huge investment opportunities across the power value chain. According to our research on the power sector, this capacity addition target entails an investment of ~USD 400 bn, assuming INR 50 mn/MW generation and an equal amount in T&D. High growth, long-term visibility and sustainable returns, coupled with demand-supply gap (~12% peak deficit) and rising energy consumption, make the sector an attractive investment option.

Table 1: Generation capacity addition target for XIth and XIIth plans (MW)

				XIth Plan	XIIth Plan
	Central	State	Private	Total	Total
Thermal	24,840	23,301	11,552	59,693	76,500
Hydro	8,654	3,482	3,491	15,627	20,100
Nuclear	3,380	-	-	3,380	3,400
Total	**36,874**	**26,783**	**15,043**	**78,700**	**100,000**

Source: Report of the Working Group on Power, CEA

Table 2: Power sector investment requirement over next 10 years

				XIth Plan	XIIth Plan
(INR bn)	State	Central	Private	Total	Total
Generation including nuclear	1,238	2,021	850	4,109	4,951
DDG		200		200	
R & M	159			159	
Transmission	650	750		1,400	2,400
Distribution including rural electrification	2,870			2,870	3,710
HRD		5		5	
R&D Outlay		12		12	
DSM		7		7	
Total Power Sector	**4,917**	**2,994**	**850**	**8,761**	
NCES and Captive	225		930	1,155	
Merchant Plants			400	400	
Total Funds Requirement	**5,142**	**2,994**	**2,180**	**10,316**	**11,061**

Source: Base Paper, International Conclave on Key Inputs for Accelerated Development of Indian Power Sector for 11th Plan and Beyond, MoP and CEA

REC plays strategic role in development of power sector

REC, being a specialised power financier, plays a strategic role in GoI's ongoing financing plans for development of the power sector.

In the Tenth Plan (FY02-07), REC accounted for 16-18% of the debt requirement in the power sector

- It disbursed INR 422 bn of loans for power projects in the Tenth Plan (FY02-07), accounting for 16-18% of the debt requirement in the power sector. Superior domain knowledge, financing expertise and government support will enable it to leverage emerging financing opportunities in the power sector over Eleventh and Twelfth plans (FY07-17) as well. According to the estimates of Working Group of Power, REC is expected to disburse at least INR 592 bn in the Eleventh Plan (against the expected disbursement of INR 812 bn for PFC).

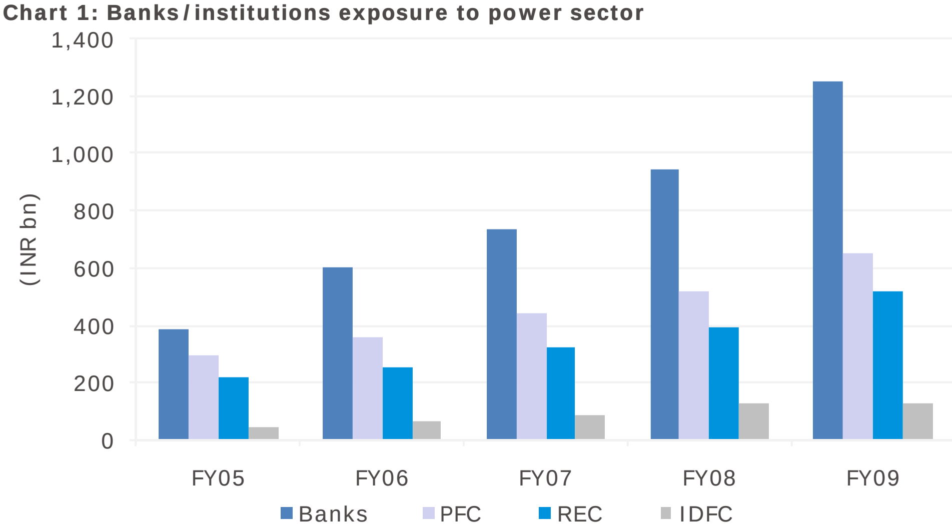
- It also provides counterpart funding for Restructured Accelerated Power Development Reform Programme (R-APDRP), an initiative to improve the financial viability of state power utilities, reduce AT&C losses and strengthen sub-transmission systems as well as distribution networks, with an estimated investment of INR 500 bn (INR 100 bn for Part A and INR 400 bn for Part B).
- Besides financing the core power projects, REC also plays a leading role in GoI's plan for rural electrification given its 40 years of experience in developing the T&D infrastructure in rural India.
- The company acts as a nodal agency for Rajiv Gandhi Grameen Vidyutikaran Yojana (RGGVY), a GoI initiative to provide electricity to the entire rural India, with an expected investment of INR 400 bn; of this amount, REC will provide ~10% in the form of long-term loan at market rates. It will receive 1% processing fee on the project cost for administering this scheme.

Space getting competitive; domain knowledge and expertise to provide an edge

The power financing space is getting increasingly competitive with several banks/FIs expanding loan offerings to power projects. Over the past five years, bank credit to the power sector has grown at ~45% CAGR, while specialised financiers like PFC, REC, and IDFC have maintained growth momentum in the range of 20-30%. Some of the key lenders to power sector are:

- Specialised government owned power financiers like Power Finance Corporation (PFC), Rural Electrification Corporation (REC), and Indian Renewable Energy Development Agency (IREDA).
- Infrastructure oriented financial institutions like Infrastructure Development Finance Corporation (IDFC), Industrial Finance Corporation of India (IFCI), and India Infrastructure Finance Company (IIFCL).
- Public and private sector banks.
- State level financial institutions.
- International financial institutions like Asian Development Bank (ADB), International Finance Corporation (IFC), Japan International Cooperation Agency, and World Bank.

Chart 1: Banks/institutions exposure to power sector



Source: Company

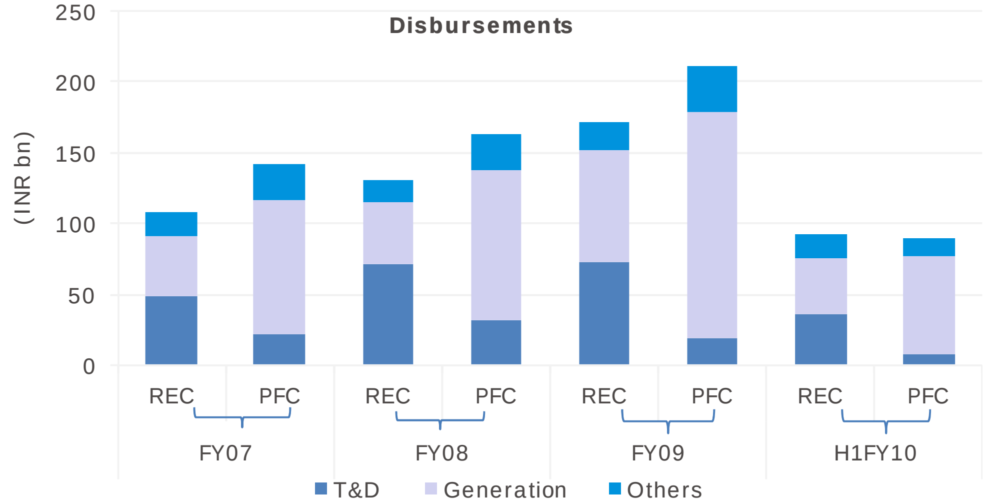
We expect REC to effectively compete in the high-growth power financing space and retain its leadership by virtue of its superior power domain knowledge, financing expertise, government support and relationship with state utilities.

Dominance in T&D; enhancing presence in generation

REC is well-positioned in the T&D space with ~40 years of experience and continues to garner higher share in T&D related projects

REC is well-positioned in the T&D space with ~40 years of experience and continues to garner higher share in T&D related projects. REC sanctioned loans worth INR 597 bn in the T&D segment since FY07-H1FY10 (compared with INR 248 bn for PFC) and disbursed loans of INR 226 bn (against INR 79 bn for PFC). Its T&D-related loan disbursements have grown at a CAGR of 38% over FY06-09, contributing ~57% to the total loan outstanding as on September 30, 2009.

Chart 2: REC dominant in T&D segment

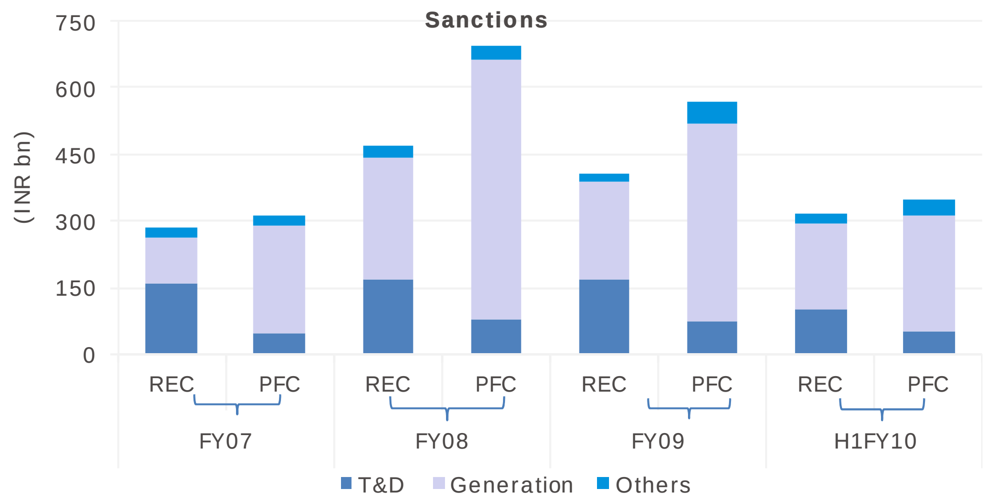


Source: Company

The company has witnessed impressive growth in loan sanctions to the generation projects, though PFC continues to get a higher share of these projects

REC started financing power generation projects in 2002 after GoI expanded its mandate to finance all types of power-related projects, irrespective of the project size and location. The company has witnessed impressive growth in loan sanctions to the generation projects, though PFC continues to get a higher share of these projects. Generation accounted for ~60% of its sanctions in H1FY10 against less than 40% in FY07. Generation projects constituted 40% to total disbursement over FY07-H1FY10.

