Flashnote

HSBC Global Research

Natural Resources and Energy
Electric Utilities
Equity – India

Indian Power & Coal

HSBC London India Inaugural Infrastructure conference attended by top policy makers and PSUs – take aways

- **Coal supply resolution top of agenda for the 12th FYP as long-term dependence of imported coal is perceived to be risky**
- **Future lending to SEBs to be contingent upon states following guidelines agreed by state power ministers**
- **Short-term solution on fuel issues being explored but 12-18 months of pain is almost certain**

Coal supply issue is being monitored at the highest level: Government representatives were concerned about shortages in domestic coal supply as restrictions could potentially be imposed by suppliers such as Indonesia and South Africa. They believed numerous measures being undertaken, including monitoring by the Prime Minister's Office, will help raise domestic supply in the next two years as well as ensuring better distribution of coal. Measures under consideration include faster environmental clearance, expediting land acquisition, private participation in coal transportation, and higher mechanisation of coal mining activity.

Cross holding by public enterprises (PSU) on the table, but unlikely: The Disinvestment Ministry white paper has various recommendations for government to meet the current year's disinvestment target. Cross holding by PSUs is one of the options suggested, but a final decision on use of this option will be taken after further deliberation among various other ministries. The officials are aware of the pit falls of such a decision and hence we believe this is unlikely.

Many short-term steps on the table to resolve fuel and State Electricity Board (SEB) financial issues: Measures to ramp up production include canalized import by government and blended pricing. Further government is also considering increasing the sale of coal via e-auctions and concessions in tariffs for those being forced to import coal. SEB financial issues to be addressed though implementation of the Shunglu committee and Forum of Regulators recommendations include: a) automatic tariff revisions by the regulator on a suo-motto basis and b) following key guidelines of state power minister's resolution. Bank lending will be contingent upon states undertaking the reforms.

12th plan set to create a fund to support distribution reform with availability limited to states undertaking reforms: The 12th plan is creating an incentive mechanism for states for regular tariff revision and loss reduction and possibly private sector participation in urban power distribution. However, we expect 12-18 months of pain in the sector mainly due to fuel supply constraints although SEB financial health adds to the problem.

Our preference for transmission: Given the fuel pressure (read coal); we recommend exposure to transmission rather than generation companies. Our preferred play is Power Grid (PWGR IN, INR95.20, target INR130, Overweight) with relatively better earnings clarity and limited operational risks.

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Exhibit 1: Summary of review of tariff orders issued over the last 1-2 years

