Company In-Depth

16 May 2007 | 23 pages

Reliance Energy (RLEN.BO)

Downgrade to Sell: Deconstructing the Enigma

Rating change ☑
Target price change ☑
Estimate change ☑

- Disappointing — We are downgrading RELE to Sell (3L) from Buy (1H) and cutting our target price to Rs510 given its 1) lack of delivery – four years after EA03, RELE has only 941MW of capacity and distribution licenses in three circles; 2) inefficient capital deployment – its RoCE is in the 2-4 % range, the lowest in our electric utilities universe; and 3) modest long-term earnings growth of ~15%.

- Lack of delivery — Many of RELE's announced projects have hit 1) fuel supply issues; 2) land allocation problems; or 3) regulatory snags leading to cash and cash equivalents not being allocated in productive assets.

- Inefficient capital deployment — RELE's 2-4% RoCE is the lowest in our rated electric utilities universe because 74% of its assets are in cash and cash equivalents, a clear case of inefficient capital deployment.

- Not the time to bottom fish — RELE's stock underperformance versus the BSE Sensex over the past six years and its expected 35% YoY earnings growth in FY08E (from a low base) might seem like a good opportunity to bottom fish. We believe this approach ignores the business realities as RoCE will be low and long-term earnings growth will likely be a modest ~15%.

- Positive ATE ruling to spur earnings growth — RELE should grow earnings at 20% CAGR over FY07E-10E driven by positive ATE rulings on the Mumbai business. Despite higher interim growth from a low base, long-term steady state earnings growth should remain a modest ~ 15%.

Sell/Low Risk	**3L**
from Buy/High Risk	
Price (16 May 07)	Rs507.05
Target price	Rs510.00
from Rs784.00	
Expected share price return	0.6%
Expected dividend yield	1.1%
Expected total return	**1.7%**
Market Cap	Rs115,876M
	US$2,858M

Price Performance (RIC: RLEN.BO, BB: RELE IN)

See Appendix A-1 for Analyst Certification and important disclosures.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	5,203	28.03	33.8	18.1	1.7	10.5	0.9
2006A	7,309	30.90	10.2	16.4	1.5	11.5	1.0
2007E	7,503	31.72	2.7	16.0	1.4	9.6	1.2
2008E	10,131	42.83	35.0	11.8	1.2	11.3	1.1
2009E	11,531	48.75	13.8	10.4	1.1	11.6	1.2

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	18.1	16.4	16.0	11.8	10.4
EV/EBITDA adjusted (x)	16.3	12.5	25.9	17.9	15.0
P/BV (x)	1.7	1.5	1.4	1.2	1.1
Dividend yield (%)	0.9	1.0	1.2	1.1	1.2
Per Share Data (Rs)					
EPS adjusted	28.03	30.90	31.72	42.83	48.75
EPS reported	28.03	27.49	33.88	42.83	48.75
BVPS	301.05	335.33	374.27	412.06	455.63
DPS	4.71	4.99	6.21	5.60	5.90
Profit & Loss (RsM)					
Net sales	41,337	40,335	57,171	63,596	70,612
Operating expenses	-38,884	-36,346	-55,037	-58,566	-64,659
EBIT	**2,453**	**3,989**	**2,133**	**5,030**	**5,953**
Net interest expense	-1,348	-1,919	-2,503	-3,570	-3,570
Non-operating/exceptionals	4,588	5,744	9,094	10,746	11,510
Pre-tax profit	**5,693**	**7,814**	**8,724**	**12,207**	**13,893**
Tax	-490	-506	-1,221	-2,075	-2,362
Extraord./Min.Int./Pref.div.	0	-805	512	0	0
Reported net income	**5,203**	**6,503**	**8,014**	**10,131**	**11,531**
Adjusted earnings	5,203	7,309	7,503	10,131	11,531
Adjusted EBITDA	5,917	7,476	4,534	7,539	8,563
Growth Rates (%)					
Sales	21.3	-2.4	41.7	11.2	11.0
EBIT adjusted	-21.2	62.6	-46.5	135.8	18.3
EBITDA adjusted	-6.1	26.3	-39.3	66.3	13.6
EPS adjusted	33.8	10.2	2.7	35.0	13.8
Cash Flow (RsM)					
Operating cash flow	**7,532**	**-9,987**	**-48,179**	**10,663**	**11,828**
Depreciation/amortization	3,464	3,486	2,401	2,508	2,610
Net working capital	-1,375	-19,412	-58,594	-1,976	-2,314
Investing cash flow	**20,112**	**-8,066**	**-10,683**	**-2,000**	**-2,000**
Capital expenditure	-1,677	-3,100	-1,000	-2,000	-2,000
Acquisitions/disposals	21,788	-4,965	-9,683	0	0
Financing cash flow	**24,209**	**14,128**	**22,686**	**-1,465**	**-1,543**
Borrowings	17,078	5,283	16,331	0	0
Dividends paid	-991	-1,209	-1,619	-1,491	-1,571
Change in cash	**51,852**	**-3,925**	**-36,177**	**7,198**	**8,285**
Balance Sheet (RsM)					
Total assets	**114,968**	**138,296**	**170,919**	**181,807**	**193,897**
Cash & cash equivalent	60,454	56,529	20,352	27,550	35,835
Accounts receivable	9,310	10,928	13,166	14,646	16,261
Net fixed assets	21,601	21,215	19,815	19,306	18,696
Total liabilities	**59,091**	**67,085**	**85,362**	**87,610**	**89,739**
Accounts payable	7,391	6,621	8,551	9,413	10,482
Total Debt	37,387	42,669	59,000	59,000	59,000
Shareholders' funds	**55,877**	**71,211**	**85,557**	**94,197**	**104,157**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	14.3	18.5	7.9	11.9	12.1
ROE adjusted	10.5	11.5	9.6	11.3	11.6
ROIC adjusted	6.0	8.0	1.1	2.6	3.2
Net debt to equity	-41.3	-19.5	45.2	33.4	22.2
Total debt to capital	40.1	37.5	40.8	38.5	36.2