Charts 3: Expanding presence in generation segment



Source: Company

Monetising across the power value chain

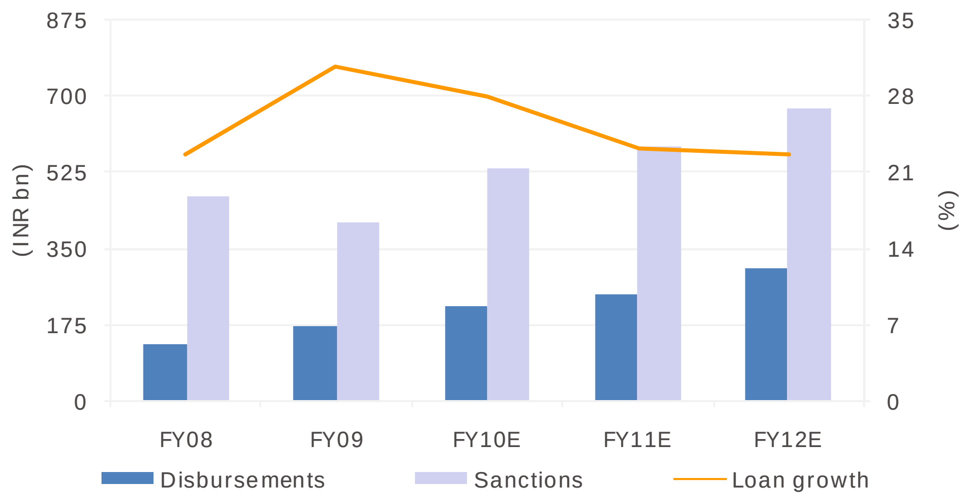
To monetise the opportunities across the power value chain, REC is now looking to finance activities with linkages to power like coal, fuel supply arrangements and other mining activities. It is also increasing its involvement in consortium lending to capitalise on private sector participation in the power sector. Further, it provides counterpart funding for Restructured Accelerated Power Development Reform Programme (R-APDRP), with an estimated investment of INR 500 bn. It acts as a nodal agent for RGGVY scheme and is coordinator for GoI's transmission BOT scheme.

Loan book to grow at 24% CAGR over FY10-12E

We expect disbursement and loan book to post 20% and 24% CAGR over FY10-12E, respectively

The underlying investment demand in the power sector, REC's competitive position and unutilised sanctions of ~INR 800 bn, provide strong visibility on REC's loan growth. We expect the disbursement and loan book to post 20% and 24% CAGR over FY10-12E, respectively.

Chart 4: Disbursement to grow at 20% CAGR over FY10-12E



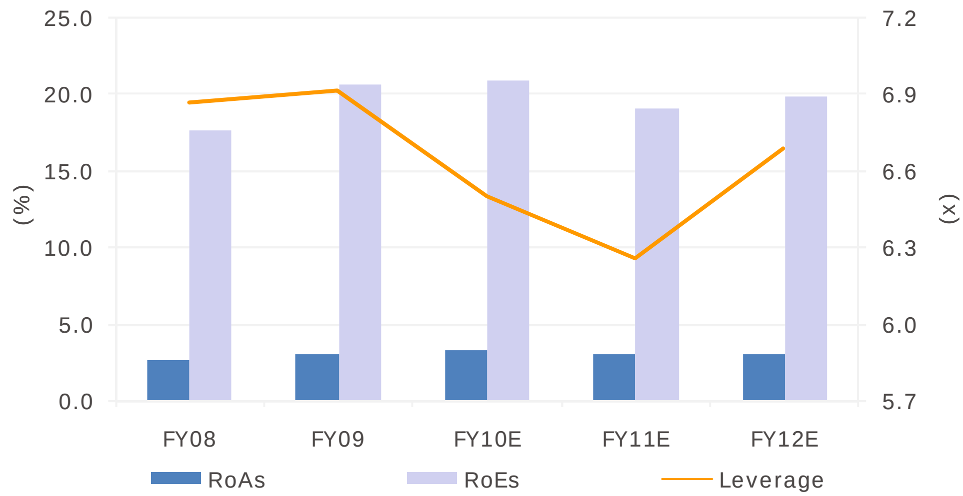
Source: Company, Edelweiss research

- **RoEs to sustain at ~20% level**

RoEs to sustain at ~20% driven by increase in leverage, higher fee income and stable asset quality, despite compression in margins and equity dilution

We expect net interest margins to come off 25bps, to 4.2%, by FY12E due to limited repricing benefit and shift in borrowings towards longer tenure high cost bonds/loans. The company is also raising money through follow-on public offer for 171.7 mn shares (15% equity dilution pre-issue). Despite this, we believe it will be able to sustain RoEs at ~20% over FY10-12E. This will be driven by increase in leverage (due to strong loan growth) and higher fee income, and will be further supported by a lean cost structure and stable asset quality (discussed in the section below).

Chart 5: RoEs to sustain despite margin compression and equity dilution



Source: Company, Edelweiss research

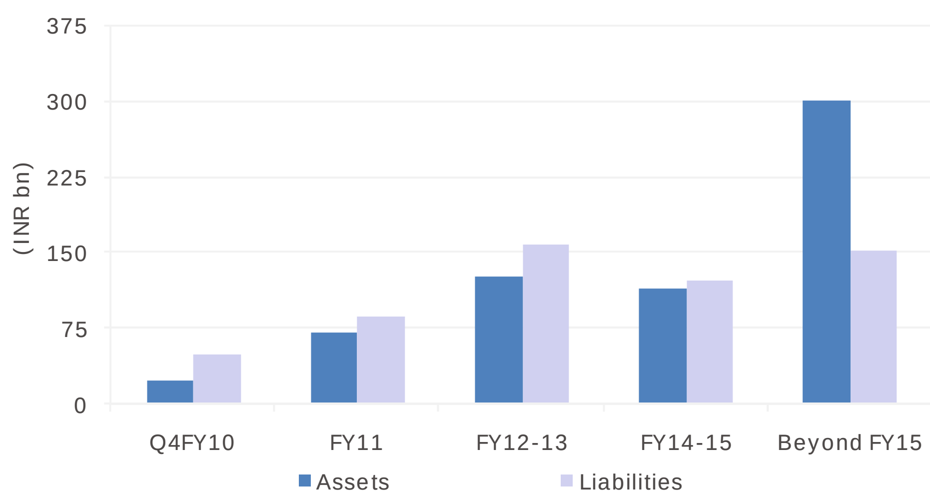
I) NIMs to come off to 4.2% by FY12E

Bridging asset-liability maturity gap

Bridging asset-liability maturity gap and effectively replacing short-term capital gain bonds with longer tenure bonds/debentures to match asset maturity duration

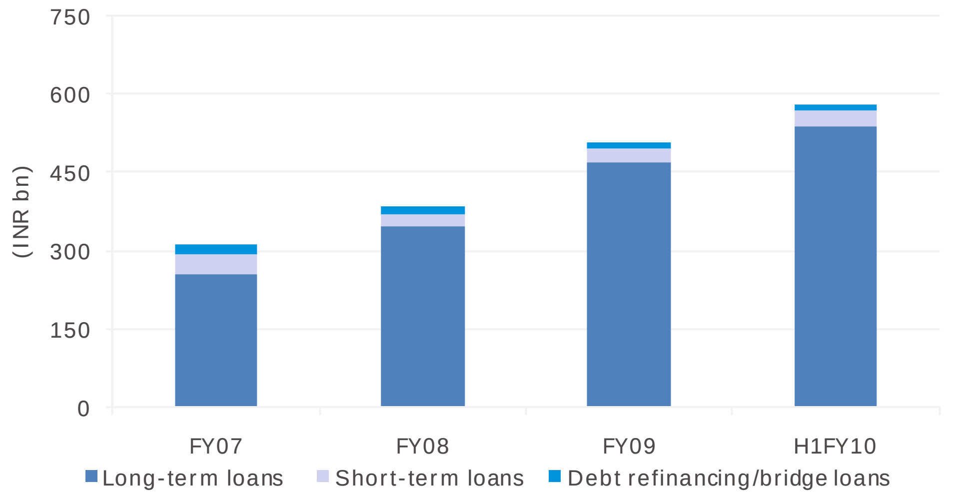
Majority of REC's loans are provided for longer tenure (average maturity of assets is 6.75 years) due to wholesale financing of large power projects. Moreover, it is increasing its presence in generation project financing which is of relatively higher tenure. However, capital gain exemption bonds (with lower maturity of three years) dominated its borrowings in the past (46% in FY07). Excess liquidity in the system and sharp decline in wholesale borrowing cost in the past 18 months aided REC in bridging asset-liability maturity gap and effectively replacing short-term capital gain bonds (raised at 5.5%) with longer tenure bonds/debentures, which, otherwise, would have put significant pressure on spreads. The average maturity liability has now increased to 5.5 years.

Chart 6: ALM profile – More liabilities to mature till FY15 than assets



Source: Company, Edelweiss research

Chart 7: Loan book composition by product type



Source: Company

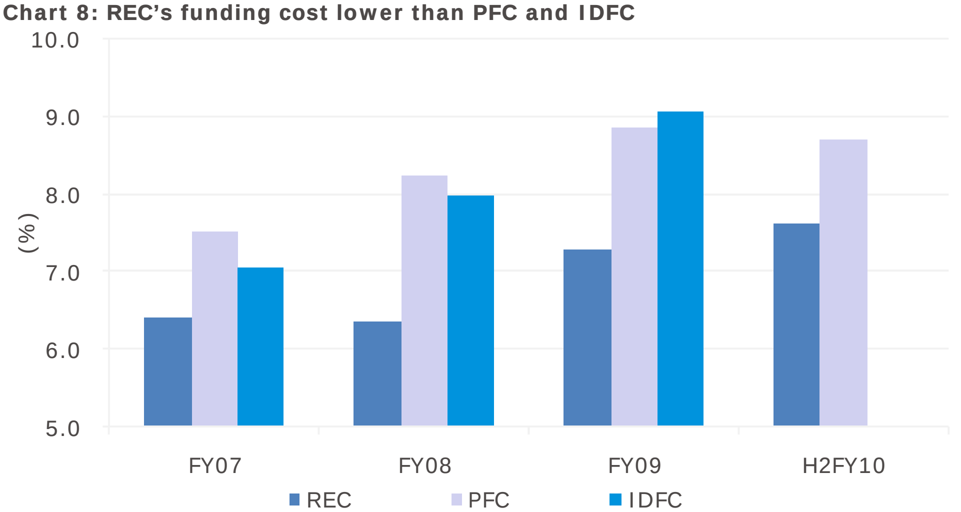
REC has been able to maintain a relatively lower effective cost of funds compared with IDFC and PFC

Relatively lower cost of funds due to access to capital gain bonds

REC has been able to maintain a relatively lower cost of funds compared with other institutions like IDFC and PFC due to direct/indirect assistance from the government and access to low-cost bond (capital gain tax exemption and infrastructure bonds).

REC's borrowing cost has been historically lower than that of PFC by more than 100bps, which allows REC to compete effectively on the loan pricing (average yield of REC in FY09 was 10.6% compared with 11% for PFC). Owing to lower reliance, offlate, on capital gain bonds, REC's cost of funds have gone up by more than 100bps, to 7.5%, in the past 18 months against 50bps rise in cost of funds for PFC during the same period.

