BUY

14th September, 2009

Key Data	(INR)
CMP	195
Target Price	243

Key Data	
Bloomberg Code	RECL IN
Reuters Code	RURL.BO
BSE Code	532955
NSE Code	RECLTD
Face Value (INR)	10
Market Cap. (INR bn.)	168
52 Week High (INR)	225
52 Week Low (INR)	54
Avg. Daily Volume (6m)	1581558
F&O	
Market Lot	1950
Turnover (Rs Mn)	117.2

Shareholding	%
Promoters	81.8
Mutual Funds / Bank/ FI	7.3
Foreign Institutional Investors	4.6
Insurance Companies	0.7
Bodies Corporate/Individuals/ others	5.6
Total	100.0

	FY09	FY10E	FY11E
Net Interest Income	18,698.2	22,187.1	27,137.4
Operating Income	20,439.3	24,480.5	29,936.5
Net Profit	12,720.7	15,197.4	18,682.2
Net interest margins	4.0%	3.7%	3.5%
EPS (Rs.)	14.8	15.4	18.9
Book value (Rs.)	72.1	98.0	110.3

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Rural Electrification Corporation Limited

We initiate coverage on Rural Electrification Corporation (REC) with a "BUY" recommendation and a target price of INR243 (12.8x PE of INR18.9 for FY11E). REC, a wholly owned public sector company, finances and promotes rural electrification projects across the country. Our recommendation is underpinned by REC's robust prospects, given its mandate of financing power projects and India's ever-growing demand for power. Moreover, strong government support helps REC secure a good credit rating and thereby access low-cost funding. Furthermore, a major portion of its loans is protected by a default "escrow" mechanism, shielding it from customer delays or defaults. At a CMP of INR195, the stock trades at PE of 12.7x its EPS of INR15.4 for FY10E and 10.3x its EPS of INR18.9 for FY11E.

Recommendation Rationale

- **Massive funding requirements in the power sector**

The Working group on Power has estimated that an investment of about INR10, 000 billion will be needed to meet the capacity addition requirement during XI Plan. Out of the total fund requirement, the state and the central utilities, which will mainly comprise REC's clients, will accounts for almost 79% of the investment. The funding for the various projects can take the form of either own capital or borrowed funds. Given a debt-equity mix of 70:30 in the power sector, ~INR7, 000 billion will be required to fund power projects. Apart from banks, Power Finance Corporation (PFC) and REC are the major financers in the power sector. Although REC's is a non-banking finance company (NBFC), the GoI mandate gives it a monopoly status along with PFC, given its critical role in India's growth agenda. We expect these companies to benefit from the expected investments.

- **REC's cost of funds is competitive**

Being a GoI company, REC is allowed to issue capital gains bonds. Apart from REC, only NHAI is allowed to issue such bonds. Since these bonds are subject to tax concessions, REC is able to price such bonds at a lower rate of interest. This enables REC to maintain a lower cost of funds and higher spread, compared with peers. The sovereign credit rating signifies low perceived risk in bonds issued by REC, which further aids in maintaining low cost of funds.

- **Gap between sanction and disbursement widening**

As on March 2009, REC's cumulative sanctions were INR2047 billion, whereas cumulative disbursements were INR924 billion. Given the gap between sanctions and disbursals and the new funding requirements, REC has substantial room to increase advances even without fresh sanctions. For FY10, REC has targeted disbursement of INR2,30,000 million. Going forward, we expect REC's loan book to grow at 27.6% CAGR during FY09-11.

Valuation and Recommendation

In the past five years (FY05-09), CAGR of total sanctions for REC was 25% while that for disbursement was 23%. The company's five-year CAGR for loan assets was 25%. With the gap between sanctions and disbursements widening, we believe that REC has substantial room to increase advances, even without fresh sanctions.

Further, the advantage of issuing low cost capital gain bonds has enabled REC to maintain higher spreads. However, with the proportion of capital gain bonds declining, we expect pressure on spreads; nevertheless, repricing of loans will provide some cushion. We expect REC's earnings CAGR to be 21.2% for FY09-11 and net interest income (NII) CAGR to be 20.5%. We assume loan CAGR of 27.6% for FY09-11, owing to the huge funding requirements of the power sector.

At a CMP of INR195, the stock trades at PE of 12.7x its EPS of INR15.4 for FY10E and 10.3x its EPS of INR18.9 for FY11E. We initiate coverage on Rural Electrification Corporation (REC) with a "BUY" recommendation and a target price of INR243 (12.8x PE of INR18.9 for FY11E).

Investment Thesis

The power sector is expected to see generation capacity addition of 78,700 MW during the eleventh five-year plan, which will entail investment of INR10,000 billion. We expect REC to be a major beneficiary of this, given GoI mandate of funding power projects in India.

Favorable exposure norms, low cost of funds, ability to lend for a high tenure of more than 10 years, extensive experience and knowledge in Indian power sector finance and well-developed relationships with clients give REC a distinct edge over other lenders.

Further, REC is diversifying its portfolio toward generation projects. We believe this enhances the company's potential to expand its loan book. With the gap between sanctions and disbursements widening, we believe that REC has substantial room to increase advances, even without fresh sanctions. We expects loan CAGR of 27.6% for FY09-11. We expect REC's earnings CAGR to be 21.2% for FY09-11 and net interest income (NII) CAGR to be 20.5%.

We initiate coverage on Rural Electrifciation Corporation (REC) with a "BUY" recommendation underpinned by its robust prospects, given its mandate of financing power projects and India's ever-growing demand for power. Moreover, strong government support helps REC secure a good credit rating and thereby access low-cost funding. Furthermore, a major portion of its loans is protected by a default "escrow" mechanism, shielding it from delays or defaults.