For further data queries on Citigroup's full coverage universe please contact CIR Data Services Asia Pacific at CitiResearchDataServices@citigroup.com or +852-2501-2791

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Company Background

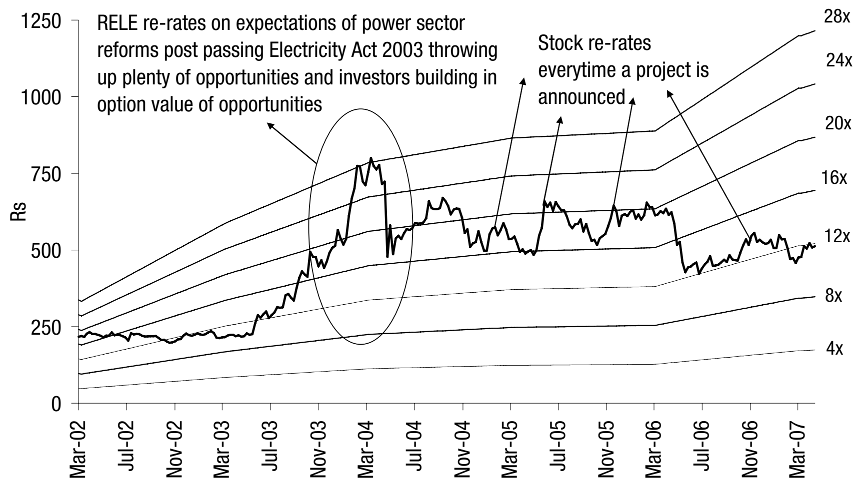
Reliance Energy (RELE) has been an enigma for the past four years. It re-rated significantly on expectations that it would capitalize on opportunities that the Electricity Act 2003 (EA03) would throw up. Projects were announced from time to time, but four years later RELE has only 941MW of generation capacity and distribution licenses in Mumbai and Delhi. The only major difference has been the substantial buildup of cash and cash equivalents and the decent ramp-up of the EPC business. This report explores RELE's multiple moving parts.

Figure 1. RELE v/s BSE Sensex

Time Frame	Relative Returns
Last 3 months	-2%
Last 6 months	-5%
Last 1 year	-25%
Last 2 years	-52%
Last 3 years	-71%
Last 4 years	-49%
Last 5 years	-42%
Last 6 years	-28%

Source: Citigroup Investment Research

Figure 2. RELE – One-year Forward P/E Band Diagram



Source: DataCentral and Citigroup Investment Research estimates

The moving parts in RELE

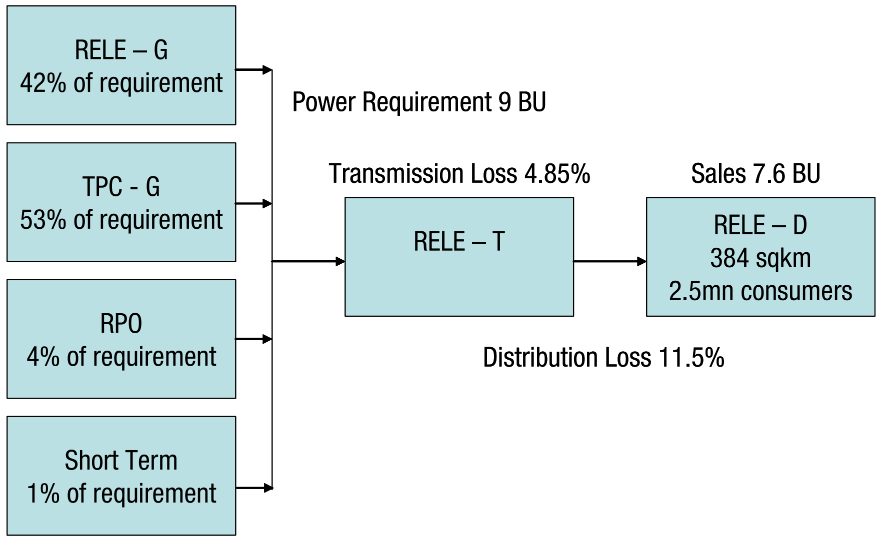
1) Mumbai Power Business: RELE's Mumbai power business is a vertically integrated utility engaged in generation, transmission, wheeling and retail supply of electricity in the Mumbai suburbs. Its retail supply license must be renewed periodically. The current license is in force until August 15, 2011.

RELE-D [Distribution] sources most of its energy for distribution from its own 500MW Dahanu plant (RELE-G [Generation]) and TPC-G (Tata Power Company – Generation).

Power from DTPS is transmitted to the REL-D license area through RELE-T's network of 4, 220 kV lines that is further stepped down to 33kV at 3 220/33kV at Aarey, Ghodbunder and Versova. Power from TPC-G is sourced from seven TPC-Transmission 22kV-33kV receiving stations. REL-D is also connected to TPC at 220 kV with a tie line at Borivali.

REL-D caters to the electricity needs of about 2.5mn consumers in its 384 sqkm license area in suburbs in and around Mumbai with energy input requirement of about 9bn units and coincident maximum demand of about 1400MVA.

Figure 3. RELE – Mumbai Power Business (FY08E estimates)



Source: MERC and Citigroup Investment Research

Figure 4. RELE – Other Generation Assets

Plant	MW
Samalkot (Combined Cycle)	220
Goa (Combined Cycle)	48
Kochi (Naphtha)	165
Wind Farm Project	8
Total Value	**441**

Source: Citigroup Investment Research

2) Other power assets: In addition to the 500MW Dahanu plant, RELE owns and operates 441MW of independent power producer (IPP) capacity in various locations.