Chart 8: REC's funding cost lower than PFC and IDFC



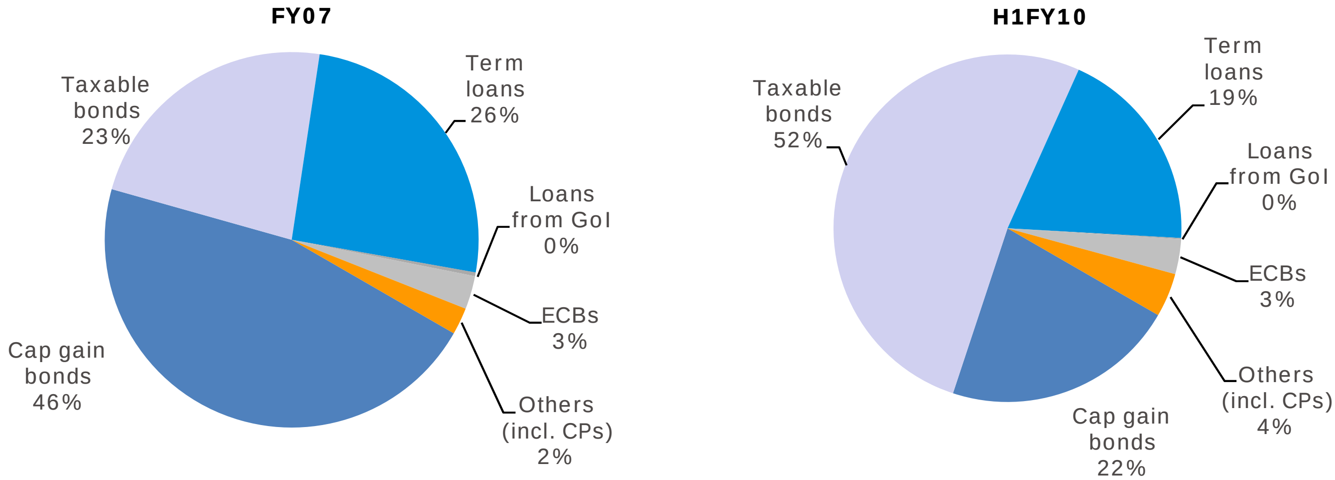
Source: Company, Edelweiss research

REC, in the past 18 months, has been increasingly relying on wholesale bond market to meet its funding requirement

Shift in borrowing towards long-term high-cost bonds/loans

REC, in the past 18 months, has been increasingly relying on wholesale bond market to meet its funding requirement (the proportion of taxable bonds has gone up from 23% in FY07 to 52% in H1FY10). Sharp decline in wholesale borrowing cost aided REC in effectively replacing capital gain bonds (raised in FY07 at 5.5%; due for redemption in three years), with lower-than-anticipated hit on margins.

Chart 9: REC's borrowing profile – Increasing proportion of taxable bonds



Source: Company

REC is eligible to issue capital gain tax exemption bonds (under Section 54EC of the Income Tax Act) at rates much lower than the market. Historically, REC has relied heavily on capital gain tax exemption bonds for its funding (raised INR 73 bn in FY07, which constituted 78% of incremental borrowings) with average cost of 5.4%. However, in the past few years, GoI has been curtailing the benefits available on the Section 54EC bonds. First, it has reduced the number of eligible bond issuers from five to two (NHAI and REC) in FY07; second, it has set a cap of INR 5 mn for investments in these bonds by an individual and fixed a limit up to which bonds can be issued by these companies. As a result, the amount mobilised through 54EC bonds declined significantly to INR 25 bn in FY09 (16% of the total borrowings).

REC also raised ~INR 17 bn through the external commercial borrowings route in the past 3-4 years, at an effective cost of ~6.5% p.a. (after accounting for foreign currency hedge), which constituted 3.3% of its total borrowings as on September 30, 2009. It plans to raise ~USD 500-700 mn via ECB route in the next few quarters.

We expect the company's cost of funds to go up 60bps, to 8.3%, over FY10-12E

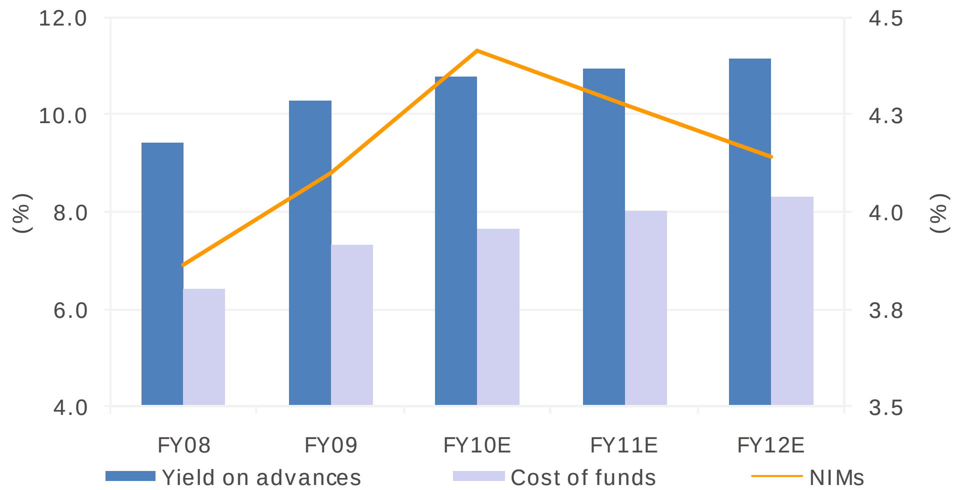
Incrementally, the company has been raising funds at an average cost of ~7.4%; cost of funds is expected to go up in the rising interest rate scenario. We expect the company's cost of funds to go up 60bps, to 8.3%, over FY10-12E.

Net interest margins to decline to 4.2% by FY12E

Owing to limited repricing benefit, and shift in borrowings towards longer tenure high-cost bonds/loans, we expect net interest margins to come off 25bps, to 4.2%, by FY12E

REC has cut its lending rates 100bps since January 2009 (against 150bps cut for PFC). Its incremental lending yield, at 11.5%, is at par with peers (compared with 25-50bps discount previously). Though ~15% of its loans are due for re-pricing in the next 12 months, the benefit is not expected to be significant as rate differential of re-pricing is not that high. We expect its lending yields to increase 40bps, to 11.2%, by FY12E. Despite favourable asset liability profile in the rising interest rate environment (90% liabilities of fixed nature and 70% of assets with 3-year re-pricing), we expect net interest margins to come off 25bps, to 4.2%, by FY12E due to limited repricing benefit, and shift in borrowings towards longer tenure high cost bonds/loans.

Chart 10: Rise in cost of funds to bring NIMs under pressure



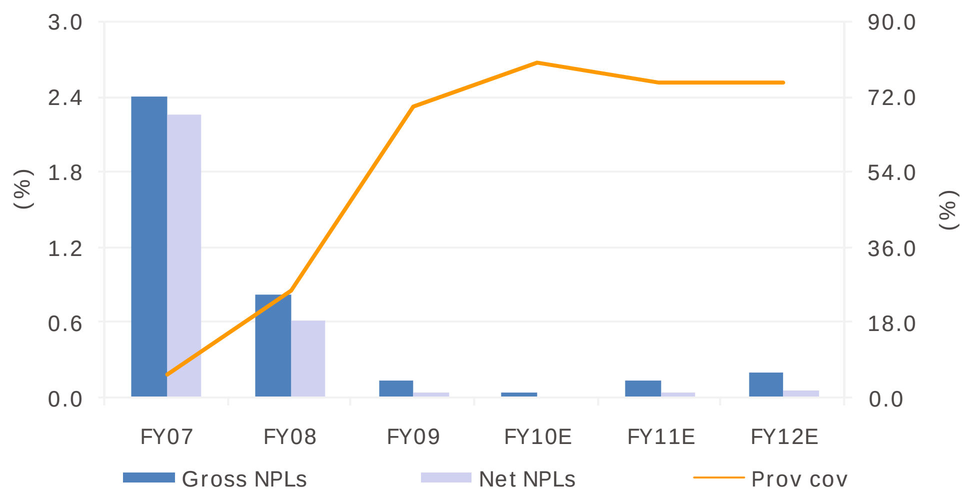
Source: Company, Edelweiss research

II) NPLs near-zero levels; to remain under check

It has reported significant improvement in its asset quality since FY07 due to upgradation/recoveries of NPAs

Generally, the perceived risk on asset quality of power financiers is high - given their significant exposure to loss making state power utilities. At present, more than 80% of REC's outstanding loan book is extended to state utilities. However, REC has reported lower delinquencies and lower loan losses compared with commercial banks and other financial institutions. In fact, it has reported significant improvement in its asset quality since FY07 due to upgradation/recoveries of NPAs, with gross NPA declining to near zero levels by H1FY10 from 2.4% in FY07. The sharp decline in NPLs can be attributed to upgradation of loans to defaulting states namely Mizoram and Manipur (as they have started meeting their obligation) and lending being protected by charge on assets, irrevocable state government guarantees, or obligation payment through default escrow account.

Chart 11: NPLs have declined sharply



Source: Company, Edelweiss research

Despite REC's significant exposure to loss making state utilities, the following factors provide comfort on its asset quality:

Escrow mechanism in place

The company has escrow mechanism in place for ~75% of the outstanding loans to the state sector

The company has escrow mechanism in place for ~75% of the outstanding loans to the state sector, to protect in the case of defaults (the borrowers have to deposit a certain pre-determined amount from payments it receives from its customers in an escrow account). As on September 30, 2009, 57% loans were secured by charges on assets, 38% had a state government guarantee as collateral and only 5% were unsecured.

Single largest borrower/group exposure relatively low

Being a specialised financier for large power projects of state utilities, REC has significant exposure to a few state sector utilities and rural electricity co-operatives. As on September 30, 2009, loans to the top 10 individual borrowers constituted ~45% of the total exposure, whereas the top 10 borrower group (all utilities in a state) contributed ~80% to the outstanding loans. Moreover, the maximum outstanding for the single largest individual borrower was 7-8% and for the group of borrowers was 12-13%.

Table 3: Top 10 borrowers and borrower groups of REC as of September 2009

Borrower	Outstanding loans (INR mn)	% of book	Borrower Group	Outstanding loans (INR mn)	% of loan book
Punjab State Electricity Board	43,854	7.6	Andhra Pradesh	73,296	12.7
Tamil Nadu State Electricity Board	43,197	7.5	Rajasthan	72,610	12.5
Andhra Pradesh Power GenCo	31,327	5.4	Maharashtra	68,793	11.9
Maharashtra State Electricity Dist Co	26,728	4.6	Tamil Nadu	55,856	9.7
Ajmer Vidyut Vitran Nigam	23,894	4.1	Punjab	43,909	7.6
Maharashtra State Power Genco	22,389	3.9	Uttar Pradesh	37,699	6.5
Maharashtra State Electricity TransCo	19,235	3.3	West Bengal	34,905	6.0
Jaipur Vidyut Vitran Nigam	17,689	3.1	Haryana	31,340	5.4
Andhra Pradesh Transmission Co	16,819	2.9	Chattisgarh	25,163	4.4
Jodhpur Vidyut Vitran Nigam	15,219	2.6	Uttaranchal	18,943	3.3
Total	**260,351**	**45.0**	**Total**	**462,514**	**79.9**

Source: Company

Improved performance of state utilities where REC has high exposure

Owing to significant T&D losses and lower realisation per unit, state sector utilities are financially weak. As per PFC's report on the performance of state power utilities, the aggregate cash losses (on revenue and subsidy realised basis) for all the states increased to INR 78 bn in FY08 (from INR 69 bn in FY07).