Target capacity addition of 78,577 MW in the eleventh five year plan stipulates power for all by 2012

Inadequate T & D infrastructure has resulted in high T&D losses in India

Industry

Capacity addition envisaged in the eleventh five-year plan (2007-2012)

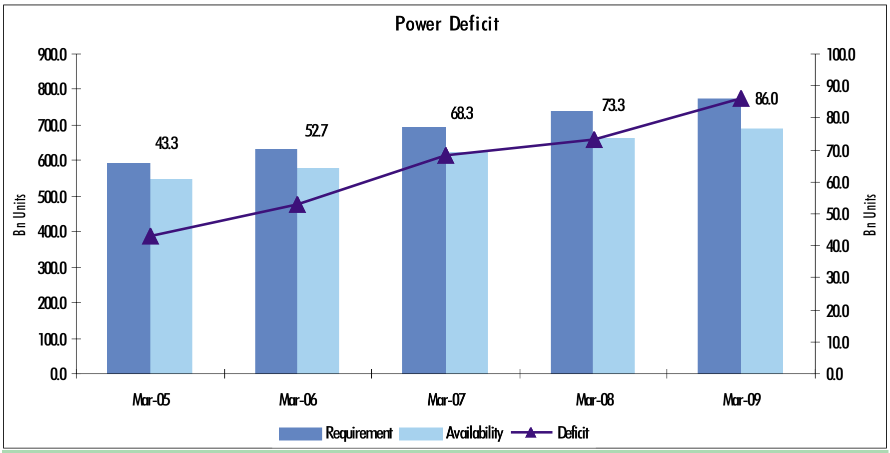
The government set a target capacity addition of 78,577 MW for the eleventh five-year plan. This target aims to meet the increasing power shortages, and the objectives of National Electricity Policy (NEP) that stipulates power for all by 2012 and increase in annual per capita consumption of electricity to 1000 units. The break up of capacity addition for the eleventh five-year Plan is as under:

Sector	Hydro	Thermal	Nuclear	Total (MW)
Central	9,685	26,800	3,380	39,865 (50.7%)
State	3,605	24,347	0	27,952 (35.5%)
Private	3,263	7,497	0	10,760 (13.8%)
Total	16,553 (21.0%)	58,644 (74.6%)	3,380 (4.4%)	78,577 (100%)

Source: Ministry of Power Annual report

Power Deficit in India

High Demand and less-than-expected capacity additions have aggravated the power deficit in India. Energy shortage has increased from 43 billion units (7.3% of the requirement) in March 2005 to 86 billion units (11.1% of the requirement) in March 2009.



Source: CEA

The main reasons for the demand supply mismatch are

- Capacity additions are not meeting plan targets.

Planned versus actual capacity additions			
In MW	Eight plan	Ninth Plan	Tenth Plan
Planned	30,538	40,245	41,110
Actual	16,423	19,015	21,180
Actual % of Planned	54%	47%	52%

Source: CEA

- T&D losses are high.

Year	T&D Losses	AT& C Losses
FY04	32.53	34.78
FY05	31.25	34.33
FY06	30.42	34.54
FY07	28.61	32.07
FY08	26.91	NA

Source: CEA

Development of power Transmission and Distribution (T&D) infrastructure is carried out in tandem with growth in generation capacities. However inadequate T & D infrastructure has resulted in high T&D losses in India. As per a report of the 'Working Group on Power for 11th Plan', a 1% reduction in T&D losses will lead to savings of INR7 billion–INR8 billion and a 10% reduction in the loss will release energy equivalent to an additional capacity of 10,000–12,000MW.

To reduce these losses and strengthen the T&D infrastructure, the government has taken a number of initiatives

- Creation of National Grid linking the power surplus regions to deficit regions.
- Introduction of the Accelerated Power Development and Reforms Program (APDRP), which aims to reduce distribution losses
- Introduction of the Rajiv Gandhi GraminVidyutikaran Yojna aimed at rural electrification and improvement of rural infrastructure in the country.

Accelerated Power Development and Reforms Programme

In FY03, the GoI implemented APDRP to expedite distribution reforms. The reforms aim to: improve financial viability of state power utilities; reduce aggregate technical and commercial losses; improve customer satisfaction; and increase the reliability and quality of the power supply by reducing outages and interruptions.

The APDRP was restructured in the eleventh Plan. The focus of the recently approved Restructured APDRP (R-APDRP) in the eleventh Plan and beyond is on actual, demonstrable performance in terms of loss reduction. The ARDRP will be implemented in two parts. Part A will cover IT application in the distribution sector and Part B will cover system improvement, strengthening, and augmentation.

Under APDRP, GoI provides funds to states that have committed to a time-bound reforms program ***(Annexure 1)***. Funds are provided through a combination of grant and loan. REC and PFC are the nodal agencies for implementing APDRP II. Hence, they will benefit by providing loans and financial assistance under this plan. Under the restructured ARDRP, the total program size is about INR 500 billion, of which INR400 billion relates to Part B Projects. Of this INR400 billion, the government will provide 50% as grant and the 50% can be availed as loan. Both REC and PFC would be sharing the remaining 50% loan sanctions.

Rajiv Gandhi GraminVidyutikaran Yojna

In Fiscal 2006, the GoI launched the RGGVY, which primarily aims at electrification of all villages and access to electricity to all rural households in India. REC is the nodal agency for implementation of the scheme and is responsible for complete oversight of the programme from conception to completion. Under RGGVY, GoI provides subsidies in the form of grants, which are channeled through REC, for 90% of the funding required for projects falling within the purview of the scheme. The remaining 10% is also provided as loans by REC at concessional rates. Both the grants and the loans are disbursed in instalments. In addition, REC is also entitled to 1% commission of the total disbursements.

“REC is the nodal agency for RGGVY”

In FY10, total disbursement expected under RGGVY is around INR77, 000 million of which REC is expected finance around INR7, 000 million worth loans and the balance will be funded by GoI.

> INR10,000 billion investments in power sector expected during the eleventh plan

> Generation capacity aggregating to 80,610 MW is under execution during the eleventh Plan

Funds requirements in the power sector during eleventh plan (2007-2012)

The Working group on Power has estimated that an investment of about INR10, 000 billion will be needed to meet the capacity additions requirement during the eleventh plan of which ~INR 4,100 billion will be required for generation projects, ~INR1, 400 billion for transmission projects, and ~INR2,900 billion for distribution projects.