3) EPC Business: The EPC division undertakes engineering, procurement and construction contracts on a turnkey basis along with other value-added services for major public and private sector projects both in India and abroad. It has undertaken total engineering, supply of electrical and mechanical equipment, installation and commissioning services and civil works for the following projects:

- Thermal, hydro, co-generation and gas-based power generating stations;
- 400/132 KV transmission lines and switch yards;
- Overhead and underground electrical networks;
- Industrial electrification works for petrochemicals, fertilizers, steel, cement plants, refineries, ports and hotels;
- Indoor and outdoor illumination works;
- Pre-moulded accessories for extra high voltage electrical cables;
- Renovation and Modernization of the Delhi distribution network; and
- Other civil works

4) Delhi distribution business: Following privatization of Delhi's power sector and unbundling of the Delhi Vidyut Board in July 2002, the power distribution business was transferred to BSES Yamuna Power Limited (BYPL) and BSES

Rajdhani Power Limited (BRPL). These two of the three successor entities distribute electricity to 1.9mn customers in two-thirds of Delhi. When RELE took over BYPL and BRPL AT&C (average technical and commercial losses) were 63% and 57%, respectively.

a) BSES Yamuna Power Limited (BYPL): BYPL distributes power to an area of160 sq kms with 0.9mn consumers spread over 14 districts across Central and East areas of Delhi.

b) BSES Rajdhani Power Limited (BRPL): BRPL distributes power to an area of 750 sq km with 1.0mn consumers spread 19 districts across South and West areas of Delhi.

Mumbai business and tariff orders

FY07 – A disappointing year

RELE's FY07 Recurring PAT at Rs7.5bn was up a lackadaisical 3% YoY despite revenues of Rs57.1bn up 42%YoY on account of a 10% EBITDA margin contraction. The key reason for the margin contraction has been Maharashtra Electricity Regulatory Commission's (MERC) October 3, 2006 tariff order for RELE's Mumbai power business wherein the regulator adjusted Rs2.6bn of surpluses for FY05 and FY06 in the FY07 numbers. As a consequence, instead of making Rs2.3bn of regulated returns RELE's Mumbai business was mandated to make a loss of Rs274mn.

Despite the 37% YoY fall in EBITDA RELE still managed to keep Recurring PAT flat because of the 52% YoY growth in other income

Figure 5. RELE – FY07 Results

Year End Mar31 (Rsmn)	FY06	FY07	% Chg
EPC Order Backlog	33000	52,500	59%
Sale of Electrical Energy	31,696	36,284	14%
Income from EPC	8,400	20,820	148%
Revenues	**40,097**	**57,104**	**42%**
Total Expenditure	**32,859**	**52,570**	**60%**
EBITDA	**7,238**	**4,534**	**-37%**
% margin	**18.1%**	**7.9%**	
Interest	(1,919)	(2,503)	30%
Depreciation	(3,486)	(2,401)	-31%
Other Income	5,982	9,094	52%
PBT	**7,815**	**8,724**	**12%**
Total Tax	(506)	(1,221)	141%
Tax Rate (%)	6%	14%	
Recurring PAT	**7,309**	**7,503**	**3%**
Tax of Previous Year	(806)	512	
Reported PAT	**6,503**	**8,015**	**23%**

Source: Citigroup Investment Research

Figure 6. RELE Mumbai G + T + D Surplus Adjustment

Rsmn	FY05	FY06	FY06+FY07	FY07
Revenue Surplus	829	559	1389	
Interest Surplus	87	25	112	
Excess Reserves			1102	
Distributable Surplus			2603	
Regulated Return				**2329**
Less Distributable Surplus				**(2603)**
Actual PAT				**(274)**

Source: MERC Citigroup Investment Research

Mumbai – The next three years

MERC has moved to a Multi Year Tariff (MYT) system and has passed an order for the next three years (FY08-FY10) for RELE's Mumbai business. However, the retail supply tariff (RST) for the distribution business has been given only for

FY08E. This will be adjusted every year post truing up of costs. According to MERC's initial ARR calculation, RELE's Mumbai business is supposed to make profits of Rs2.47bn in FY07.

Figure 7. RELE – Mumbai G + T + D ARR Calculations

Year End Mar31 (Rsmn)	FY07T	FY08T	FY09T	FY10T
Power Purchase	22311	26636	29711	33068
Standby Charges	2026	2200	2310	2426
Tx Charges	1707	1900	2000	2109
Fuel Cost	5125	5809	5811	5814
O&M Cost	3667	5063	5425	5707
R&M Cost	980	1439	1548	1631
Depreciation	1259	1417	1463	1459
Interest on Long Term Loans	470	547	625	625
Interest on WC	289	269	269	270
Provision for bad debts	47	70	70	70
Income Tax	173	783	796	805
Contingency contribution	114	125	130	136
Return on Equity	2329	2470	2546	2571
Less Distributable Surplus	(2603)	0	0	0
Less Non Tariff Income	(611)	(615)	(616)	(618)
ARR	**36303**	**46674**	**50541**	**54441**
Equity (b-o-y)	**14806**	**15765**	**16642**	**16825**
Capex	3167	2922	610	470
Equity Portion	950	877	183	141
Equity (e-o-y)	**15756**	**16642**	**16825**	**16966**
RoE	**2329**	**2470**	**2546**	**2571**

Source: MERC and Citigroup Investment Research estimates; #Note T = Tariff Year

Figure 8. RELE – Mumbai G + T + D Profit & Loss Based on ARR

	FY07T	FY08T	FY09T	FY10T
Sales	**36303**	**46674**	**50541**	**54441**
Operating Costs	3828	5258	5626	5913
Standby Charges	2026	2200	2310	2426
Fuel Cost	5125	5809	5811	5814
Power Purchase	22311	26636	29711	33068
Tx Charges	1707	1900	2000	2109
EBITDA	**1306**	**4871**	**5083**	**5112**
Margin %	**3.6%**	**10.4%**	**10.1%**	**9.4%**
Depreciation	1259	1417	1463	1459
EBIT	**47**	**3454**	**3621**	**3653**
Interest	759	815	895	895
Other Income	611	615	616	618
PBT	**(101)**	**3253**	**3342**	**3376**
Tax	173	783	796	805
Tax Rate %	-170.9%	24.1%	23.8%	23.8%
PAT	**(274)**	**2470**	**2546**	**2571**

Source: MERC and Citigroup Investment Research estimates; #Note T = Tariff Year

However, MERC also notes the Appellate Tribunal of Electricity's (ATE) ruling that the surplus adjusted for in the FY07 tariff order is actually recoverable from consumers. As a consequence MERC is mandated to adjust Rs2.64bn of additional profits equally in the next three years with annual incremental profits of Rs880mn for the next 3 years.