Table 4: Financial details of top 10 borrowers of REC **(INR bn)**

Borrower - FY08	Outstanding loan	% of total loan	Accumulated losses	Net worth	PAT	PAT (without subsidy)	Cash profit (subsidy recd. basis)
Punjab State Electricity Board	44	*7.6*	(73.7)	(44.5)	(13.9)	(42.4)	(13.9)
Tamil Nadu State Electricity Board	43	*7.5*	(96.3)	(70.8)	(35.0)	(35.0)	(49.6)
Andhra Pradesh Power GenCo	31	*5.4*	0.5	23.0	2.0	2.0	2.0
Maharashtra State Electricity Dist	27	*4.6*	(4.2)	28.3	(1.3)	(1.3)	(1.3)
Ajmer Vidyut Vitran Nagar Nigam	24	*4.1*	-	5.2	-	13.5	7.5
Maharashtra State Power GenCo	22	*3.9*	3.7	34.9	3.0	3.0	3.0
Maharashtra State Electricity TransCo	19	*3.3*	6.2	34.1			
Jaipur Vidyut Vitran Nigam	18	*3.1*		5.0			
Andhra Pradesh Transmission Company	17	*2.9*	2.8	11.1	0.4	0.4	0.4
Jodhpur Vidyut Vitran Nigam	15	*2.6*		5.0			
Total	**260**	***45.0***					

Source: PFC report on performance of the state power utilities

Table 5: Profitability of top 10 borrower groups of REC **(INR bn)**

	REC's outstanding loan	*% of total loan*	Cash Profit (subsidy recd basis)			Profit/ (Loss) (subsidy recd basis)		
			FY06	FY07	FY08	FY06	FY07	FY08
Eastern			**(5.4)**	**(31.4)**	**3.5**	**(16.9)**	**(46.6)**	**(8.4)**
Bihar			(8.0)	(8.0)	(7.2)	(9.2)	(8.6)	(7.8)
Jharkhand			(5.1)	(2.7)	(8.5)	(5.9)	(3.6)	(11.6)
Orissa			4.6	7.0	11.6	0.8	3.1	7.6
Sikkim			(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)
West Bengal	34.9	*6.0*	3.3	(27.5)	7.8	(2.3)	(37.3)	3.7
North Eastern			**(5.0)**	**(5.6)**	**(2.4)**	**(6.7)**	**(7.5)**	**(4.7)**
Arunachal Pradesh			(1.3)	(0.8)	(0.8)	(1.3)	(0.8)	(0.8)
Assam			(0.7)	(1.7)	(0.2)	(1.4)	(2.6)	(1.4)
Manipur			(2.0)	(1.2)	(1.0)	(2.4)	(1.7)	(1.6)
Meghalaya			(0.3)	(0.8)	0.1	(0.4)	(0.9)	0.0
Mizoram			(0.4)	(0.7)	(0.4)	(0.4)	(0.7)	(0.4)
Nagaland			(0.7)	(0.8)	(0.6)	(0.9)	(0.9)	(0.8)
Tripura			0.3	0.5	0.5	0.1	0.3	0.2
Northern			**(27.7)**	**(50.3)**	**(65.4)**	**(63.7)**	**(84.5)**	**(104.5)**
Delhi			8.5	6.2	4.5	3.4	3.8	(1.0)
Haryana	31.3	*5.4*	0.6	0.5	(1.2)	(4.3)	(4.2)	(6.3)
Himachal Pradesh			0.7	0.6	0.6	0.2	0.0	(0.3)
Jammu & Kashmir			(13.3)	(11.4)	(12.6)	(14.2)	(12.3)	(13.5)
Punjab	43.9	*7.6*	6.0	(10.2)	(7.3)	0.1	(16.3)	(13.9)
Rajasthan	72.6	*12.5*	0.5	1.2	(16.1)	(6.2)	(6.0)	(22.1)
Uttar Pradesh	37.7	*6.5*	(29.7)	(35.2)	(32.4)	(40.4)	(46.3)	(45.1)
Uttarakhand	18.9	*3.3*	(1.0)	(2.0)	(1.0)	(2.3)	(3.3)	(2.4)
Southern			**30.4**	**35.7**	**7.2**	**(9.3)**	**(3.8)**	**(32.9)**
Andhra Pradesh	73.3	*12.7*	18.4	18.5	16.1	3.1	1.5	(1.2)
Karnataka			9.4	12.2	8.4	0.9	4.4	0.7
Kerala			3.5	10.3	10.4	(0.4)	2.2	2.2
Puducherry			0.6	0.6	0.6	0.4	0.4	0.3
Tamil Nadu	55.9	*9.7*	(1.5)	(5.9)	(28.3)	(13.3)	(12.2)	(35.0)
Western			**26.4**	**29.0**	**25.4**	**(0.2)**	**0.3**	**(4.8)**
Chattisgarh	25.2	*4.4*	4.6	5.4	6.0	4.0	4.4	4.7
Goa			1.6	1.4	1.6	1.4	1.3	1.4
Gujarat			8.4	8.9	8.7	2.0	1.9	0.6
Madhya Pradesh			(0.2)	(2.7)	(11.7)	(5.9)	(9.9)	(18.3)
Maharashtra	68.8	*11.9*	12.1	15.9	20.8	(1.7)	2.7	6.8
Total	**462.5**	**79.9**	**18.7**	**(22.6)**	**(31.8)**	**(96.7)**	**(142.1)**	**(155.4)**

Source: PFC report on performance of the state power utilities

Though the company has not faced any major delinquency over FY05-08, it had, in the past, restructured its loans to state utilities. The total restructured assets stand at INR 22.7 bn (equivalent to 4% of its loan book). However, the positive trend is that there has been no fresh restructuring in the past 3-4 years (the entire banking sector has undergone significant restructuring in past 12-18 months).

We expect asset quality to remain under check, with net NPAs maintained at the current levels

Considering the state guarantees, we believe loan losses, in case of default, will be insignificant; however, its payment may be delayed, which could hit profitability. However, well-developed relationships with major power sector companies have a role to play in successful collection. Moreover, the company is also strengthening its appraisal team by hiring professionals from institutions like NHPC and ICICI. We expect asset quality to remain under check, with net NPAs maintained at the current levels.

III) Agency/advisory services to kick in higher fee income

Nodal agency for RGGVY; to get 1% of project cost as processing fee

REC is the nodal agency for implementation of RGGVY, a GoI initiative launched in April 2005 with the aim of electrification of rural households. The government has approved capital subsidy of INR 280 bn for RGGVY in the Eleventh Plan. As of January 2010, it approved 576 projects, covering 0.47 mn villages (0.12 mn un-electrified villages and 0.35 mn electrified villages requiring intensive electrification).

REC will get 1% processing fee on the project cost for administering this scheme

GoI will provide subsidies in the form of grants, which will be channelised through REC, for 90% of the funding requirement and the remaining 10% will be disbursed by REC as long-term loans. REC disbursed loans (long-term loans, forming 10% of project cost) of INR 11 bn during FY08-H1FY10. The loans issued under this scheme will carry the prevailing lending rate for T&D projects less 50bps. REC will get 1% processing fee on the project cost for administering this scheme. We expect additional disbursement of INR 140 bn during FY10-12E (under RGGVY by both GoI and REC) to result in fee income of INR 1.4 bn over 2-3 years.

REC appointed as nodal agency in transmission projects

To invite private sector investments, GoI initiated a scheme in FY07 where it proposed private developers to become transmission providers on a "build, own and operate" basis and has identified 14 such transmissions related projects.

REC is appointed the coordinator for three of the six projects allocated under the scheme. REC will receive a professional fee of INR 150 mn for each project

REC is appointed the coordinator for three of the six projects allocated under the scheme - North Karanpura Transmission Project, Talcher Augmentation System Transmission Project, and Krishnapattnam UMPP Transmission Project. It will also bid to act as the nodal agency for additional eight transmission projects yet to be allocated by GoI. Under this scheme, REC will receive a professional fee of INR 150 mn for each project successfully assigned to a private sector bidder.

To provide consultancy services in distribution

Further, to leverage its expertise in the distribution sector, REC has ventured into the power distribution business and plans to operate and provide consultancy services through its wholly owned subsidiary, REC Power Distribution Company (RECPDCL). In the first year of its operation, the company has bagged three consulting assignments from state power utilities (Jodhpur Vidyut Vitran Nigam, Punjab State Electricity Board, Ajmer Vidyut Vitran Nigam).

Equity participation in power projects in coal-rich states

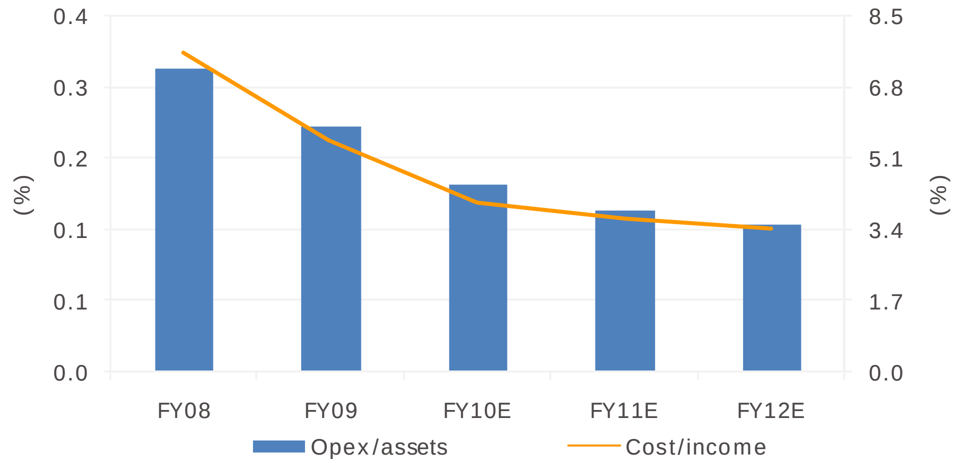
REC is inviting expression of interest from various private players to form a public-private partnership in developing power projects. This proposal, if approved by its board, will lead to a joint venture, where REC will have 26% stake, government 26% with balance held by private players. However, REC is carefully monitoring the terms of partnership and expected returns, whereby it is targeting RoEs in excess of 25% plus. It may also venture into financing of coal mines in the near term for projects where it has equity stakes; its articles are being amended to include the same.

IV) Presence in wholesale financing keeping opex/asset ratio low

With higher operating leverage, we expect its cost-to-income ratio to decline below 4% and operating expenses–to-asset ratio to fall below 0.15% by FY12E

Being a wholesale financier, REC has been able to manage its loan book of INR 579 bn through only 18 project offices and ~683 employees. Therefore, its operating expenses, when compared with assets, are lower than other commercial banks and NBFCs, and have led to higher RoAs. With the company consistently building its loan book, the cost-to-income ratio has come off to 5%, with employee cost constituting 80% of the total cost. With higher operating leverage, we expect its cost-to-income ratio to decline below 4% and operating expenses–to-asset ratio to fall below 0.15% by FY12E.