State	Last tariff / proposed hike %	Comment
Andhra Pradesh	3-4%	▸ Regulator has raised tariff suo-motu without a proposal by power distribution companies (Discoms) to bridge revenue gap for FY12 ▸ Still a revenue gap of INR41bn in FY12; government has agreed to payout a subsidy to cover the amount. ▸ Current aggregate technical and commercial loss level at the 3 Discoms are at c16%; Discoms are being paid a subsidy every quarter
Assam	5.0%	▸ Regulator has regularly issued tariff orders in last ten years, approves marginal tariff hike of 25 paise per unit in FY12 ▸ Marginal revenue gap remains in FY11-12 after proposed hike, which is expected to be offset through operational efficiencies
Bihar	19.0%	▸ Regulator has issued tariff order with a significant 19% tariff hike after a gap of five years ▸ Regulator has created a regulatory asset for the revenue gap (INR2.5bn for FY12), to be recovered from consumers later ▸ Premium tariff as well as time-of-day tariff introduced, similar to other states
Chhattisgarh	14.0%	▸ Regulator has approved an average 14% increase in tariff for FY12, a double digit increase post the FY10 order ▸ Regulator has created a regulatory asset for the revenue gap (INR3.4bn for FY12) to be recovered from consumers later ▸ Regulator has retained time-of-day tariff for high tension and extra-high-tension consumers, also asked to submit a proposal for charging even low-tension consumers
Delhi	22.0%	▸ No major tariff hike in last 3-4 years ▸ All the four Discoms have indicated huge revenue tariff hike (c40-84%) required to meet the revenue gap - **Regulator has allowed 22% increase in FY12**
Gujarat	0.0%	▸ No tariff hike in FY11; 25 paise increase in tariff proposed for FY12 by Discoms, representing a 5.3% increase; **regulator has not allowed any tariff increases**. ▸ Regulator silent about the revenue gap of INR12.2bn in FY11. But Discoms have proposed the creation of a regulatory asset for the INR8.2bn revenue gap in FY12
Haryana	0.4%	▸ Negligible increase in tariff in FY12 (0.4%) resulting in a huge revenue gap of INR10bn despite subsidy of INR34bn booked. ▸ Regulator allows Discoms to borrow money to fund revenue gap and claim interest on the same as pass-through to consumers
Himachal Pradesh	9.7%	▸ **Regulator has allowed tariff hike of c9.7% on average for FY12**
Jammu & Kashmir	17.4%	▸ Annual revenue requirement for FY12 filed with proposal of a significant 41% increase in tariff for FY12. **Regulator has allowed 17.4% increase in FY12.** ▸ Despite this, there is a huge revenue gap of INR24bn in FY12 (INR25bn in FY11); expect financial support from government ▸ Proposal for introduction of time-of-day tariff to manage demand and improve load factor similar to other states
Jharkhand	18.5%	▸ JSEB has proposed a significant tariff hike of 51% in FY12 across all categories of consumers ▸ A revenue gap of INR7.0bn still exists; accumulated revenue gap of INR91bn is proposed to be treated as a regulatory asset to be recovered in the next five years ▸ Regulator has announced an average hike of 18.5% effective 1 August 2011
Karnataka	7.0%	▸ **Regulator has allowed tariff hike of c7.0% on average for FY12 about 30 paise per unit** ▸ Discom had proposed an increase of 88 paise for all except agricultural & BPL consumers, representing 16.7% increase for FY12 ▸ Regulator had approved 25-35pasie tariff hike in FY11 against proposal of 75paise for all except agricultural and below poverty line consumers. Huge revenue gap of INR18bn persists, despite government's INR24bn subsidy for FY11
Madhya Pradesh	6.0%	▸ Regulator has approved an average 6% hike in tariff across all categories of consumers ▸ No revenue gap, unlike others states, exists post tariff hike
Maharashtra	3.0%	▸ **Regulator has allowed tariff hike of 25-80 paise effective November 2011** ▸ Regulator has approved an average 3% hike in tariff across in FY11 for various categories of consumers ▸ No revenue gap, unlike others states, exists post tariff hike
Punjab	9.2%	▸ **Regulator has allowed tariff hike of c9.2% on average for FY12**
Rajasthan	23.0%	▸ **Regulator has allowed 23% increase**. Discoms had proposed for an average 24% increase in tariff in FY12 since the last revision in 2005. ▸ Additional revenue gap of INR62bn exists for FY12 which the Discoms expect to be taken up at the time of true-up [a process of approving the actual expenditure by the regulator]
Tamil Nadu	**ARR filed in Nov 2011** Last hike - 9.0%	▸ **ARR filed in November 2011, significant tariff hike sought by the Discoms.** Last tariff hike was in FY11; prior to this, only one order was issued in 2003, since Tamil Nadu Electricity Board never applied to the regulator for a tariff revision. ▸ Regulator has created a large regulated asset of INR168bn to bridge accumulated shortfall up to FY10 ▸ Regulator expects the regulated asset to increase in the next two years, as the revenue gap continues (estimated at INR175bn in FY11-13) and can be addressed only in the long term
Uttar Pradesh	13.0%	▸ No annual revenue requirement filed since FY10, unlike the other states; last tariff revision was significant (c13% in FY10) ▸ Still a revenue gap of INR2.5bn, which was expected to be met by a government subsidy or bank loan ▸ Revenue gap could be much higher at present; historical data shows cash loss of INR184bn over FY06-09, highest in India
West Bengal	>15%	▸ Significant tariff hike in FY11; a more than 15% increase across all categories ▸ Regulatory asset of INR15.7bn yet to be recovered through tariff hike

Source: Respective state tariff orders, HSBC comments

Note: We note that Kerala has imposed a 25 pasie fuel surcharge for a period of six months from 1 August 2011.