Figure 9. RELE – Mumbai G + T + D Consolidated Revenue Gap

Item	Rsmn
Revenue to be recovered from FY08 tariff	38400
Revenues from existing tariffs	32120
Current Year Revenue Gap	6280
Incremental adjustments (ATE Ruling)	880
Gap to be covered	**7160**

Source: MERC and Citigroup Investment Research

Meeting the Rs7.16bn revenue gap would lead to a severe tariff shock on the Mumbai license area consumers. As a consequence MERC has only made an incremental allowance of Rs6.14bn through a 19% YoY tariff hike. This might seem unfair from RELE's perspective as this does not even make up for the current year's gap of Rs6.28bn. But MERC has mentioned that it would make up for the Rs7.16bn – Rs6.14bn = Rs1.02bn and remaining Rs1.76bn (Out of the ATE directed Rs2.64bn) in the next two years.

- *What all this means is that RELE's Mumbai business is mandated to make Rs2.33bn of profit in FY08 vis-à-vis Rs274mn of losses in FY07, which would provide a smart recovery to RELE's numbers in FY08E.*
- *If one carries this forward under MERC's tariff philosophy, we believe that RELE's Mumbai business should make profits of ~ Rs2.5bn annually in FY09 and FY10 from the normal regulated returns.*
- *Further, MERC would have to allow additional profits of Rs1.02bn + Rs1.76bn (ATE adjustments) in FY09 and FY10.*

Pending standby charges issues vs. Tata Power

The long-standing TPC vs. RELE dispute had led to Tata Power filing an appeal with the Supreme Court against the ATE order directing Tata Power to refund Reliance Energy Rs3.5bn and Rs1.1bn of interest. The case had been listed for admission in the Supreme Court since 31 January 2007. The Supreme Court passed an interim order on 7 February 2007 granting stay of the impugned order of the ATE subject to the condition that, TPC furnishes a bank guarantee of Rs2.27bn and, in addition deposits a sum of Rs2.27bn with the Registrar General of the Court, which can be withdrawn by RELE. However, RELE has also given an undertaking to the Court that in the event the appeal is decided against RELE, this money will be refunded to TPC.

Business Outlook

EPC business

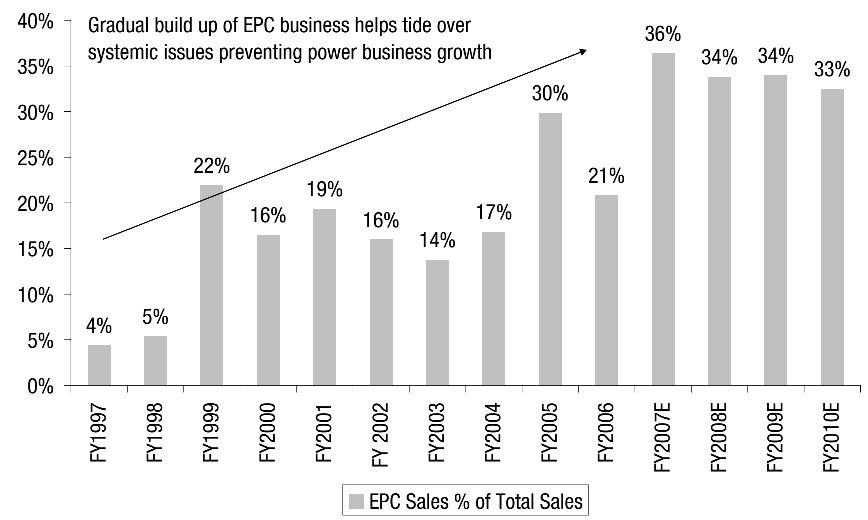
Figure 10. EPC – Order Backlog Break Up

Projects	Rsbn
600MW Yamunagar + UP Electrification	13.0
1200MW Hisar	38.0
Others	1.5
Total	52.5

Source: RELE and Citigroup Investment Research

RELE's EPC business started as an in-house power project business. The power business being restricted by systemic issues has led to the company taking numerous external contracts resulting in the buildup of a reasonable EPC franchise. The last big orders that RELE won were when the company outbid BHEL for the Rs38bn, 1200 MW Hisar coal-fired power plant in Haryana. According to our calculation RELE bid 10% lower at Rs31.7mn/MW vis-à-vis BHEL's bid at Rs34.9mn/MW. Given that RELE does not have a boiler-turbine-generator (B-T-G) manufacturing facility, the equipment would be sourced from Shanghai Electric (SEPCO).[1] RELE ended FY07 with an order backlog (OB) of Rs52.5bn, which is 2.5x FY07 EPC sales. This OB should provide EBITDA margins of 9-11%. RELE has also bid for Rs60bn of projects in generation, transmission and distribution.

Figure 11. EPC –Sales as a percentage of Total Sales



Source: Citigroup Investment Research estimates

Does RELE prefer partnering with SEPCO?

Despite the fact that RELE's 500MW plant at Dahanu has been built by BHEL it has given the Rosa plant order to SEPCO, as Chinese power equipment is ~20% cheaper than Indian power equipment.

- According to RELE the Chinese have inherent advantages in manufacturing because of lower interest costs, better infrastructure and economies of scale because of mass-manufacturing that makes their equipment cheaper than that manufactured in India.

[1] RELE has built a strong relationship with SEPCO. SEPCO is executing the 600MW Yamunanagar order that RELE won a few years contract. SEPCO is also executing RELE's in house 1200MW Rosa power project in Uttar Pradesh

- Besides, if a power project is being set up in Tamil Nadu (TN) and if BHEL has to manufacture equipment at the Haridwar and send it to TN by road, its transportation cost would be not significantly different than that of Chinese equipment being transported by sea.

- Lastly when it comes to civil works BHEL also outsources most of the work to other players, losing margins on the same.

Delhi distribution business

According to RELE the opening aggregate technical and commercial losses (AT&C losses) in the BRPL and BYPL were higher than that communicated at the time of the privatization. However, DERC could interpret the situation as there have been no overachievements in the reduction of losses and RELE is not supposed to get incentives for the same.

