

# Regulatory Uncertainty Hit FY07 But Recovery Ahead

## FY07: Regulatory hit of FY07 is set to reverse

Reliance Energy's (REL) FY07 Rec. PAT at Rs7.5bn (+2.7%YoY) was 5% below MLE, mainly on Rs2.6bn write-off taken to accommodate disallowed expenses for previous years, as per the MERC order. We maintain our Buy as the stock offers potential growth on privatization of the power sector & value – cash of Rs286/share (55% of share price) & 12.8x FY08E EPS. However, the stock may move sideways till it concludes gas supply agreement with Reliance Industries.

## Regulatory business likely to get its acts together in FY08E

REL wrote off Rs2.64bn of past expenses disallowed by MERC. However, REL's petition against the MERC order disallowing expenses has now been upheld by Appellate Tribunal of Electricity (ATE) on April 4, 2007. With this MERC has now allowed recovery of Rs2.64bn written off in FY07 over FY08-10. With this, REL would recover Rs880mn in FY08E as per MERC. This should not only improve profitability of the operations but also help secure future profitability.

## Revenue Up 42% YoY Led By E&C Business

REL registered 42.4%YoY sales growth in FY07, primarily driven by 147.8%YoY rise in sales of EPC business (37% of sales) – to reach Rs20.8bn. Power business revenues were up 14.3%YoY led by 8.4%YoY volume growth to 8.8bu.

## Operating profits dip by 32.6%YoY due to prior-period items

Write-off of past claims disallowed by MERC, deferring Rs2.6bn and fall in EPC EBIT margins by 819bps to 5.9% led to EBITDA decline of 32.6%YoY to Rs4.8bn. Further, despite a higher effective tax rate of 14% (vs 6.5% in FY06), REL registered Rec. PAT growth of 2.7%YoY, primarily led by +45%YoY growth in other income earned on the ~Rs80bn of cash pile.

## Key potential triggers ahead, in our view, are

- REL/Reliance Natural Resources concluding gas purchase contract with RIL
- Start rapid construction of now up-rated 5600 MW Dadri (UP) & other coal/Hydro power projects & expand generation/acquire distribution franchise.
- Improve visibility on infra SPVs like Metro rail (Rs22bn) and roads (Rs28bn).

## We maintain our Buy rating on REL based on:

Expansion in its distribution franchise & generation outside Mumbai and reduction in T&D losses at its Delhi JVs – BSES Rajdhani (29.9%); BSES Yamuna (39.1%). Our 12-month PO of Rs730 is based on its sum-of-parts valuation. At Rs730, the stock implies a P/E of 17.7x and an EV/EBITDA of 13.6x (FY09E).

Equity | India | Electric Utilities  
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# Merrill Lynch

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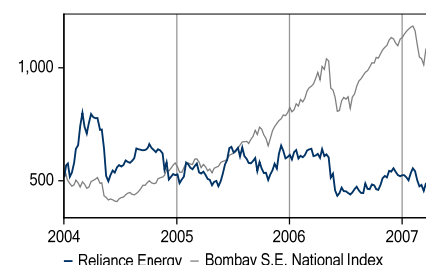
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## Stock Data

Price (Common / GDR)	Rs517.35 / US\$36.03
Price Objective	Rs730.00 / US\$50.00
Date Established	18-Jan-2006 / 18-Jan-2006
Investment Opinion	C-1-7 / C-1-7
Volatility Risk	HIGH / HIGH
ML Symbol / Exchange	RCTDF / BSE
ML Symbol / Exchange	RELFF / LIN
Bloomberg / Reuters	RELE IN / RLEN.BO



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Refer to important disclosures on page 4 to 6. Analyst Certification on page 2. Price Objective Basis/Risk on page 2.

**Table 1: Reliance Energy - 4QFY07 and FY07 Results Review**

(Rs mn)	4QFY06	4QFY07	% YoY	FY06	FY07	% YoY
Sales Volume (MU)	2,007	2,129	6.1%	8,087	8,766	8.4%
Net Sale of Electrical Energy	7,749	8,849	14.2%	31,582	36,110	14.3%
Income from EPC	2,671	7,294	173.1%	8,400	20,820	147.8%
<b>Total Income</b>	<b>10,421</b>	<b>16,143</b>	<b>54.9%</b>	<b>39,982</b>	<b>56,930</b>	<b>42.4%</b>
Cost of Purchases	2,527	4,285	69.6%	10,876	15,324	40.9%
% of electricity sales	32.6%	48.4%		34.4%	42.4%	
Cost of Fuel	2,096	2,480	18.4%	8,121	9,213	13.4%
% of electricity sales	27.0%	28.0%		25.7%	25.5%	
Materials & Direct expenses	2,116	6,471	205.9%	6,086	18,406	202.4%
% of EPC Income	79%	89%		72%	88%	
Surcharge on Generation	273	295	8.3%	1,140	1,246	9.3%
% of electricity sales	3.5%	3.3%		3.6%	3.5%	
Staff Cost	428	967	125.6%	2,366	3,135	32.5%
% of total sales	4.1%	6.0%		5.9%	5.5%	
Other Expenses	1,041	1,046	0.5%	4,271	4,800	12.4%
% of total sales	10.0%	6.5%		10.7%	8.4%	
<b>Total Expenditure</b>	<b>8,480</b>	<b>15,545</b>	<b>83.3%</b>	<b>32,859</b>	<b>52,125</b>	<b>58.6%</b>
<b>EBITDA</b>	<b>1,940</b>	<b>598</b>	<b>-69.2%</b>	<b>7,123</b>	<b>4,805</b>	<b>-32.6%</b>
<b>% margin</b>	<b>18.6%</b>	<b>3.7%</b>		<b>17.8%</b>	<b>8.4%</b>	
Interest	(477)	(823)	72.4%	(1,919)	(2,503)	30.5%
Depreciation	(891)	(535)	-40.0%	(3,486)	(2,401)	-31.1%
Other Income	1,824	2,754	51.0%	6,097	8,823	44.7%
<b>PBT</b>	<b>2,396</b>	<b>1,994</b>	<b>-16.7%</b>	<b>7,815</b>	<b>8,724</b>	<b>11.6%</b>
Provision for Taxation	(106)	(146)		(856)	(902)	
Provision for deferred Tax	218	9		393	(272)	
Fringe Benefit Tax	(7)	(10)		(43)	(48)	
<b>Recurring PAT</b>	<b>2,500</b>	<b>1,848</b>	<b>-26.1%</b>	<b>7,309</b>	<b>7,503</b>	<b>2.7%</b>
<b>Recurring PAT margin</b>	<b>24.0%</b>	<b>11.4%</b>		<b>18.3%</b>	<b>13.2%</b>	
Exceptional	(806)	527		(805)	512	
<b>Reported PAT</b>	<b>1,695</b>	<b>2,374</b>	<b>40.1%</b>	<b>6,504</b>	<b>8,015</b>	<b>23.2%</b>