INR Billion	State	Central	Private	Total
Generation	1237.9	2020.7	850.4	4109.0
Transmission	650.0	750.0	0.0	1400.0
Distribution	2870.0	0.0	0.0	2870.0
Captive	225.0	0.0	930.0	1155.0
Merchant Power Plant	0.0	0.0	400.0	400.0
Others	158.8	223.3	0.0	382.0
Total Funds Required	5141.7	2994.0	2180.4	10316.0

Source: Working Group Report on Power

Of the total fund requirement, the state and the central utilities, REC's main clients, will account for almost 79% of investment. The funding can be either own capital or borrowed funds. At present, the debt-equity mix in the sector 70:30. Based on this ratio, total debt required would be ~INR7, 000 billion. Apart from banks, PFC and REC are the major financers in the power sector. Therefore we expect these companies to benefit from the expected investments.

Eleventh Plan status

According to the latest assessment of the Central Electricity Authority (CEA), as against planned capacity addition of 78,700 MW, generating capacity aggregating to 80,610 MW is under execution during the eleventh Plan.

- 15,036 MW (18.7%) capacity already commissioned till date
- 65,574 MW (81.3%) under construction (i.e. orders have been placed and work is in progress)
- 12,000 MW Captive Power Plants under execution, against 2700 MW already commissioned
- 5482 MW of the target of 14,000 MW from renewables commissioned as on March 2009
- Coal linkages provided to all thermal projects. (Capacity of 14,507 MW is scheduled for commissioning during 2009-10).

Besides these, projects aggregating to 26,640 MW capacity planned for commissioning during the Twelfth Five Year Plan are also under execution.

Company Background

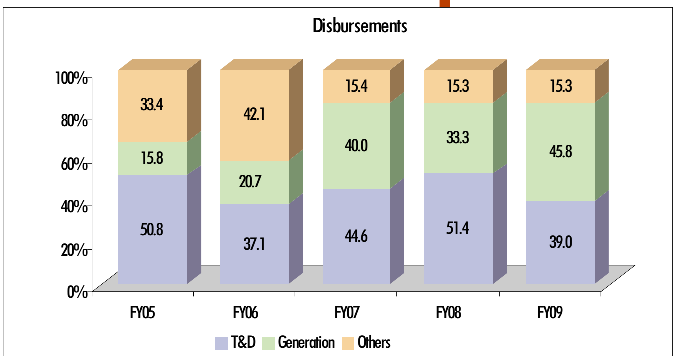
Rural Electrification Corporation (REC), a wholly-owned public sector enterprise, was incorporated on July 25, 1969. The company's main objective is to finance and promote rural electrification projects across the country. REC provides financial assistance to State Electricity Boards (SEBs), State Government Departments, and Rural Electric Cooperatives for rural electrification projects sponsored by them. However, with increasing requirements for meeting power demand in the country, the mandate of the company has evolved in accordance with the development priorities of the (Government of India) GoI. REC now provides finance to all segments of the power sector.

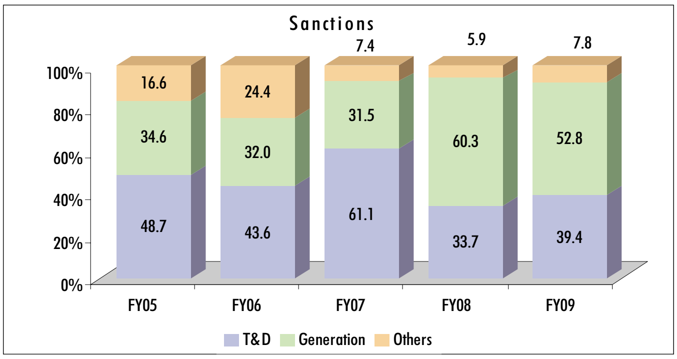
Favorable exposure norms, low cost of funds, ability to lend for a high tenure of more than 10 years, extensive experience and knowledge in Indian power sector finance and well-developed relationships with clients give REC a distinct edge over other lenders. Furthermore, a major portion of its loans is protected by a default "escrow" mechanism, shielding it from delays or defaults.

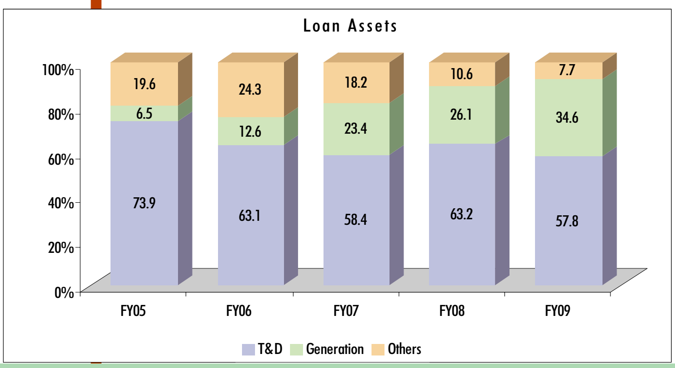
REC's Loan Book

"Sanction mix shifting towards generation projects"

In the past five years (FY05-09) REC's total sanctions grew at 25% CAGR and its disbursement grew at 23% CAGR. REC's loan assets grew at a five-year CAGR of 25%. Its loan asset is highly skewed toward T&D, which comprises 58%, followed by power generation and others with 35% and 7% respectively. This is mainly because the company originally started with the objective of financing T&D projects. However, due to increased financing requirements for generation projects, REC shifted its focus to generation projects. This is clearly visible in the shift in its sanction mix toward generation projects.