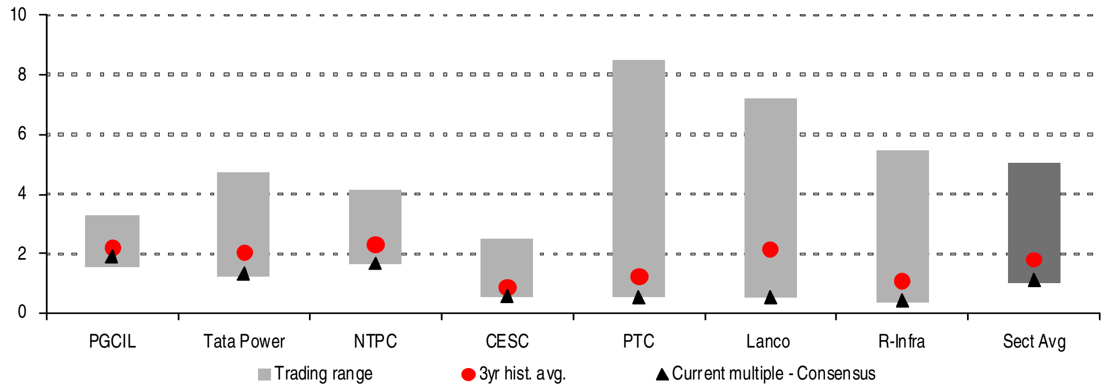
Exhibit 2: Indian Utilities coverage universe and compared to peers

Company	Ticker	CMP INR/sh	TP INR/sh	HSBC rating	Mcap (USDm)	PE FY12e	PE FY13e	Net profit CAGR FY12-13e	PB FY12e	PB FY13e	EV/EBITDA FY12e	EV/EBITDA FY13e
Coverage Universe												
Power Grid	PWGR IN	96	130	OW	7,766	14.6	12.7	16%	1.9	1.7	10.3	9.5
Tata Power	TPWR IN	92	118	N(V)	4,193	10.6	8.9	21%	1.4	1.3	7.4	6.0
PTC India	PTCIN IN	46	90	OW	261	7.1	5.4	23%	0.5	0.5	9.0	6.7
CESC	CESC IN	275	475	OW	657	9.7	5.0	51%	0.7	0.6	10.1	6.5
NTPC	NTPC IN	157	194	N	24,763	14.1	12.7	6%	1.8	1.6	11.4	10.3
Lanco Infra	LANCI IN	12	14	N(V)	548	10.9	7.1	-5%	0.6	0.5	10.3	7.4
Average – weighted						**13.2**	**11.7**	**11%**	**1.6**	**1.5**	**10.7**	**9.5**
Other Competitors												
Adani Power	ADANI IN	73	NA	NR	3,042	7.3	6.1	110%	1.6	1.3	7.4	6.5
JPVL	JPVL IN	34	NA	NR	1,387	11.6	5.9	108%	1.3	1.1	11.0	NA
NHPC	NHPC IN	23	NA	NR	5,380	11.5	10.6	2%	0.9	0.9	9.1	7.5
Reliance Power	RPWR IN	88	NA	NR	4,730	18.3	12.9	31%	1.3	1.2	20.5	15.3
JSW Energy	JSW IN	42	NA	NR	1,326	8.5	8.6	-2%	1.0	0.9	6.3	6.2
KSK Energy	KSK IN	56	NA	NR	394	7.1	NA	27%	0.6	NA	8.8	NA
Total Average – weighted						**13.0**	**11.2**	**20%**	**1.5**	**1.4**	**11.1**	**9.6**