Chart 12: Opex to decline consistently vis-à-vis revenue and asset growth



Source: Company, Edelweiss research

- ### Follow-on public offer; floor price set at INR 203

REC has fixed the floor price of INR 203 for its follow-on public offer. The overall FPO offer is for 171.7 mn shares (15% dilution pre-issue), of which, 75% will be fresh issue and 25% is offer of sale by the government. At INR 203, it is expected to raise proceeds of INR 34.8 bn, of which, INR 26 bn will accrue to the company. Retail and non-institutional applicants will get the allotment at floor price (INR 203), while French auction method will be followed for QIBs (with an option to revise the bid).

Table 6: FPO issue details

Issue details	
Issue size (# of shares in mn)	171.7
- New shares	128.8
- Offer for sale	42.9
Post-issue number of shares (mn)	987.5
Pre-issue number of shares (mn)	858.7
Dilution (pre-issue) (%)	15.0
FPO floor price (INR)	203
FPO proceeds (INR mn)	34,862
Proceeds to accrue to company (INR mn)	26,146

Source: Company

The company's capital adequacy ratio (CAR) currently stands at 13.5% and post this issue it will go up to 17%; as per the norms, it is required to maintain CAR at 10%.

- ### Auditors' qualification over internal controls: A key concern

The auditors have qualified their report on REC's financial statements since FY05, which we have highlighted below, as they could be cause for concern for investors:

"However, in certain areas internal control needs further strengthening like financial accounting; loan pricing being linked to rating linked policy; review of transmission and distribution lending norms prescribing appropriate debt equity ratios; adoption of control records regarding status of loan documents; receipt, disbursement and utilization of grants received under various schemes; monitoring of loans given to various SEBs / Discoms / xvi Transcoms / Gencos including obtaining search reports for charges created against the loan given."

"Corporation is having Internal Audit Department responsible for carrying out the internal audit of various departments at Head Office and at Project Offices at periodical intervals as per the approved audit plan. In our opinion internal audit needs to be further strengthened with identification of critical areas for risk based audit."

These concerns reflect loose ends in the functioning of the company in some areas and may not have any quantitative impact on financial statements at present, but could be an area of concern from a long-term perspective.

Valuation

We like REC for its strategic positioning in GoI's plan to develop the power sector in India

We like REC for its strategic positioning in GoI's plan to develop the power sector in India. We expect the company to grow its disbursements and loan book by 20% and 24% CAGR, respectively, over FY10-12E. While we expect margins to come off to 4.2% by FY12E (from 4.4% in FY10), we believe it will be able to sustain RoEs at ~20% and grow its earnings by 19% over FY10-12E, driven by increase in leverage, higher fee income and stable asset quality.

Post equity dilution, the stock is trading at 1.4x FY12E book and 7.8x earnings

Post equity dilution, the stock is trading at 1.4x FY12E book and 7.8x earnings. We believe REC should trade at higher valuations than PSU banks, given strong visibility of loan growth, better asset quality due to state guarantees on its loans and lean cost structure.

Table 7: REC should trade at premium to PSU banks

REC	PSU Banks
Key advantages	
Competitive advantage in leveraging the emerging opportunities in the power sector	Sectoral exposure capped at 15% of the net worth by RBI regulation
Strong visibility of growth due to huge investments planned in the power sector	With retail and corporate loan segment slowing down, PSU banks may see lower growth
No regulatory constraints on deploying, funds; can maintain its assets in high-yielding segments	Have to maintain SLR and CRR ratio as per RBI regulation
Robust asset quality due to state guarntees on its loans	Asset quality may deterioate due to rising deliquency, primarily on the retail side
Low opex/asset ratio due to wholesale financing business	High operating expenses compared to REC
Eligibility of the tax benefits on the long term financing income with respect to special reserve created	
Key disadvantages	
With access to low cost funds curtailed by the government, cost of funds will rise, going forward	Strong CASA base, leading to low cost of capital

Source: Edelweiss research

We expect REC to trade at 1.9x FY12E book based on residual income methodology, implying an upside of 25% plus over 12-18 months. We initiate coverage on REC with '**BUY'** and recommend investors to subscribe to the FPO. On a relative basis, we rate it **'Sector Outperformer'.**

Table 8: Relative valuation

	Price (INR)	Mkt cap (INR bn)	Loan book (INR bn)	FY10 Revenues (INR mn)	PAT (INR mn)	P/B (x) FY11E	FY12E	P/E (x) FY11E	FY12E	RoE (%) FY11E	FY12E	EPS growth (%) (FY10-12E)	Reco
REC	214	211	657	26,939	19,222	1.7	1.4	9.1	7.8	19.5	19.8	18.9	BUY
PFC	233	267	791	30,888	21,708	1.8	1.5	10.7	9.1	17.8	18.1	16.4	BUY
IDFC	151	196	252	19,981	10,831	2.4	2.1	16.1	14.0	16.2	16.2	13.6	HOLD

Source: Company, Edelweiss research

Chart 13: Historical P/B valuation

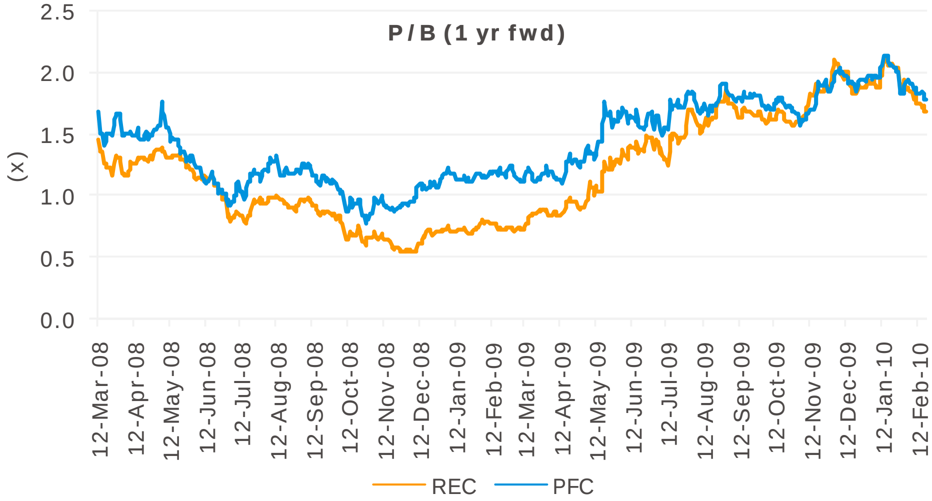
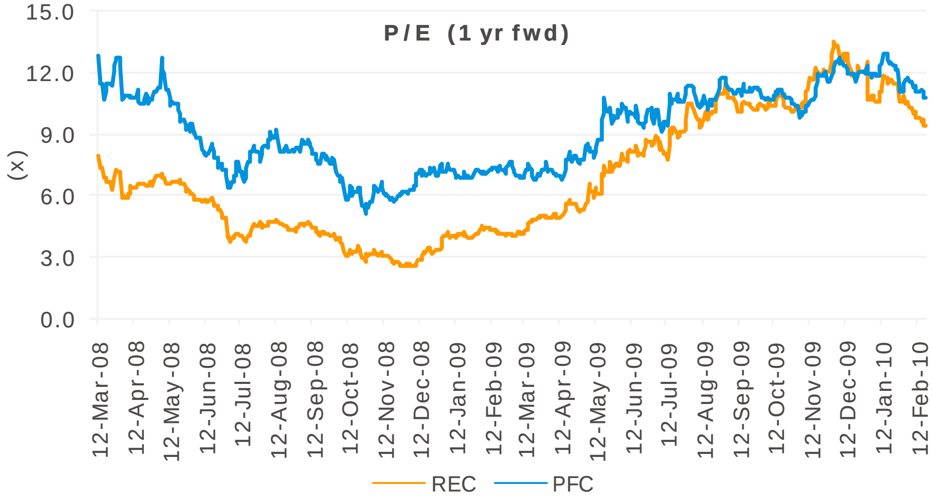


Chart 14: Historical P/E valuation



Source: Company, Edelweiss research

Key Risks

- REC's growth depends on its ability to remain effectively competitive in the power financing space and to pass the higher cost of funds to customers. Also, benefits under Section 54EC are being curtailed continuously and there are uncertainties surrounding the level of benefits REC will receive from these instruments, going forward.

- REC's gross NPAs are at near zero levels. Any major slippage or ineffective recoveries can raise NPAs significantly, adversely affecting profitability and growth.

- REC is subject to risk arising from asset-liability mismatch as majority of its loans are long-term in nature due to wholesale financing of large power projects, whereas its borrowings are relatively for shorter term.

- REC's ability to borrow from banks may be restricted with the limit on exposure of a bank in infrastructure finance companies at 20% of bank's capital funds (tier I+tier II).

- REC is exposed to project-specific and general risks inherent to the power sector. Any delay in the power sector projects due to lack of fuel supplies, supply of key equipment or delay in getting environment clearances can adversely affect the profitability of power projects, increasing the company's NPAs.

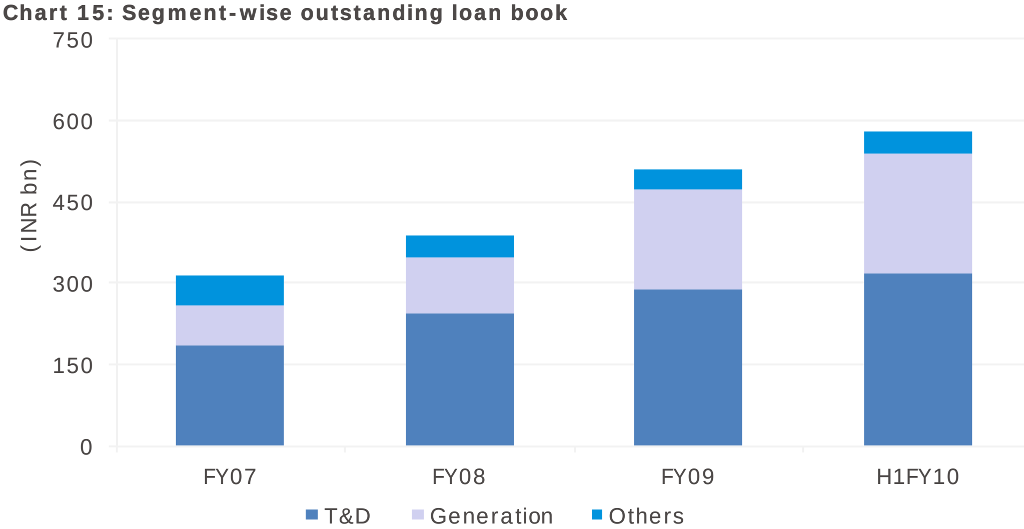
- There have been qualifications by auditors with respect to internal control and audit system; these do not have any quantifiable impact as of now, but could impact REC's business in the long term.