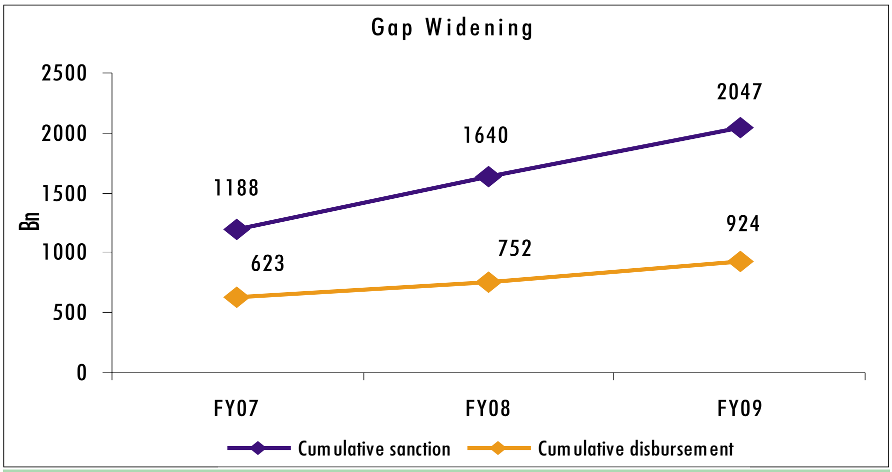




Source: Company, ACMIIL Research

In terms of borrower profile, state sector comprises 85% followed by central with 9% and private sector with 6%.

Wide gap between sanction and disbursals provide strong loan visibility



Source: Company, ACMIIL Research

As on March 2009, REC's cumulative sanctions were INR2047 billion, whereas cumulative disbursements were INR924 billion. Given the gap between sanctions and disbursals and the new funding requirements, REC has substantial room to increase advances even without fresh sanctions. For FY10, REC has targeted disbursement of INR2,30,000 million. Going forward, we expect REC's loan book to grow at 27.6% CAGR during FY09-11.

Borrowing Profile

For funding its loans, REC depends on bonds, loans from financial institutions, and overseas borrowings. Being a GoI company, REC has been able to access funds at a lower cost. Further REC has the highest domestic credit rating for its long-term borrowings from each of the domestic credit agencies and its international long-term credit ratings from Moody's and Fitch are on par with India's sovereign ratings. This further enables REC to raise funds at favourable rates.

The most important advantage enjoyed by REC is that, being a GoI company, REC is allowed to issue capital gains bonds. Apart from REC, only NHAI is allowed to issue such bonds. Since these bonds are subject to tax concessions, REC is able to price such bonds at a lower rate of interest. This enables REC to maintain a lower cost of funds and higher spread, compared with peers.

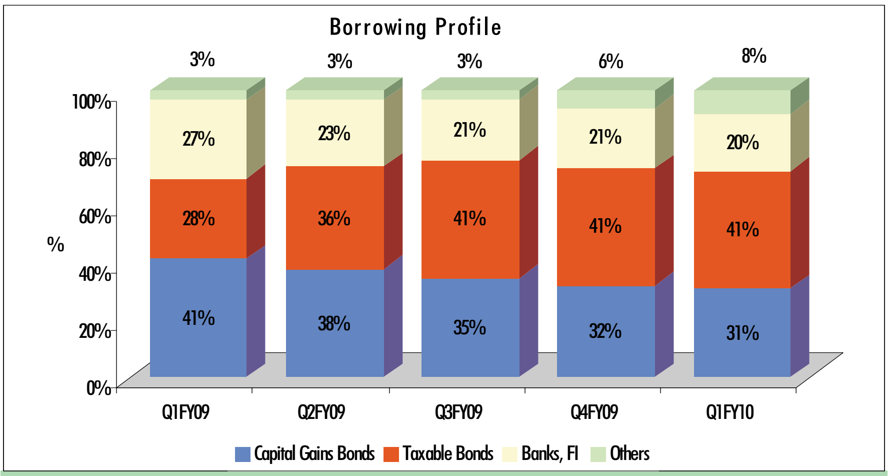
Low-coupon capital gains tax saving bonds enable REC to maintain low cost of funds

Average Coupon Rate	2009
Tax Free bonds	7.68%
Taxable bonds	9.40%
Capital Gains Bonds	5.52%
Infrastructure bonds	5.43%
SLR bonds	10.84%

Source: ACMIIL Research

However, the proportion of capital gains bonds in total borrowings is declining. Moreover, since majority of these bonds are due for repayment in the next three years, we expect that this would impact the weighted average cost of funds (WACC), depressing the spreads.

> Share of low-cost capital gains bonds declining, putting pressure on cost of funds



Source: Company, ACMIIL Research

Net Interest Margins (NIMs)

REC's NIMs have improved from 3.23% in 1Q FY08 to 4.42% in 1Q FY10 despite increase in cost of funds. With reduction in low cost capital gains bonds, the cost of funds has increased from 6.40% in 1Q FY08 to 7.61% in 1Q FY10. The improvement in NIMs is attributable to repricing of loans at higher rates.

Bonds comprise 70% of the loans and they have fixed coupon rate. Moreover, the new bonds issues in previous year have higher coupon rates. The management has indicated that bonds having average coupon of 8% are replacing capital gains bonds having coupon of 5.5%. This, along with reduction in the proportion of capital gains bonds, will impact REC's WACC.

> Reset of loans in FY10 to offset the rise in cost of funds to some extent

Average Coupon Rate	2008	2009
Tax Free bonds	7.68%	7.68%
Taxable bonds	7.63%	9.40%
Capital Gains Bonds	5.43%	5.52%
Infrastructure bonds	5.43%	5.43%
SLR bonds	10.84%	10.84%

However, loans of INR78 billion (15.4% of the loan book as of FY09), which were disbursed at average rate of 9.5%, are expected to come up for being reset in FY10 and the management expects loans to be reset at about 11-11.5%. In FY11, INR90 billion worth loans (~20%+ of existing loan book) that were disbursed at average rate of 10.5% are expected to be reset. Such resets would provide cushion to some extent against the rise in cost of funds. Therefore, we expect the spreads to slightly reduce to 2.9% in FY10 and FY11 from 3.1% in FY09.