Figure 12. RELE – Delhi Loss Reduction

	Opening According to RELE	Opening According to Regulator	FY07 Ending	Targets	Reduction According to Regulator	Reduction According to RELE
BRPL	51%	48%	30%	31%	17%	21%
BYPL	63%	57%	39%	40%	17%	24%

Source: RELE and Citigroup Investment Research

Status of other announced projects

Over the last three years RELE has announced or won numerous power/infrastructure projects. However, many projects have run into regulatory snags or have faced other problems. Out of the list of projects below we expect:

- Two toll roads to be operational by FY09-FY10

- Progress on the 300MW Vidharba CPP

- Commissioning of 600MW of Rosa power plant by Jan 2010.

- MRTS Phase I to be operational by FY11

Figure 13. RELE – Infrastructure Projects

Projects	Remark	Size	Fuel	Cost (Rsmn)	Status
Road Projects		**400km**		**31,000**	**70:30 Debt - Equity**
DS Toll Road	49% Stake				SPV formed. Operational FY09-FY10
NK Toll Road	49% Stake				SPV formed. Operational FY09-FY10
Road Number 3	49% Stake				SPV Not Formed
Road Number 4	49% Stake				SPV Not Formed
Road Number 5	49% Stake				SPV Not Formed
Power Transmission Projects					
Reliance Energy Transmission (RET)	**RELE has a 51% stake in RET**				
- Package B (Southern Maharashtra)	100% Stake	1500km		12,000	No activity
- Package C (Gujarat)	100% Stake			6,000	No activity
- Parbati Koldam Project	51% Stake			NA	No activity
CPP					
Thane Belapur	NM	165MW	Gas	NA	Stalled
Vidharbha	RELE has 34%	300MW	Coal	NA	Land/customer finalization ongoing.
Hydel Power Projects					
Urthing Sobla Project	Project Won by RELE	280MW	Hydel	NA	DPR/Financial Closure Ongoing.
Tato	MoA	700MW	Hydel	NA	DPR/Financial Closure Ongoing.
Siyom	MoA	1000MW	Hydel	NA	DPR/Financial Closure Ongoing.
Thermal Power Projects					
Hirma Power	Eventually 12,000MW over 15 years	12,000MW		NA	No activity
Reliance Energy Generation (REG)	**RELE has a 50% stake in REG**				
- Dadri Project	Ultimate capacity of 7480MW	5600MW	Gas	NA	Clearance/land got. No gas linkage.
- Rosa Power Plant	Eventual capacity of 1200MW	600MW	Coal		Construction commenced in Jan07. Will be completed in 33-36 months
Shahapur Project	Eventual capacity of 4000MW	2X1200MW	Coal	NA	25,000 acres allotted by GoM
Anpara Project	Lanco Infratech won competitive bid	1000MW	Coal	nm	Lost the competitive bid
Mass Rapid Transit System (MRTS)					
MRTS – Phase I	RELE - 69% Stake	62.68km		23,000	Will be operational in FY11

Source: Citigroup Investment Research estimates

Figure 14. Mumbai MRTS Project

Phase I	km	Cost (Rsbn)
Versova - Andheri - Ghatkopar	11.07	
Colaba - Bandra - Charkop	38.24	
Bandra - Kurla - Makhurd	13.37	
Total	**62.68**	**23.57**
Phase II	**km**	
Charkop - Dahisar	7.50	
Ghatkopar - Mulund	12.40	
Total	**19.90**	**80.00**
Phase III	**km**	
BKC - Kanjur Marg via airport	19.50	
Andheri (E) - Dahisar (E)	18.00	
Hutatma Chowk - Ghatkopar	21.80	
Sewri - Prabhadevi	3.50	
Total	**62.80**	**91.68**
Grand Total	**145.38**	**195.25**

Source: Indian Infrastructure and Citigroup Investment Research

Details of the MRTS Project

RELE won the Mumbai MRTS Phase I project in competitive bidding. The total project costs Rs23.57bn and will be financed by Rs5.13bn of equity, Rs11.94bn of debt and Rs13.37bn of viability gap funding. Phase I is expected to be completed by FY11. RELE has also put in bids for Phase II of the project, which is likely to cost Rs80bn

Targeted infrastructure assets IRRs

According to RELE a few years back it had expected significant opportunity in the power/infrastructure space and as a consequence had steadily tied up funds to invest in opportunities as and when they came up. RELE expects project IRRs of 14-15% from infrastructure projects.

Views on the UMPPs

RELE believes that the bidding for the first two Ultra Mega Power Projects (UMPP) was aggressive and expects bidding to become more rational. With equipment from SEPCO it was expecting to make RoEs of 14% on the Sasan UMPP at its tariff bid of Rs1.29/kwh.

RELE has not heard from Power Finance Corporation (PFC) and does not know if Sasan UMPP would be handed over to it as it was the second-lowest bidder or if PFC would go in for re-bidding in the event that PFC finally decides to disqualify the Lanco-Globeleq combine.

Figure 15. Sasan and Mundra UMPP Bidding Results

Sasan UMPP	Rs/kwh	Mundra UMPP	Rs/kwh
Lanco-Globeleq	1.20	TPC	2.26
RELE	1.29	RELE	2.66
TPC	1.41	Adani Exports	2.69
JPA	1.65	Essar Power	2.8
Essar Power	1.65	L&T	3.22
Sterlite	1.75	Sterlite	3.75
JSPL	1.79		
NTPC	2.01		
L&T	2.25		

Source: Citigroup Investment Research

Key growth assumptions

We expect RELE to grow FD EPS at 20% CAGR over FY07E-10E primarily driven by the positive ATE rulings on the Mumbai business.

RELE's Mumbai business is mandated to make Rs2.33bn of profits in FY08E vis-à-vis Rs274mn of losses in FY07E according to the latest MERC MYT, which would provide a smart recovery to RELE's numbers in FY08E with EBITDA margins improving 400bps and earnings growing 35% YoY.