Source: Company

## Price Objective Basis & Risk

Our 12-month PO of Rs730 is based on its sum-of-parts valuation. At Rs730, the stock implies a P/E of 17.7x and an EV/EBITDA of 13.6x (FY09E). **Risks:** Ability to source quality power/viable gas supply and discontinuity/delay of power sector reforms.

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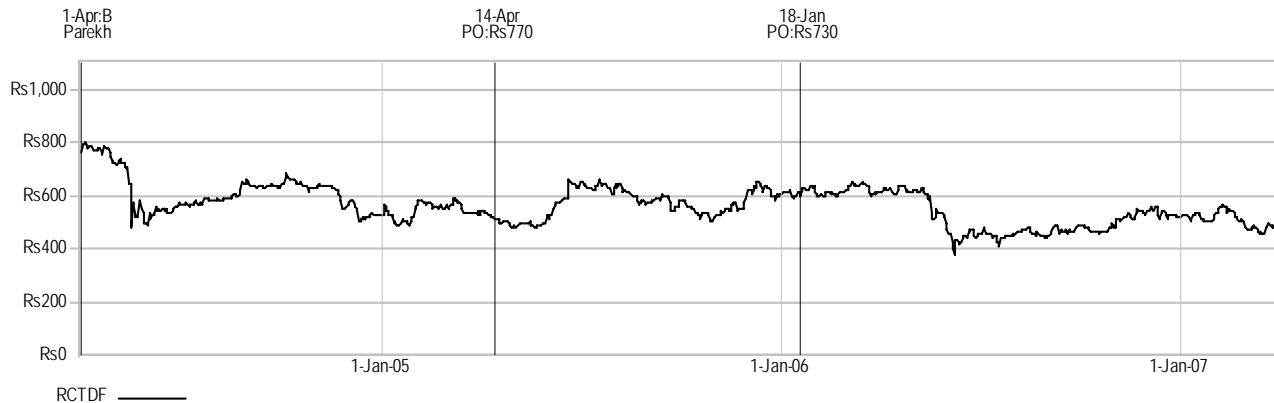
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27 April 2007

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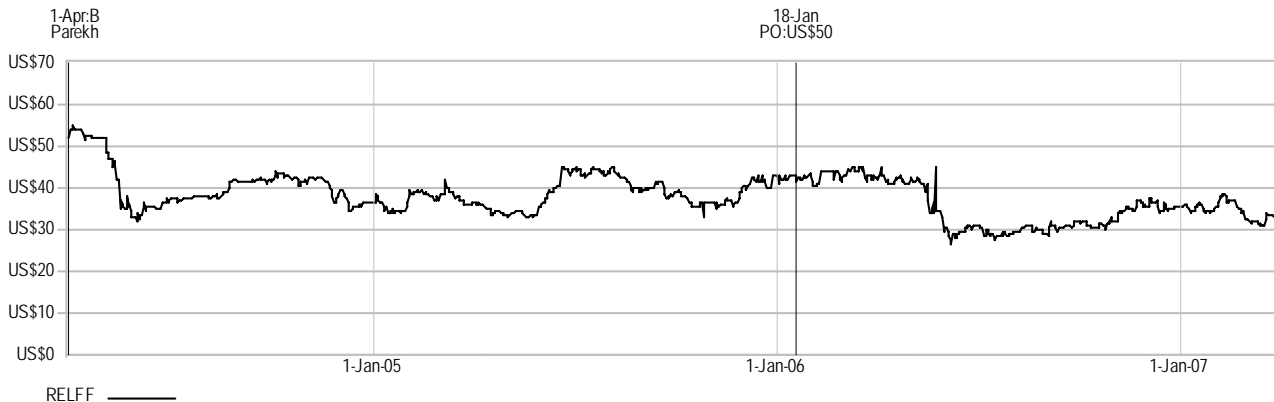
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B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

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### RELFF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	62	37.35%	Buy	19	37.25%
Neutral	89	53.61%	Neutral	39	51.32%
Sell	15	9.04%	Sell	2	14.29%

### Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

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