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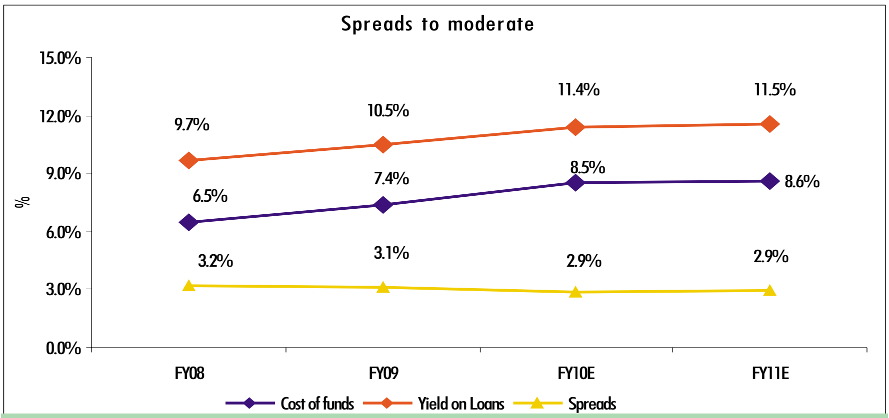


Source: Company, ACMIIL Research

Asset Quality

REC's asset quality has remained robust with net NPA's being below 1%. Gross NPA's has declined from INR6.6 billion in FY05 to INR690 million in FY09. Net NPAs declined from INR2.1 billion in FY05 to INR210 million in FY09.

State-wise outstanding	2008-09	% To total
Andhra Pradesh	70900.6	14%
Rajasthan	66433.5	13%
Maharashtra	56712.1	11%
Tamil Nadu	45941.1	9%
Punjab	40644	8%
Source: Annual report 2008-09		

"Asset quality improving"

REC's aggregate loans outstanding to SEBs constitute over 85% of total loans. Within SEBs, bulk of REC's exposures are to better performing entities. REC's largest clients are the power utilities of Andhra Pradesh, Rajasthan, Maharashtra, and Tamil Nadu.

According to CRISIL, the only states that reported profits in 2006-07 were Orissa, Delhi, Himachal Pradesh, Kerala, Pondicherry, Chhattisgarh, Goa and Maharashtra. These states have done well in covering costs through revenue. States such as Delhi, Andhra Pradesh, Uttar Pradesh, Haryana and Karnataka have also shown improved performance.

In a report dated June 2006, CRISIL and ICRA, at the instance of the Ministry of Power (MoP), Government of India carried out a performance rating of the state power sector across all states based primarily on data obtained till December 2005. According to the report, Andhra Pradesh was rated the best performing state in the power sector in 2005-06, followed by Gujarat and Delhi.

Further, while current NPAs are below 1%, any future changes in regulations or accounting policies could cause an increase in NPAs. Consequently, from the earlier approach of lending primarily for T&D projects and to SEBs, REC plans to diversify its portfolio to generation and private sector players. This shift will assist REC to (i) diversify its portfolio away from SEBs; and (ii) increase exposure to financially stronger private sector players. In addition, REC has well-established mechanisms including escrow covers and guarantees to improve asset quality.

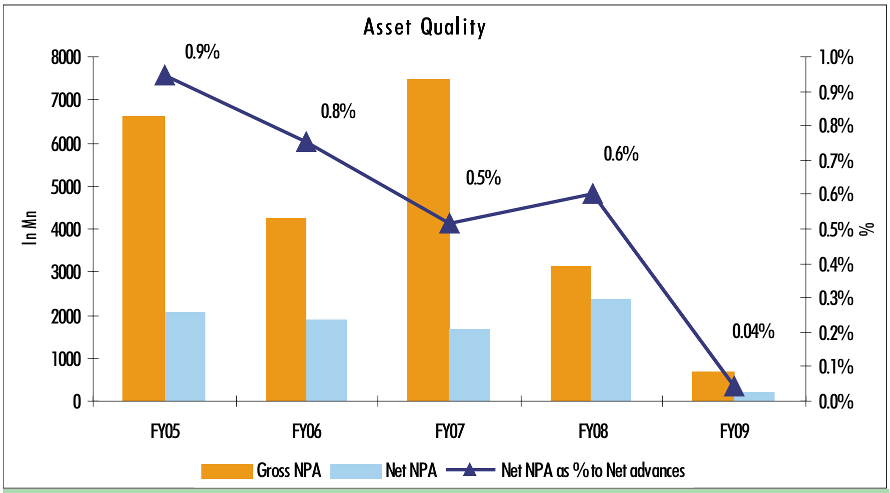
Escrow Mechanism

At present, 70% of loans given by REC are backed by default escrow accounts. Under this mechanism, certain predetermined amounts from the payments received by SEBs from their respective customers are deposited in an escrow account pursuant to a tripartite escrow agreement between REC, the SEBs and an escrow agent (the bank). The deposited amount is available to the SEBs except in case of a default due to non-payment of dues. In such cases, the escrow agent makes the default amount available to REC on demand.

Further, the other parameters that REC considers while lending to projects include

- A minimum 12% internal rate of return
- Promoter capability
- Manpower
- Clearances from state and central agencies
- Land clearance
- Tie-ups for fuel supply.

"Escrow" mechanism helps shield loans from customer delays or defaults



Source: Company, ACMIIL Research

"Capital raising to enhance lending capacity"

Capital Raising

The company is mulling raising INR25 billion in FY10.This could be either through a QIP or a follow on public offer. The company has written to the Minister of Power seeking approvals for the same. The government is also considering divesting 5% stake in REC, therefore fresh issue would then constitute 15% of the paid up capital. The money will be used for disbursement of loans sanctioned for power projects.

We have assumed a 15% dilution for REC in our projections. Therefore the company will issue 128.8 million new shares to raise INR25 billion.

Deferred Tax Liability Adjustment

REC is eligible for tax exemption on profits under section 36(1) (viii) of the Income Tax Act. If REC transfers 20% of its profits earned from long-term infrastructure lending to a special reserve, then the amount transferred is tax exempt, the condition being that the reserves should not be utilized.

Until 2005-06, REC did not provide for deferred tax liability (DTL) for the special reserve created. However, ICAI's Expert Advisory Committee held that a deferred tax liability needs to be created because such companies could utilize the reserves in the future, which could lead to a reversal of the tax benefits already availed.

REC started creating a provision for deferred tax liability on the special reserve created. Thus REC's effective tax rate is 34%. Housing finance companies are also eligible for a similar deduction; however these companies do not create DTL for the special reserve. In line with the same, PFC has also done away with the deferred tax provisioning policy and has considered accumulated DTL as part of its net worth. However, REC has not taken a decision on the same. We have factored in both these scenarios in our projections.