HSBC ratings: OW = Overweight, N = Neutral, UW = Underweight, V = Volatile

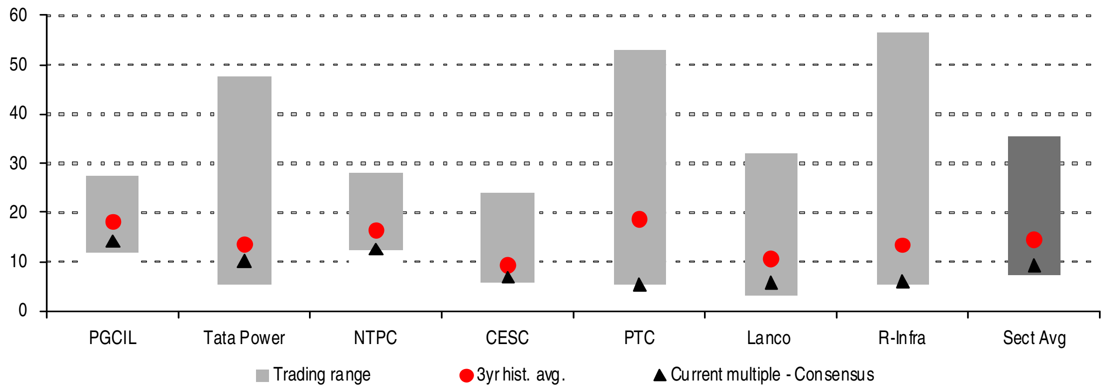
Source: HSBC estimates, Reuters for non-rated stocks, Pricing as at close of 28 November 2011

Exhibit 3: PB range candle chart - stocks trading well below historical range



Source: Thomson Reuters Datastream, Pricing as at close of 28 November 2011

Exhibit 4: PE range candle chart - stocks trading well below historical range



Source: Thomson Reuters Datastream, Pricing as at close of 28 November 2011

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Power Grid (PWGR IN, OW, CMP INR95.2, TP INR130)

Given our preference for the transmission segment, Power Grid, the largest transmission company in India, is our preferred pick. The stock has been resilient in the power space and has delivered better than expected performance in the 1H on all fronts mainly the capacity addition which is key driver for the stock. We expect the regulated equity base to grow at 22% CAGR from cINR141bn in 1H to cINR232bn by end-FY14, which drives our expectation of net profit growth of 15.5% CAGR over FY12-14 from a high base in FY11. We do not see any significant downside risks to these earnings estimates, given the assured return model.

Valuation and risks

We use DCF to value Power Grid and apply a cost of equity of 11.8% and terminal growth rate of 3% to derive our target price of INR130 per share. Our target price implies a FY13e PB of 2.3x versus the current FY12e PB of 1.9x, and an FY13e PE of 17.2x versus the current FY12e PE of 14.4x.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5 ppts above and below the hurdle rate for Indian stocks of 11%. At the time we set our target price, it implied a potential return including dividends that was above the Neutral band; therefore, we rate the stock Overweight. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Key downside risks include longer-than-expected delays in commissioning of projects. Other risks include a potential default by SEB and a reduction in regulated returns, although both look highly improbable in the immediate future.

Exhibit 5: PGCIL: Valuation summary

Particulars	INRm	INR/Share
Equity value - Core	550,937	119
Add: Cash & bank	40,256	9
Add: Investments	11,032	2
Equity value - Total	**602,225**	**130**

Source: HSBC estimates

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Share price and rating changes for long-term investment opportunities

Power Grid Corp Of India (PGRD.BO) Share Price performance INR Vs HSBC rating history

Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight	14 January 2011
Target Price	**Value**	**Date**
Price 1	130.00	14 January 2011

Source: HSBC

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