Further earnings momentum in FY09E and FY10E would be provided as MERC should allow additional profits of Rs1.76bn plus Rs1.02bn over and above the Rs2.5bn of base profits to the RELE Mumbai business.

The EPC business is expected to grow at a stable 6% CAGR over FY07-08E but we expect 110bps PBIT margins improvement over this period from a base of 5.9% in FY07E.

We expect other income at a steady 11% CAGR over FY07-10E driven by cash, mutual funds and ICDs. RoEs would move back to the 11-12% range from the FY07E levels of 9.6%.

Figure 16. RELE – Key Assumptions

Year End Mar31 (Rsmn)	FY05A	FY06A	FY07E	FY08E	FY09E	FY10E	CAGR FY07E-10E
Power Revenues	28,899	31,790	36,284	42,023	46,468	51,845	13%
Growth %		10%	14%	16%	11%	12%	
EPC Revenues	12,347	8,400	20,820	21,500	24,000	25,000	6%
Growth %		-32%	148%	3%	12%	4%	
- EPC Order Backlog	35,000	33,000	52,500	41,000	32,000	22,000	
Others	91	144	66	73	144	66	0%
Total Revenues	**41,337**	**40,335**	**57,171**	**63,596**	**70,612**	**76,911**	**10%**
Growth %		-2%	42%	11%	11%	9%	
EBITDA	**5,917**	**7,476**	**4,534**	**7,539**	**8,563**	**9,419**	**28%**
Margin	**14.3%**	**18.5%**	**7.9%**	**11.9%**	**12.1%**	**12.2%**	
EBIT	2,453	3,989	2,133	5,030	5,953	6,706	46%
Interest	1,348	1,919	2,503	3,570	3,570	3,570	
Other Income	4,588	5,744	9,094	10,746	11,510	12,409	11%
PBT	**5,693**	**7,814**	**8,724**	**12,207**	**13,893**	**15,546**	**21%**
Tax	490	506	1,221	2,075	2,362	2,643	
Effective Tax Rate	8.6%	6.5%	14.0%	17.0%	17.0%	17.0%	
Recurring PAT	**5,203**	**7,309**	**7,503**	**10,131**	**11,531**	**12,903**	**20%**
Growth %		40%	3%	35%	14%	12%	
Exceptional	0	(806)	512	0	0	0	
Reported PAT	**5,203**	**6,503**	**8,014**	**10,131**	**11,531**	**12,903**	**17%**
FD Shares	186	237	237	237	237	237	
FD EPS	28.03	30.90	31.72	42.83	48.75	54.55	20%
Growth %		10%	3%	35%	14%	12%	
D/E	0.67	0.60	0.69	0.63	0.57	0.51	
RoCE	2.8%	3.5%	1.4%	2.8%	3.1%	3.3%	
RoE	10.5%	11.5%	9.6%	11.3%	11.6%	11.8%	

Source: Citigroup Investment Research estimates

Valuations

Total shares outstanding and potential dilution

At end of March 31, FY07 RELE had 228.5mn shares outstanding, which already incorporates all the promoter warrant conversion. However RELE still has ~ Rs8bn of FCCBs with a conversion price of Rs1007. If this is converted it will lead to a dilution of 3.5%.

Net cash/share on the books of RELE

At the end of March 31, 2006 RELE had a cash balance of Rs56.5bn, mutual funds of Rs9.1bn and inter corporate deposits (ICD) of Rs20.3bn. The gross cash and equivalents on RELE's books was Rs85.9bn (74% of the assets).

We asked the management if RELE's huge cash balance actually indicated that its growth plans had gone awry. RELE has been building a war chest of cash over the last few years to leverage on the Indian infrastructure capex boom. However, a few projects not taking off has thrown a spanner in the works in the near term, but the cash would be put to good use in the long term. Meanwhile, a strong treasury has put the cash to work and earned returns.

We believe that the net cash/FD share has gone up Rs251 in FY07E. If one assumes status quo that none of RELE's power/infrastructure projects take off and the treasury continues to do its job, RELE could have a net cash/FD share of Rs316 by FY09E.

Figure 17. RELE – Net Cash/Share

Year End Mar31 (Rsmn)	FY06	FY07E	FY08E	FY09E	FY10E
Debt (ex FCCB)	34,668	50,998	50,998	50,998	50,998
Cash Balance	56,529	20,352	27,550	35,835	45,789
Mutual Funds	9,172	14,000	14,000	14,000	14,000
ICDs	20,268	76,000	76,000	76,000	76,000
Gross Cash	**85,968**	**110,352**	**117,550**	**125,835**	**135,789**
As a % of Assets	74%	75%	76%	76%	77%
Net Cash	**51,301**	**59,354**	**66,552**	**74,837**	**84,791**
Net Cash/Share	**217**	**251**	**281**	**316**	**358**

Source: Citigroup Investment Research estimates

Value of RELE (ex Net Cash)

One way to approach the valuation exercise would be to consider RELE's business lines one by one:

Mumbai Business: To value the Mumbai power business one could use a 3-stage modified DCF where we discount the regulatory PAT using a cost of equity 12%. What this implicitly assumes is that depreciation + capex + change in working capital +change in debt = 0 implying that free cash flow to equity (FCFE) = Regulatory PAT.

Figure 18. RELE – Mumbai Generation, Transmission and Distribution Business Modified DCF Model