Key Concerns

- **Asset liability mismatch**

INR Mn		Repayment Due by period			
Obligation	Outstanding as on FY09	Within one year (FY10)	1-3 years (FY11 & FY12)	3-5 years (FY13 & FY14)	More than 5 years beyond FY14
Taxable, Tax free and SLR bonds	182184	5669	42314	45176	89025
Capital gains Bonds	143943	31620	112323	0	0
Infrastructure Bonds	188	146	42	0	0
Secured Term loans	20533	4849	10585	4335	764
LIC loans	33500	1500	7000	7000	18000
ECB & Foreign Borrowings	14937	-	-	8702.6	6234.2
Unsecured Term loans	40478				
GOI Loan	647				
Commercial paper	12950				

Source: Company, ACMIIL research

Typically, REC funds projects with duration of ten years or more, whereas its borrowings have duration of much lower than ten years. The above is repayment schedule of 85% of the liabilities. The schedule suggests that out of the 85% of the borrowings, almost 60% of the borrowings (48% of the total borrowings) are due for repayment in the next three years. A larger portion of capital gains bonds is due for repayment. As a result, REC's loan book is always exposed to ALM mismatches.

- **Interest rate risk**

REC is also exposed to interest rate risks with most of its loan assets being contracted at relatively longer tenures compared with its borrowings. While in the past REC's loans carried a ten-year reset clause, at present 70% of loans have a three-year reset clause, which should protect REC to an extent from re-pricing risks.

- **Delays in Execution of power projects**

India's power sector has always been exposed to delays in execution as witnessed in the past. In power financing, the conversion of sanctions into disbursals and loan book is directly linked to the execution of power projects. Therefore are these slippages continue, REC's loan sanction will not translate into disbursement, thereby impacting growth in loans and earnings in turn.

- **Regulatory Risk**

Being a power sector-specific public financial institution, REC receives assistance from the government in many way such as not required to comply with complex regulatory requirements as is the case for banking (CRR/SLR, and Priority Lending Requirement), special allowance to issue low cost capital gains bonds, tax benefits due to their status as a lending institution etc. Therefore any change in the regulatory requirements remains a risk.

Financials

Earnings Summary				(INR Mn)
Particulars	**FY08**	**FY09**	**FY10E**	**FY11E**
Interest Income	33782.2	47571.7	66742.0	86317.0
Interest expended	20528.1	28873.5	44555.0	59179.6
Net Interest Income	**13254.1**	**18698.2**	**22187.1**	**27137.4**
Other Income	1594.4	1741.1	2293.4	2799.2
Operating Income	14848.5	20439.3	24480.5	29936.5
Operating Expenses	1318.7	1207.8	1407.4	1569.7
Pre Provisioning Profits	13529.8	19231.4	23073.1	28366.9
Provisions & contingencies	399.9	34.2	46.7	60.4
Profit before Taxes and Prior period items	13129.9	19197.2	23026.4	28306.4
Prior period items	-5.7	3.9	0.0	0.0
Profit before Taxes	13124.2	19201.1	23026.4	28306.4
Provisions for taxes	4522.8	6480.3	7829.0	9624.2
Net Profit	**8601.5**	**12720.7**	**15197.4**	**18682.2**
Net Profit (excluding DTL)	**9375.6**	**14116.8**	**17039.5**	**21003.4**
Source: Company, ACMIIL research				

Sources and Application of Funds				(In Rs. Mn.)
Particulars	**FY08**	**FY09**	**FY10E**	**FY11E**
Liabilities				
Capital	8586.6	8586.6	9874.6	9874.6
Reserves & Surplus	45090.5	53314.2	86889.7	99016.1
Networth	53677.1	61900.8	96764.3	108890.7
Borrowings	342827.9	449359.6	596649.3	779091.9
Deferred Tax Liability	8170.8	9566.9	11409.0	13730.1
Total	**404675.7**	**520827.2**	**704822.5**	**901712.6**
Assets				
Fixed assets	779.0	809.0	932.4	1081.8
Investments	11474.0	10048.6	10048.6	10048.6
Loans	393165.1	513814.5	656713.6	836113.6
Net Current Assets	-742.4	-3844.9	37127.9	54468.6
Total	**404675.7**	**520827.2**	**704822.5**	**901712.6**
Source: Company, ACMIIL research				

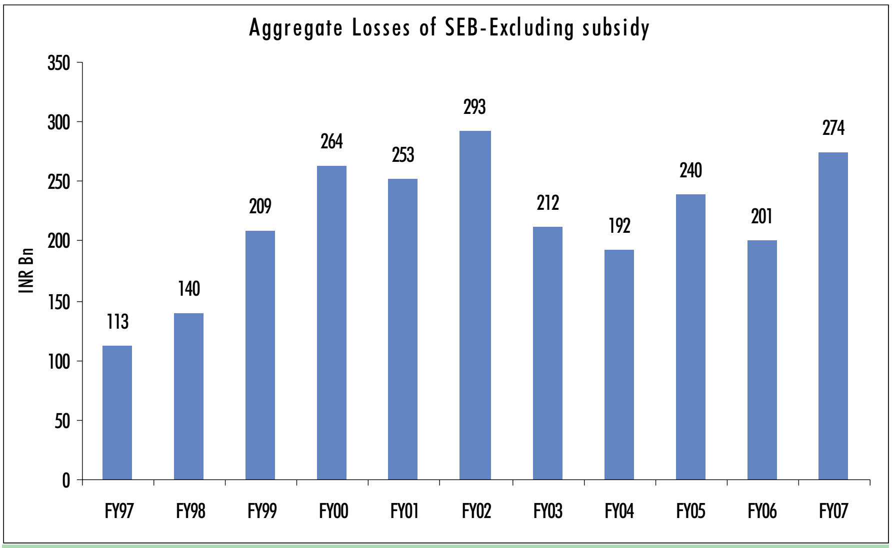
Key Ratios				
	FY08	FY09	FY10E	FY11E
Spreads				
Cost of Borrowings	6.5%	7.4%	8.5%	8.6%
Yield on Advances	9.7%	10.5%	11.4%	11.5%
Net Interest Income	3.2%	3.1%	2.9%	2.9%
Net interest margins	3.8%	4.0%	3.7%	3.5%
Profitability ratios				
Return On Average Assets (ROAA)	2.3%	2.7%	2.5%	2.3%
Return On Average Net worth (ROANW)	18.3%	22.0%	19.2%	18.2%
Balance sheet ratios				
Loan to borrowings ratio (%)	114.7	114.3	110.1	107.3
Debt/Equity Ratio (Times)	6.4	7.3	6.2	7.2
Growth Ratios				
Borrowings	13.2%	31.1%	32.8%	30.6%
Loans	22.5%	30.7%	27.8%	27.3%
Networth	33.8%	15.3%	56.3%	12.5%
NII Growth	61.4%	35.9%	19.4%	21.6%
Book value	21.6%	15.3%	35.9%	12.5%
EPS	18.4%	47.9%	3.9%	22.9%
Valuation ratios				
EPS (Rs.)	10.0	14.8	15.4	18.9
EPS (Rs.) Excl DTL	10.9	16.4	17.3	21.3
Book value (Rs.)	62.5	72.1	98.0	110.3
Book Value Per Share (Rs.) Incl DTL	72.0	83.2	109.5	124.2
P/E (X)	-	-	15.8	12.8
P/E (X) Excl DTL	-	-	14.1	11.4
P/BV (X)	-	-	2.5	2.2
P/ABV (X)	-	-	2.2	2.0