Company Description

Rural Electrification Corporation (REC), incorporated in 1969, is a leading public institution primarily involved in the financing of T&D and generation projects across India. It was established by GoI for the purpose of developing the T&D infrastructure in rural India and currently acts as a nodal agency for RGGVY, a GoI initiative for rural electrification. Over the last decade, the company has diversified into urban areas and it plays a strategic role in GoI plan to improve the transmission and distribution infrastructure of India. REC, along with Power Finance Corporation (PFC), is the nodal agency for APDRP, a GoI initiative to improve the financial viability of state power utilities. Loans to T&D projects constituted ~54% to the total loan book as on December 31, 2009.

REC ventured into financing of generation projects in 2002 and has reported strong growth in sanctions and disbursements related to power generation projects in the past few years. Disbursement to generation projects contributed 40% of total disbursement over FY07-H1FY10. Generation accounted for ~60% of its sanctions in H1FY10 compared with less than 40% in FY07. As on September 30, 2009, loan to generation projects contributed 39% to the total loan book.

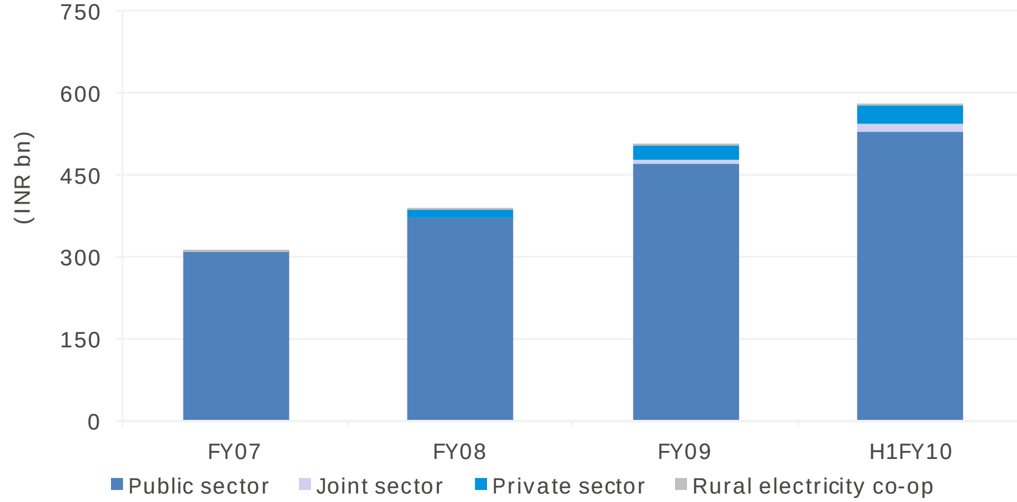
Chart 15: Segment-wise outstanding loan book



Source: Company

REC offers funding to state power utilities, central power utilities, private power utilities, joint sector utilities and rural electricity co-operatives. Loans to state utilities and central PSUs comprise ~84% and ~9%, respectively, of the outstanding loan book as on December 31, 2009, with private sectors and joint venture utilities contributing the remaining. The company is aiming to increase its involvement in the private sector and consortium lending to further diversify its product portfolio. It has sanctioned loan to the power generation projects of Essar Power, Adani Power and Lanco in the past two years.

Chart 16: Borrower-wise outstanding loan book



Source: Company

REC has witnessed 28% CAGR growth in loan book over FY06-H1FY10, primarily driven by substantial investment requirement in the Indian power sector. With expansion in margins, aided by pricing power and funding cost advantage, net revenues grew 32% during the same period. To leverage its expertise in the power space, the company has ventured into the power distribution business wherein it plans to operate and provide consultancy services through its wholly owned subsidiary, REC Power Distribution Company (RECPDCL). It is also acting as nodal agency for transmission projects to be developed by private developers on BOT basis. Further, it plans to take equity stakes in power projects in coal-rich states and has invited expression of interest from various private players to form a public-private partnership.

The company has witnessed sharp decline in NPLs due to upgradation/recoveries of NPAs, with gross NPA declining to near zero levels by H1FY10 from 2.4% in FY07. With the company consistently building its loan book, the cost-to-income ratio has come off to 5%. Earnings grew by 30% CAGR over FY06-H1FY10 and the company has generated RoEs in the range of 20-25% over FY06-H1FY10.

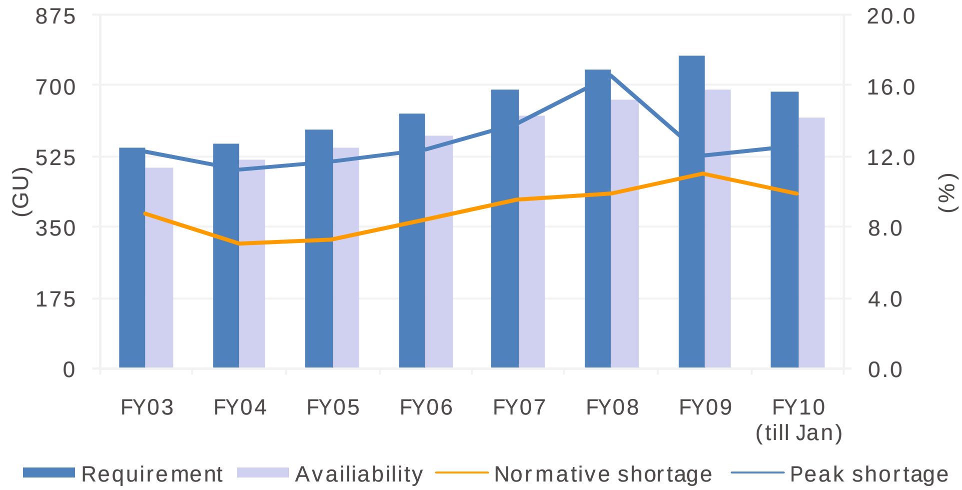
Industry Overview

India's power sector is characterised by persistent shortages due to rising energy consumption

■ Widening demand-supply gap leading to high investments

Electrical energy is the most important input for the economic growth. However, India's power sector is characterised by persistent shortages due to rising energy consumption, driven by strong economic growth and inadequate investments in infrastructure developments in both generation and transmission and distribution (T&D) space. As per Central Electricity Authority (CEA), total energy deficit in India has increased to 85k MW in FY09 from 66 bn units in FY07 (11% of total energy demand in FY09). Even in FY10 (till January 2010), normative energy deficit was estimated at 9.9% and peak energy deficit at 12.6%.

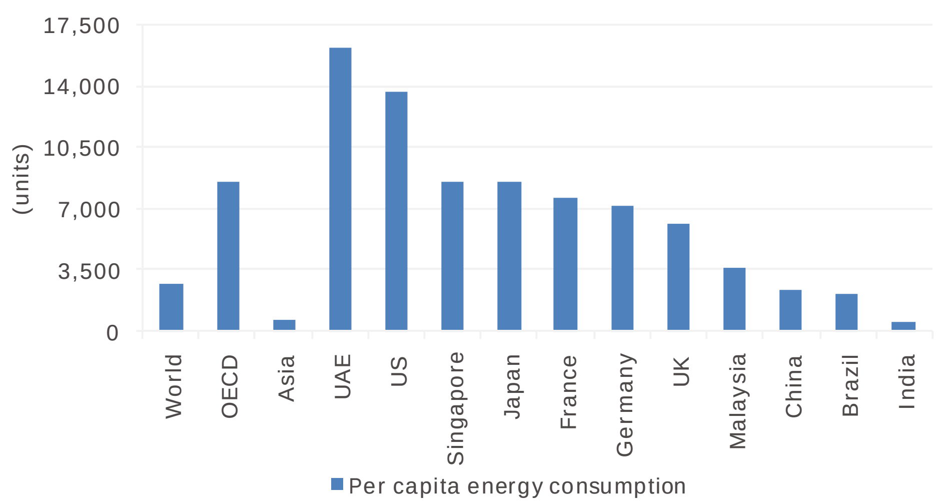
Chart 17: Peak energy shortage at 12-13% of demand in FY10



Source: CEA

Per capita energy consumption in India is relatively low at 543 KwH compared with world average of 2,752 units and yearly per capital consumption of 2,346 units in China, 705 units in Asia, 3,252 units in Middle East and 1,838 units in Latin America.

Chart 18: Per capita electricity consumption in India is low (2007)



Source: World Energy Statistics

GoI is taking various measures to restructure the power sector to improve its commercial and financial viability and to attract investments in this sector. GoI, in its mission "Power to all by 2012", has prepared a comprehensive blueprint with the aim of generating sufficient power to achieve GDP growth of 8%. As per Sixteenth Electric Power Survey (EPS) estimates, electric supply in India needs to grow over 8-9% annually over FY07-12E and is required to install additional generation capacity of ~66-79 GW by 2012, 152-183 GW by 2017 and 271-334 GW by 2022 to sustain the GDP growth at 8-9%.

Table 9: Capacity addition requirement to maintain GDP growth

	Power generation reqd (bn units)	Estd peak demand (GW)	Installed Capacity (GW)	Capacity addition required (GW)
XIth Plan				
GDP @ 8%	1,097	158	220	66
GDP @ 9%	1,167	168	233	79
XIIth Plan				
GDP @ 8%	1,524	226	306	152
GDP @ 9%	1,687	250	337	183
XIIth Plan				
GDP @ 8%	2,118	323	425	271
GDP @ 9%	2,438	372	488	334

Source: Integrated Energy Policy, Expert Committee on Power, August 2006

According to CEA, as on January 31, 2010, India's power generation systems has a total installed capacity of 156.9 GW. To fulfill the objectives of National Electricity Policy, a capacity addition of 78.7K has been proposed for the Eleventh Plan. According to the 'Base Paper, International Conclave on Key Inputs for Accelerated Development of Indian Power Sector', 18-19 August 2009 published by MoP and CEA, ~15,036 MW capacity (18.7%) has already been commissioned and a capacity of 65,574 MW (81.3%) is under construction for which orders have been placed and work is in progress. According to the report of the Working Group on power for Eleventh Plan MoP, the overall requirement of funds has been estimated at INR 10.3 tn. For the Twelfth Plan, CEA estimates that to meet the projected demand requirement by 2017, capacity addition of 100 GW would be required and including expansion in transmission and distribution system, the total funding requirement for the Twelfth Plan period would be INR 11 tn.