Generation										
		1	2	3	4	5	6	7	8	TY
Year End Mar31 (Rsmn)	**FY07E**	**FY08E**	**FY09E**	**FY10E**	**FY11E**	**FY12E**	**FY13E**	**FY14E**	**FY15E**	**FY16E**
Equity Base	4406	5208	5242	5260						
Regulatory PAT	612	673	731	735	772	818	867	919	974	994
Growth		9.9%	8.7%	0.5%	5%	6%	6%	6%	6%	2%
CAGR 07E-10E				6.3%						
Discounted Value		**601**	**583**	**523**	**491**	**464**	**439**	**416**	**394**	
Terminal Value									**9939**	
PV of forecasts	3911	49%								
Terminal Value Discounted	4014	51%								
Total Value	**7925**	**100%**								
Value/FY07E Equity Base	**1.8x**									
Cost of Equity	**12%**									
Transmission										
		1	2	3	4	5	6	7	8	TY
Year End Mar31 (Rsmn)	**FY07E**	**FY08E**	**FY09E**	**FY10E**	**FY11E**	**FY12E**	**FY13E**	**FY14E**	**FY15E**	**FY16E**
Equity Base	1321	1348	1375	1377						
Regulatory PAT	184	187	191	193	195	197	199	201	203	206
Growth		1.7%	2.0%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1%
CAGR				1.6%						
Discounted Value		**167**	**152**	**137**	**124**	**112**	**101**	**91**	**82**	
Terminal Value									**1868**	
PV of forecasts	966	56%								
Terminal Value	755	44%								
Total Value	**1720**	**100%**								
Value/FY07E Equity Base	**1.3x**									
Cost of Equity	**12%**									
Distribution										
		1	2	3	4	5	6	7	8	TY
Year End Mar31 (Rsmn)	**FY07E**	**FY08E**	**FY09E**	**FY10E**	**FY11E**	**FY12E**	**FY13E**	**FY14E**	**FY15E**	**FY16E**
Equity Base	9131	10038	10086	10207						
PAT	(1070)	1610	1623	1643	1684	1726	1769	1813	1859	1896
Growth		nm	0.8%	1.2%	2.5%	2.5%	2.5%	2.5%	2.5%	2%
ATE Adjustment of Rs2640mn		(140)	1390	1390						
Total	(1070)	1470	3013	3033	1684	1726	1769	1813	1859	
CAGR				1.0%						
Discounted Value		**1312**	**2402**	**2159**	**1070**	**979**	**896**	**820**	**751**	
Terminal Value									**18960**	
PV of forecasts	10391	58%								
Terminal Value	7658	42%								
Total Value	**18048**	**100%**								
Value/FY07E Equity Base	**2.0x**									
Cost of Equity	**12%**									

Source: Citigroup Investment Research estimates

Other Power Asset: The remaining power assets could be valued assuming a replacement cost, debt – equity mix of 70:30 and a suitable P/BV.

Figure 19. RELE – Valuing other power assets

Rsmn	MW	Equity	P/BV	Value
Samalkot (Combined Cycle)	220	2310	1.5	3465
Goa (Combined Cycle)	48	504	2.0	1008
Kochi (Naphtha)	165	1733	1.0	1733
Wind Farm Project	8	148	1.5	222
Total Value	**441**	**4695**	**1.4**	**6428**

Source: Citigroup Investment Research estimates

Delhi distribution business: RELE's Delhi distribution could be valued at FY07E P/Equity Base of 2.0x in-line with derived Value/FY07E Equity Base for the Mumbai distribution business. A higher multiple might not be warranted given that with the end of FY07 RELE by not over achieving the reduction of AT&C loss targets has effectively lost out on incentives

Figure 20. BRPL and BYPL – Valuation

	Equity Base	RELE Stale	RELE Base	P/BV	Value
BYPL	2269	26.0%	590	2.0	1166
BRPL	6811	26.0%	1771	2.0	3500
Total	**9080**	**26.0%**	**2361**	**2.0**	**4666**

Source: Citigroup Investment Research estimates

EPC Business: RELE's EPC business could be valued using an FY09E EV/EBIT multiple of 9x, which is a 22% discount to what EV/EBIT BHEL would trade at on our target price of Rs2764.

Figure 21. RELE – Valuing EPC Business

	FY07E	FY08E	FY09E	FY10E
Sales	20946	21715	24240	25250
PBIT	1226	1520	1697	1768
PBIT Margin %	5.9%	7.0%	7.0%	7.0%
EV/EBIT multiple	9			
EV of RELE EPC	**15271**			

Source: Citigroup Investment Research estimates

Note: Net Debt/Net Cash gets adjusted in our Net Cash calculations

If we add up the value of each of these businesses, what we get is RELE's value (ex Net Cash) = Rs229.

Figure 22. RELE – (ex Net Cash)

Part	Remark	Value	Value/Share
- Generation	DCF (P/Equity Base of 1.8x)	7,925	34
- Transmission	DCF (P/Equity Base of 1.3x)	1,720	7
- Distribution	DCF (P/Equity Base of 2.0x)	18,048	76
Mumbai License Area		**27,693**	**117**
Samalkot (CC)	P/Equity Base of 1.5x	3,465	15
Goa (CC)	P/Equity Base of 2.0x	1,008	4
Kochi (Naphtha)	P/Equity Base of 1.0x	1,733	7
Wind Farm Project	P/Equity Base of 1.5x	222	1
Other Generation Assets	**P/Equity Base of 1.4x**	**6,428**	**27**
EPC Business	**EV/EBIT 10x FY09E**	**15,271**	**65**
BSES Yamuna	P/Equity Base of 2.0x	1,166	5
BSES Rajdhani	P/Equity Base of 2.0x	3,500	15
Delhi Distribution Business		**4,666**	**20**
RELE (ex-Net Cash)		**54,059**	**229**

Source: Citigroup Investment Research estimates

Net cash on RELE's book

RELE's target price would be sensitive to how one would value the financial assets. Should cash be valued at book value or should one give it a multiple higher than 1.0x.

- Either assuming the option value that RELE would invest in projects which one can value higher than book value
- Or assuming that RELE's treasury will put the cash to good use and one should add the FY09E net cash/FD share to get RELE's target price

We are comfortable valuing the company using FY08E Net Cash/Share of Rs281 to set a target price of Rs510.

Figure 23. RELE – Possible Target Price Range

	FY07E	FY08E	FY09E
RELE (ex-Net Cash)	229	229	229
Net Cash/FD Share	251	281	316
Times FY07E Net Cash	1.0	1.1	1.3
Possible Target Price	**479**	**510**	**545**

Source: Citigroup Investment Research

Alternate way of valuing RELE

Alternatively, if one assumes that RELE is one homogeneous entity (without looking at the asset mix) one sees that RELE's earnings are growing at 13-15% range (Note: CAGR over FY07E-10E is inflated because of the low base in FY07E), RoE of 11-12% and RoCE of 2-4%.