Source: Company, ACMIIL research

Annexure 1- Reforms in the power sector

The Indian Power Sector is plagued with mounting inefficiencies driven by commercial and technical losses. Populist policies have increased the subsidy burden of the states. To revitalize the power sector and improve its performance, GoI initiated the reforms process in 1991.

The biggest roadblock to development of the power sector has been the deteriorating financial health and poor creditworthiness of the SEBs. This is mainly due to un-economic tariffs for agriculture, lower slabs of domestic consumption and high T&D losses and low billing and collection efficiency.



Source: Company, ACMIIL Research

Reorganization of the SEBs

The state electricity reform act provided for reorganization of the State Electricity Boards (SEBs). The reorganization involved trifurcating the SEB's into separate generation, distribution and transmission companies. As part of the reforms, unbundling was made mandatory as most state electricity boards functioned as loss-making entities with high outstanding dues owing to fundamental inefficiencies. Restructuring aimed at promoting greater efficiency by streamlining operations of distribution, transmission, generation and trading, while also promoting transparency and accountability.

So far, 14 states have reorganized their SEBs: 10 States — Orissa, Haryana, Andhra Pradesh, Karnataka, Uttar Pradesh, Uttarakhand, Rajasthan, Delhi, Gujarat and Madhya Pradesh have done this under their State Electricity Reforms Acts. Assam, Maharashtra, West Bengal (w.e.f. 1.4.2007), Chhattisgarh (w.e.f. 1.1.2009) have reorganized their SEBs under the provisions of the Electricity Act, 2003. The remaining states of Bihar, Jharkhand, Kerala, Punjab, Tamil Nadu, Meghalaya and Himachal Pradesh are formulating schemes for reorganization of their SEBs. Since the formulation of the scheme in 1999, until June 2009, 21 out of the 29 states have unbundled or are doing so.

One-time settlement of dues based on Ahluwalia Committee recommendations

Another scheme introduced for improving the financial viability of the SEBs was securitisation of outstanding dues.

The gap between average revenue realization and average cost of supply constantly increased. All this caused erosion in the volume of internal resources generation of the SEBs and led them to virtual bankruptcy. Consequently SEBs were unable to make full payments to Central Power Sector Utilities (CPSUs) for purchase of power and coal resulting in accumulation of huge outstanding amount to be paid by SEBs. This adversely affected the growth and performance of CPSUs.

In pursuance of the reforms process, the expert group formed by the govt. under the Chairmanship of Member (Energy), Planning Commission recommended a scheme for one time settlement of dues payable by the SEBs to CPSUs and Railways. This one-time settlement scheme of dues (launched in 11th May, 2001) owed by SEBs/Utilities to CPSUs, was aimed at making the loss-making power utilities bankable. In terms of the Scheme, 60% of interest/surcharge on the delayed payments/dues as on 30.9.2001 was waived and the rest of the dues were securitized through tax-free bonds issued by the respective state governments. Considerable progress has been made since in the settlement of dues payable by SEBs to CPSUs and the Railways.

Trend in Outstanding Dues to CPSUs by SEBs/ Utilities	
Year	Total Outstanding Dues (INR Bn)
FY03	414.9
FY04	80.9
FY05	62.5
FY06	26.01
FY07*	29.37
FY 08*	35.96
*As reported by CPSUs upto 31-03-08. Source: CEA	

Distribution reforms to reduce T&D losses

The Accelerated Power Development and Reform Programme (APDRP) began from FY01 as a means to restore the commercial viability of the distribution sector. The main objective of the programme was to reduce the AT&C losses to 15%.

Under the APDRP, nine states have shown reduction of cash loss amounting to INR57.5 billion and became eligible for APDRP incentive of INR28.8 billion. Government has released INR28.8 billion so far to Andhra Pradesh, Gujarat, Haryana, Kerala, Madhya Pradesh, Maharashtra, Punjab, Rajasthan and West Bengal.