Table 10: Power sector investment requirement over next 10 years

(INR bn)	State	Central	Private	XIth Plan Total	XIIth Plan Total
Generation including Nuclear	1,238	2,021	850	4,109	4,951
DDG		200		200	
R & M	159			159	
Transmission	650	750		1,400	2,400
Distribution including Rural electrification	2,870			2,870	3,710
HRD		5		5	
R&D Outlay		12		12	
DSM		7		7	
Total Power Sector	**4,917**	**2,994**	**850**	**8,761**	
NCES and Captive	225		930	1,155	
Merchant Plants			400	400	
Total Funds Requirement	**5,142**	**2,994**	**2,180**	**10,316**	**11,061**

Source: Base Paper, International Conclave on Key Inputs for Accelerated Development of Indian Power Sector for 11th Plan and Beyond, MoP and CEA

Table 11: Estimated funding mobilisation for XIth Plan (INR bn)

Description	State	Central	Private	Total
Funds Required	5,142	2,994	2,180	10,316
Equity Required (D/E - 70:30)	1,543	898	654	3,095
Equity Available				
Promoters including FDI for IPPs	-	-	255	255
-Promoters including FDI for NCES & Captive	-	-	279	279
-Merchant Power Plant	-	-	120	120
Internal Resources	-	629	-	629
Govt. Support				
- State Govt.	-	-	-	-
- Central Govt.	-	-	-	-
Total Equity Available	-	629	654	1,283
Additional Equity to be arranged	1,543	269	-	1,811
Debt Required (D/E - 70:30)	3,599	2,096	1,526	7,221
Debt Available				
Direct Market Borrowing	100	150	-	250
Banks and AIFIs	372	584	106	1,062
PFC	650	81	81	812
REC	473	59	59	592
IIFCL	-	60	90	150
Multilateral/Bilateral Credits	55	193	28	276
ECA/ECB/Syndicated Loan etc.	-	460	115	575
Total Debt Available	1,650	1,588	479	3,717
Additional Debt to be arranged	1,949	508	1,047	3,505
Funding by Special Schemes				
APDRP	400	-	-	400
RGGVY	400	-	-	400

Source: White paper on strategy for 11th plan, CEA, Aug '07

To further improve the demand-supply situation, GoI also plans to tap the significant potential of power generation available from the non-conventional energy resources such as wind, small hydro, bio mass and solar energy. India has added ~6,750 MW of generation capacity in the Tenth Plan, taking the total installed capacity to 10,256 MW as on March 31, 2007. The government plans to add generation capacity of ~14,000 MW in the Eleventh Plan using renewable energy.

- **Power sector characterised by slippages in capacity addition**

  The power sector is India is characterised by delays/slippages in capacity addition. In the last three plan periods (Eighth to Tenth Five Year plans), India has achieved only ~48-54% of the target capacity addition due to poor execution and project delays. This resulted in investment in the range of 65-70% of the planned funds.

Table 12: Target versus achieved addition in the previous plans

Year	Plan	Target	Achieved	Achieved (%)
51-56	I	1.3	1.1	84.6
56-61	II	3.5	2.3	64.3
61-66	III	7.0	4.5	64.2
69-74	IV	9.3	4.6	49.5
74-79	V	12.5	10.2	81.6
80-85	VI	19.7	14.2	72.3
65-90	VII	22.2	21.4	96.2
92-97	VIII	30.5	16.4	53.8
97-02	IX	40.2	19.0	47.5
02-07	X	41.1	21.2	51.8
07-12	XI	78.7	-	
12-17	XII	92.5	-	

In XIth plan, 13 GW was added up to FY09, another 4 GW was added in H1FY10

Source: White paper on strategy for XI[th] plan, CEA, Aug '07

Table 13: Slippages in FY10 **(units)**

FY10 (till date)	Target	Achievement	Deviation
Thermal	10,617	6,701	3,916
Hydro	552	39	513
Nuclear	660	-	660
Total	**11,829**	**6,740**	**5,089**

Source: CEA

- ### Inadequate T&D infrastructure resulted in high losses

However, in India, every rupee invested in generation has a corresponding investment of only 0.5 rupee invested in T&D

India's power T&D infrastructure is inadequate with outdated distribution network and lower automation level, resulting in high aggregate technical and commercial (AT&C) losses. Over the years, the transmission capacity added has been lower than the generation capacity addition. Globally, for every rupee invested in generation there is an equal amount invested in T&D. However, in India, every rupee invested in generation has a corresponding investment of only 0.5 rupee invested in T&D. As a result, the nationwide AT&C losses are very high at ~32-35% compared with 10-15% in the developed countries. This has resulted in poor financial condition of all SEBs.

To accomplish its mission of power to all, the government has emphasised the need of significant expansion of T&D network in both rural and urban areas and estimates fund requirement of INR 1.4 tn for transmission and INR 2.9 tn for distribution and rural electrification in the Eleventh Plan. As per the report of "Working Group on Power for the Eleventh Plan", 1% reduction in T&D losses will lead to savings of INR 7-8 bn and 10% reduction in the loss will release energy equivalent to an additional capacity of 10,000-12,000 MW.

Financial Outlook

We believe REC will be able to fund 15-20% of its total funding requirement in the Eleventh Plan. We, thus, expect its loan book to post 24% CAGR over FY10-12E

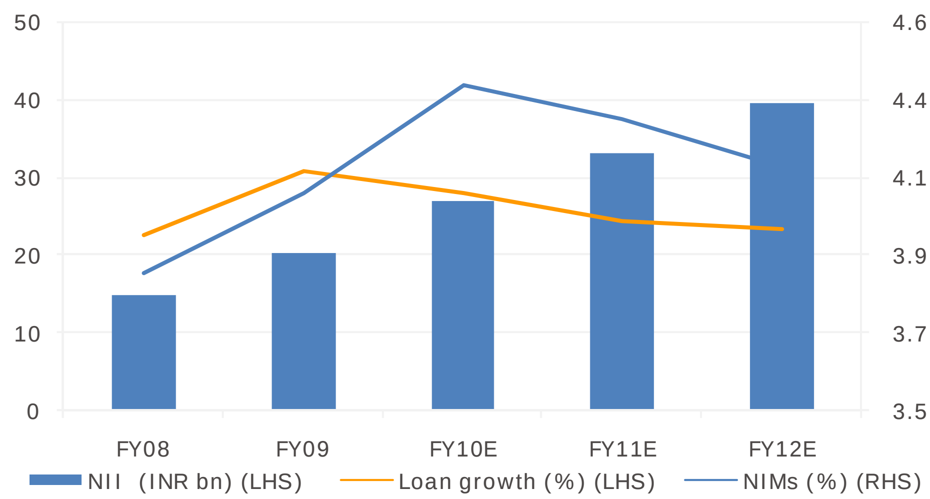
Strong asset growth to offset the impact of decline in margins

We believe REC will be able to fund 15-20% of its total funding requirement in the Eleventh Plan. We, thus, expect its loan book to grow at 24% CAGR over FY10-12E.

REC, in the past 18 months, has been increasingly relying on the wholesale bond market to meet its funding requirement (the proportion of taxable bonds has gone up from 23% in FY07 to 52% in H1FY10). Incrementally, the company has been raising funds at an average cost of ~7.4%; cost of funds is expected to go up in the rising interest rate scenario (by 60bps to 8.3% over FY10-12E). Its incremental lending yield, at 11.5%, is at par with peers (against 25-50bps discount previously). Though ~15% of its loans are due for re-pricing in the next 12 months, the benefit is unlikely to be significant as the rate differential of re-pricing is not that high. We expect its lending yields to increase 40bps, to 11.2%, by FY12E. Despite favourable asset liability profile in a rising interest rate environment (90% liabilities are of fixed nature and 70% of assets with 3-year re-pricing), we expect NIMs to come off 25bps, to 4.2%, by FY12E (due to limited re-pricing benefit and shift in borrowings towards longer tenure high-cost bonds/loans) and net interest income to post 21% CAGR over FY10-12E.

REC is entitled to 1% processing fee (on project cost) for its nodal agency role in GoI's RGGVY scheme; additional disbursement of INR 140 bn expected under this scheme is likely to result in fee income of INR 140 mn for REC over 2-3 years. It will also receive a professional fee of INR 150 mn for each of GoI's transmission-related BOT project assigned successfully to the bidder; the company is appointed the coordinator for three (of six) transmission projects and is bidding for additional eight projects.

Chart 19: Net interest income to post 21% CAGR over FY10-12E



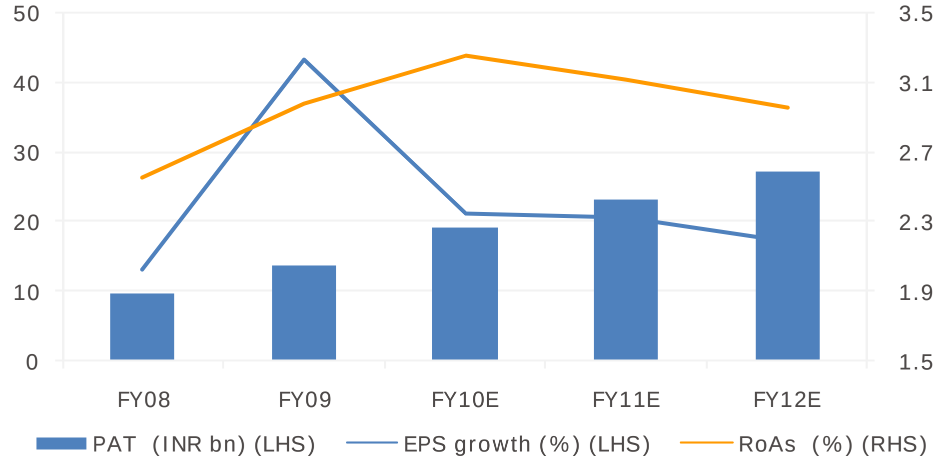
Source: Company, Edelweiss research

We expect profitability to post 19% CAGR over FY10-12E, to INR 27 bn, driven by similar growth in net interest income and aided by lower provisions and higher operating leverage

Higher fee income and stable asset quality to support earnings growth

We expect profitability to post 19% CAGR over FY10-12E, to INR 27.2 bn, driven by similar growth in net interest income and aided by lower provisions and higher operating leverage. We expect its cost-to-income ratio to decline below 4% and operating expenses-to-asset ratio to fall below 0.15% by FY12E. Factors such as an established escrow mechanism (for ~75% of its loans), government guarantees and strengthening appraisal/collection process provide comfort on its asset quality, despite perceived risk being higher due to large exposure to loss making state utilities.

Chart 20: EPS to post 19% CAGR over FY10-12E



Source: Company, Edelweiss research

Q3FY10 results: Key highlights

In Q3FY10, REC reported PAT of INR 4.7 bn – growth of ~35% Y-o-Y (after adjusting for deferred tax benefit in Q3FY09) and decline of 4% Q-o-Q.

- Yield on advances, cost of funds and margins have remained steady Q-o-Q at 11%, 7.7% and 4.2%, respectively.
- Disbursements grew ~14%, to INR 60 bn. For 9mFY10, disbursements grew 19%, to INR 152 bn. Loan book grew 30% Y-o-Y in Q3FY10 to INR 627 bn.
- Sanctions in Q3FY10 were relatively lower, at ~INR 100 bn, compared with INR 315 bn in H1FY10. However, sanctions of 9mFY10, at INR 410 bn, have already crossed the FY09 mark.
- There were no accretion to NPLs during the quarter and gross NPLs stand at the Q2FY10 level. Hence, no NPL provisioning was required during the quarter.