With such low earnings growth and RoCE, the maximum P/E multiple we would be comfortable with would be 10xFY09E. At these P/E multiples, RELE's value (ex Delhi) would be Rs488.

If we add back the value of RELE's distribution business of Rs20, which is not captured in these earnings, we get Rs508, which is close to our earlier analysis.

Figure 24. RELE – Earnings Growth, RoE and RoCE

Year End Mar31	FY06A	FY07E	FY08E	FY09E	FY10E
FD EPS	30.9	31.7	42.8	48.7	54.5
CAGR FY06A-10E	15%				
CAGR FY07E-10E	20%				
CAGR FY08E-10E	13%				
RoE	11.5%	9.6%	11.3%	11.6%	11.8%
Post Tax RoCE	3.5%	1.4%	2.8%	3.1%	3.3%

Source: Citigroup Investment Research estimates

RELE's RoCE compared with other Indian electric utilities

RELE's RoCE in the 2-4% range is the lowest in our rated Electric Utility Universe on account of 74% of the assets being cash and cash equivalents, a clear case of inefficient capital deployment.

Figure 25. India Electric Utilities Post Tax RoCE

	FY05A	FY06A	FY07E	FY08E	FY09E	FY10E
Reliance Energy	2.8%	3.5%	1.4%	2.8%	3.1%	3.3%
Tata Power	5.7%	5.2%	6.0%	6.1%	5.9%	7.0%
NTPC	6.8%	6.7%	8.2%	8.7%	8.7%	9.1%
CESC	8.2%	7.7%	7.4%	7.5%	7.7%	7.9%

Source: Citigroup Investment Research estimates

Note: 1) RoCE calculated as Core EBIT X (1- Effective Tax Rate) / Average Capital Employed. 2) Core EBIT = EBIT (excluding other income) 3) Average Capital Employed includes cash in the case of RELE, telecom investments in case of Tata Power and SEB bonds in case of NTPC.

Reliance Energy

Company description

Reliance Energy is a vertically integrated utility carrying out the functions of generation, transmission, wheeling and retail supply of electricity in the suburbs of Mumbai. RELE has the license to supply electricity in the suburbs of Mumbai until August 15, 2011. RELE sources its Mumbai requirement from its own 500MW Dahanu power plant and Tata Power. In addition to this the company has distribution licenses in two circle of Delhi, 441MW of generation capacity, EPC business and cash and cash equivalents, which was 74% of the value of total assets as of March 31, 2006

Investment thesis

We rate Reliance Energy Sell/ Low Risk (3L) with a target price of Rs510. Despite huge expectations about the company's ability to capitalize on opportunities post the passing of the Electricity Act 2003 the company continues to have only 941MW of generation capacity and distribution licenses in Mumbai and Delhi. Most of Reliance Energy's projects have hit regulatory, land clearance or fuel supply snags. The only major difference in the past four years has been the substantial build up of cash and cash equivalents and the ramp-up of the EPC business. Though RELE's stock underperformance vs. the BSE Sensex over the last six years and the expected 35% YoY earnings growth in FY08E (coming off a low base) might seem like a good opportunity to bottom fish, we believe this approach would completely ignore the business realities. Long-term steady state earnings growth in the 13-15% range and low RoCE of 2-4%, which is the lowest in our Indian Electric Utilities Universe (as a result of 74% of the assets being cash) clearly indicates inefficient capital deployment.

Valuation

Our 12-month target price for Reliance Energy of Rs510 is based on RELE (ex Net Cash) value of Rs229 and Net Cash value of Rs281 (1.1x FY07E Net Cash/FD Share). RELE (ex Net Cash) would comprise Mumbai business value of Rs117, other power assets value of Rs27, EPC Business value of Rs65 and Delhi distribution value of Rs20. At our target price of Rs510 RELE (ex Delhi) would trade at a P/E multiple of 10.1x FY09E.

Risks

We rate Reliance Energy Low Risk which differs from the High Risk rating that our quantitative risk-rating system accords. Our Low Risk rating is in-line with that of other rated Electric Utility stocks NTPC, Tata Power and CESC given: 1) Stable and regulated earnings and cash flows from operations, with fuel costs being a pass-through; and 2) Secular growth prospects for the power sector in India, given current shortages and low usage and penetration levels. Upside risks to our target price are: 1) Announcement of new projects, which leads to short-term re-rating of the stock; 2) The company finishing any of its announced projects way before schedule commissioning; and 3) Better than expected order wins and order execution in the EPC Business

Appendix A-1

Analyst Certification

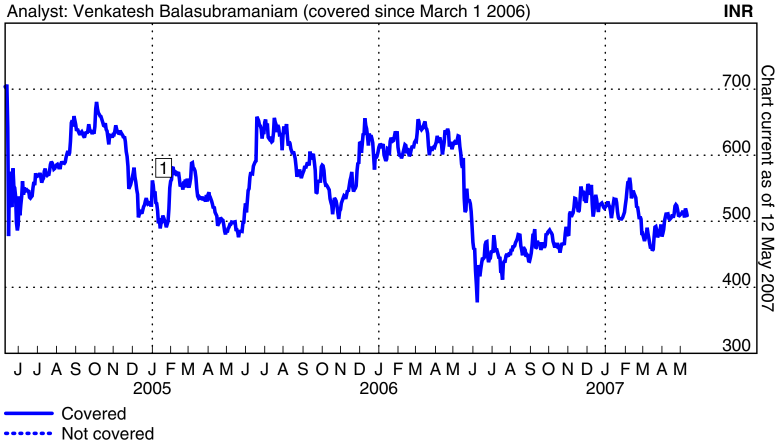
We, Venkatesh Balasubramaniam and Pierre Lau, CFA, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Reliance Energy (RLEN.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Venkatesh Balasubramaniam (covered since March 1 2006)



#	Date	Rating	Target Price	Closing Price
1:	20 Jan 05	*1H	784.00	505.25

*Indicates change.

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The subject company's share price set out on the front page of this Product is quoted as at 16 May 2007 01:11 PM on the issuer's primary market.

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