Financial snapshot

(INR mn)	Q3FY10	Q3FY09	*Growth (%)*	Q2FY10	*Growth (%)*
Interest income	16,532	12,335	*34.0*	15,324	*7.9*
Interest expenses	10,279	7,878	*30.5*	9,413	*9.2*
Net income from operation	6,254	4,458	*40.3*	5,911	*5.8*
Other operating income	185	130	*42.2*	512	*(63.9)*
Other income	345	289	*19.3*	393	*(12.3)*
Net revenues	6,783	4,877	*39.1*	6,816	*(0.5)*
Expenses	338	280	*20.7*	351	*(3.6)*
- Staff cost	265	221	*19.8*	282	*(6.0)*
- Other expenditure	70	54	*28.6*	65	*6.7*
- Depreciation	4	5	*(25.5)*	4	*(2.8)*
PPOP	6,445	4,597	*40.2*	6,466	*(0.3)*
Provisions	-	(146)	*NA*	1	*NA*
PBT	6,445	4,742	*35.9*	6,465	*(0.3)*
Taxes	1,705	1,556	*9.6*	1,521	*12.0*
- Current tax	1,711	1,263	*35.5*	1,504	*13.8*
- Deferred tax	(7)	293	*NA*	17	*NA*
PAT	4,741	3,186	*48.8*	4,944	*(4.1)*
EPS (INR)	5.5	3.9	*41.0*	5.8	*(4.2)*
Cost to income (%)	5.0	5.7		5.1	
Tax rate	26.4	32.8		23.5	

Financial Statements

Income statement **(INR mn)**

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Interest income	35,178	47,898	64,281	82,086	103,061
Interest expended	20,632	28,971	38,212	50,055	64,807
Net interest income	14,546	18,927	26,069	32,031	38,255
Non interest income	177	922	802	1,137	1,125
Income from operations	14,723	19,849	26,871	33,168	39,380
Other income	22	378	67	19	21
Net revenues	14,745	20,227	26,939	33,187	39,401
Operating expenses	1,119	1,110	1,300	1,645	1,834
- Employee exp	923	872	1,021	1,336	1,480
- Depreciation /amortisation	14	14	14	13	13
- Other opex	182	224	264	296	341
Preprovision profit	13,626	19,117	25,639	31,542	37,567
Provisions	400	34	2	203	326
PBT	13,226	19,083	25,637	31,340	37,242
Taxes	3,599	5,295	6,415	8,164	10,074
PAT	9,627	13,788	19,222	23,176	27,168
Extraordinaries	(75)	88	56	-	-
Reported PAT	9,552	13,876	19,278	23,176	27,168
Basic number of shares (mn)	859	859	987	987	987
Basic EPS (INR)	11.2	16.1	19.5	23.5	27.5
Diluted number of shares (mn)	859	859	987	987	987
Diluted EPS (INR)	11.2	16.1	19.5	23.5	27.5
DPS (INR)	3.0	4.5	5.5	6.0	6.5
Dividend pay out (%)	26.8	28.0	28.3	25.6	23.6

Growth metrics (%)

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Net interest income	49.2	30.1	37.7	22.9	19.4
Net revenues growth	36.8	37.2	33.2	23.2	18.7
Opex growth	71.4	(0.8)	17.1	26.5	11.5
PPP growth	34.6	40.3	34.1	23.0	19.1
Provisions growth	90.0	(91.4)	(95.4)	NA	60.7
PAT growth	24.5	43.2	39.4	20.6	17.2

Operating ratios (%)

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Yield on assets	9.3	10.4	10.9	11.0	11.2
Yield on advances	9.4	10.3	10.8	11.0	11.2
Cost of funds	6.4	7.3	7.6	8.0	8.3
Spread	2.9	3.0	3.2	3.0	2.9
Net interest margins	3.9	4.1	4.4	4.3	4.2
Cost-income	7.6	5.5	4.8	5.0	4.7
Tax rate	27.2	27.7	25.0	26.1	27.1

Balance sheet (INR mn)

As on 31st March	FY08	FY09	FY10E	FY11E	FY12E
Liabilities					
Equity capital	8,587	8,587	9,875	9,875	9,875
Reserves & surplus	51,353	59,904	96,820	112,061	130,471
Net worth	59,940	68,490	106,695	121,935	140,346
Reserve for doubtful debts	2,637	3,437	4,303	5,306	6,553
Secured Loans	294,220	376,137	469,739	611,076	770,238
Unsecured loans	48,608	73,223	81,757	86,660	95,495
Deferred tax liability	(319.3)	(78.9)	(78.9)	(78.9)	(78.9)
Total liabilities	**405,085**	**521,208**	**662,414**	**824,898**	**1,012,553**
Assets					
Loans	393,165	513,814	657,123	815,896	1,005,437
Investments	11,474	10,049	9,349	8,698	8,092
Current assets	*24,135*	*35,273*	*40,027*	*48,601*	*52,865*
Current liabilities	*24,468*	*38,737*	*44,830*	*49,039*	*54,600*
Net current assets	(333)	(3,464)	(4,802)	(438)	(1,735)
Fixed assets (net block)	779	809	745	742	759
Total assets	**405,085**	**521,208**	**662,414**	**824,898**	**1,012,553**
Balance sheet ratios (%)					
Loan growth	22.5	30.7	27.9	24.2	23.2
Borrowings growth	13.2	31.1	22.7	26.5	24.1
EA growth	15.6	28.7	27.1	24.6	22.8
Gross NPA ratio	0.8	0.1	0.1	0.1	0.2
Net NPA ratio	0.6	0.0	0.0	0.0	0.0
Provision coverage	25.8	69.7	80.0	75.0	75.0

Sanctions and disbursements

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Sanctions (INR mn)	468,321	407,459	529,697	582,666	670,066
Disbursements (INR mn)	129,529	171,573	216,443	250,771	311,925
Disbursements to sanction ratio (%)	27.7	42.1	40.9	43.0	46.6
Disbursements growth (%)	20.7	32.5	26.2	15.9	24.4
Sanctions growth (%)	63.6	(13.0)	30.0	10.0	15.0

RoE decomposition (%)

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Net interest income/assets	3.9	4.1	4.4	4.3	4.2
Non interest income/assets	0.0	0.2	0.1	0.2	0.1
Other income/assets	0.0	0.1	0.0	0.0	0.0
Net revenues/Assets	3.9	4.4	4.6	4.5	4.3
Operating expense/Assets	0.3	0.24	0.22	0.22	0.20
Provisions/Assets	0.1	0.0	0.0	0.0	0.0
Taxes/Assets	1.0	1.1	1.1	1.1	1.1
Total costs/Assets	1.4	1.4	1.3	1.3	1.3
ROA	2.6	3.0	3.3	3.1	3.0
Equity/Assets	14.6	14.5	15.5	16.0	14.9
ROAE	17.5	20.5	21.0	19.5	19.8

Valuation metrics

Year to March	FY08	FY09	FY10E	FY11E	FY12E
Diluted EPS (INR)*	11.2	16.1	19.5	23.5	27.5
EPS growth (%)	*13.1*	*43.2*	*21.2*	*20.6*	*17.2*
Book value per share (INR)	72.9	83.8	112.4	128.9	148.8
Diluted P/E (x)	19.1	13.3	11.0	9.1	7.8
Price/ BV (x)	2.9	2.6	1.9	1.7	1.4
Dividend yield (%)	*1.4*	*2.1*	*2.6*	*2.8*	*3.0*

excluding extraordinaries

Company	Absolute reco	Relative reco	Relative risk
Federal Bank	Buy	SO	M
ING Vysya Bank	Buy	SO	H
LIC housing finance	Buy	SO	M
Oriental Bank Of Commerce	Buy	SO	H
Power Finance Corp	Buy	SP	L
South Indian Bank	Buy	SO	H
SREI Infrastructure Finance	Buy	SO	H
Syndicate Bank	Buy	SU	H
Union Bank Of India	Buy	SO	L
Yes Bank	Buy	SO	M
Axis Bank	Buy	SO	M
Allahabad Bank	Buy	SO	H

Company	Absolute reco	Relative reco	Relative risk
HDFC Bank	Hold	SP	L
ICICI Bank	Buy	SO	L
Kotak Mahindra Bank	Buy	SP	M
Punjab National Bank	Buy	SO	L
State Bank of India	Buy	SP	L
HDFC	Hold	SU	L
Indian Overseas Bank	Hold	SU	H
IDFC	Reduce	SU	M
Karnataka Bank	N R	N R	N R
Reliance Capital	Hold	SU	M
Shriram City Union Finance	Buy	SP	H
Bank of Baroda	Buy	SO	L

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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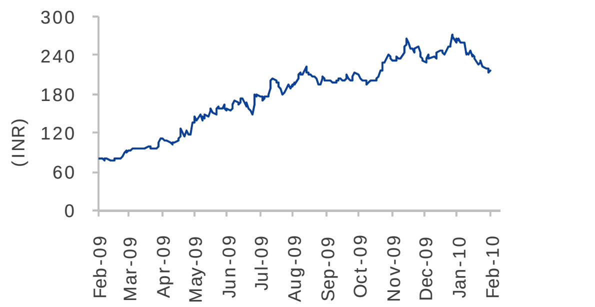
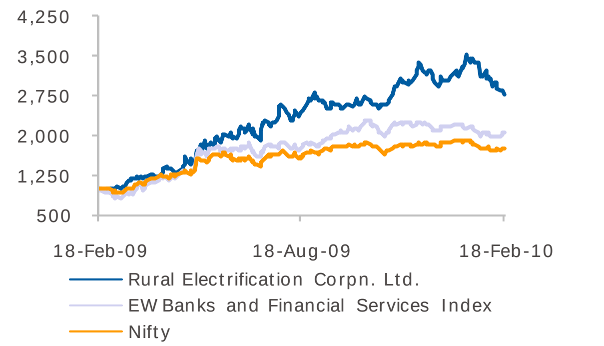
Coverage group(s) of stocks by primary analyst(s): Banking

Allahabad Bank, Axis Bank, Bank of Baroda, Federal Bank, HDFC Bank, ICICI Bank, IOB, Karnataka Bank, Kotak Mahindra Bank, OBC, SBI, Yes Bank, IDFC, HDFC, LIC Housing Finance, PNB, Power Finance Corporation, Reliance Capital, SREI Infrastructure Finance, Shriram City Union, Syndicate Bank and Union Bank.

Rural Electrification Corporation



EW Indices



Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	95	54	11	162

* 2 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	104	46	12

Recent Research

Date	Company	Title	Price (INR)	Recos
01-Feb-10	**Shriram City Union Finance**	Disbursement growth resurfaces; margins contract; *Result Update*	453	Buy
30-Jan-10	**Reliance Capital**	Lower investment profits dent earnings; *Result Update*	804	Hold
29-Jan-10	**Syndicate Bank**	Margin expansion continues; *Result Update*	87	Buy

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