At the national level, nevertheless the AT&C loss of state power utilities has not shown much improvement over the past three years. The loss has come down in towns where APDRP has been implemented. AT&C losses have been bought down below 20% in 215 APDRP towns in the country of which 163 towns have been brought below 15%. The billing efficiency at national level has improved from 68.37% during 2002-03 to 71.04% during 2006-07. The national average collection efficiency has also improved from 92.68% during 2002-03 to 94.20% during 2006-07. With this improvement in billing and collection efficiency, the national average AT&C loss of the distribution companies has reduced from 36.63% to 33.07%. (Refer Annexure below)

Aggregate Technical and Commercial (AT &C) Losses (in %)

State/UT	Power Utilities	2003 -04	2004-05	2005-06	2006-07
Chandigarh	Electricity Deptt				
Delhi	DVB				
	BSES Rajdhani Power Ltd.	45.73	41.97	41.25	32.93
	BSES Yamuna Power Ltd.	55.54	51.70	48.58	43.25
	North Delhi Power Ltd.	48.16	35.90	28.01	28.33
Haryana	DHBVN Ltd.	40.53	43.96	40.79	34.48
	UHBVN Ltd.	40.09 4	3.37	41.90	28.96
Himachal	HPSEB	9.27	21.71	15.15	13.18
J & K	Electricity Deptt	68.79	68.33	66.69	67.56
Punjab	PSEB	25.52	24.00	25.84	24.88
Rajasthan	Jodhpur VVNL	45.75 4	7.56	47.04	37.21
	Jaipur VVNL	41.67	43.22	42.26	38.06
	Ajmer VVNL	46.20	49.75	47.54	42.61
Uttar Pradesh	UPPCL				
	MVVNL, Lucknow	39.48	38.72	47.19	45.12
	PVVNL, Meerut	38.28	32.40	42.43	31.51
	DVVNL, Agra	51.46	58.03	55.60	50.21
	PVVNL, Varanasi	45.36	58.07	46.08	63.55
	KESCO		60.88	47.06	49.14
Uttarakhand	UtPCL	43.48	45.63	38.20	42.85
Gujarat	Gujarat Urja Vikas Nigam	35.48	35.15		
	Ltd (GEB/GUVNL)				
	PGVCL			43.06	38.27
	MGVCL.			24.60	20.07
	DGVCL			22.40	20.59
	UGVCL			27.57	20.15

Madhya Pradesh	MPSEB	41.52	54.27	50.36	
	MP Paschim KVVCo			46.91	39.25
	MP Poorva KVVCo			47.90	52.15
	MP Madhya KVVCo			43.20	56.64
Chhattisgarh	CSEB,Chhattisgarh	30.99	32.30	37.84	36.12
Maharashtra	MSEB	38.95	27.98	50.22	
	Maharashtra State Elecy. Distribution Co.Ltd.			36.74	39.35
GOA	GOA	21.28	18.34	15.18	19.39
Andhra Pradesh	APEPDCL, Visakhapatnam	16.57	14.27	12.68	12.46
	APSPDCL, Tirupati	17.06	20.55	16.51	17.2
	APNPDCL, Warangal	9.79	21.91	19.21	26.61
	APCPDCL, Hyderabad	18.99	23.95	18.83	18.24
Karnataka	KPTCL				
	BESCOM,Bangalore	28.91	29.99	35.75	26.88
	MESCOM,Mangalore	25.82	27.02	20.80	12.08
	HESCOM,Hubli	31.66	41.77	40.39	37.4
	GESCOM,Gulberga	43.86	42.99	52.73	46.98
	CESCOM,Chamundi			46.03	40.58
Kerala	KSEB	32.74	32.12	25.95	25.02
Tamil Nadu	TNEB	20.64	19.40	20.53	20.10
Lakshadweep	Electricity Deptt				
Puducherry	PPCL	20.52	16.44	16.06	16.54
Bihar	BSEB	66.26	82.50	78.16	42.64
Jharkhand	JSEB	62.47	62.84	51.67	52.51
Orrisa	SESCO, Berhampur	38.22	35.65	45.10	42.17
	NESCO, Balasore	45.06	39.51	41.31	32.52
	CESCO, Bhubneswar	49.96	55.82	42.54	46.96
	WESCO, Bhubneswar	38.33	35.88	33.95	36.93
Sikkim	Energy & Power Deptt.	66.55	38.44	44.77	40.72
West Bengal	WBSEB	32.87	23.91	26.59	30.9
Assam	ASEB			43.35	39.31
	CAED Co.Ltd,Assam			37.35	42.59
	LAED Co.Ltd,Assam			27.83	31.71
	UAED Co.Ltd,Assam			39.45	38.55
Manipur	Electricity Deptt	69.73	88.50	77.83	94.32
Meghalaya	MeSEB	39.31	38.16	33.36	37.32
Nagaland	Deptt. Of Power	55.55	43.22	44.76	52.19
Tripura	Electricity Deptt	14.82	20.93	24.92	23.46
Arunachal Pradesh	Power Deptt.	16.26	25.54	37.17	52.03
Mizoram	Power & Electricity Deptt.	38.44	24.62	17.17	44.97
	ALL INDIA	34.78	34.33	35.18	33.07

SOURCE: Power Finance Corporation Limited

Annexure 2- Comparison of banks with NBFC

2008 data	All banks average	SBI	PSU	Private	All NBFC average
Cost of Funds	4.8	4.7	5.0	5.2	9.0
Yield on Income	7.2	7.0	7.2	7.6	12.3
Spreads	2.4	2.3	2.2	2.4	3.3
Return on Assets	1.2	1.0	1.0	1.2	2.4
RONW	19.0	22.8	20.7	15.3	20.1
CRAR	13.0	13.2	12.1	14.3	17.2
Net NPA ratio	1.0	1.4	0.8	1.1	0.8
PE	9.0	6.0	5.0	15.8	14.1
PBV	1.5	1.3	1.1	2.1	2.6

Source: Capitaline, RBI, ACMIIL Research

Note: NBFC taken into consideration- Dewan Housing Finance, Gruh Finance, HDFC, IDFC, LIC Housing Finance, M&M Financial, Shriram Transport Company, PFC and REC.

Compared with the banking industry, NBFCs typically have delivered higher net interest margins, return on assets, and return on equity, while maintaining low NPA ratios.

Cost of Funds: Banks enjoy lower cost of funds vis-avis NBFCs mainly because banks have access to low cost deposits such as current account and savings account. On the other hand, NBFCs depend on wholesale funding sources such as bonds, debentures and loans from banks.

Yield on Advances: Banks earn yields lower than NBFCs because of the drag from low yield SLR and CRR investments and priority sector advances.

Higher Spreads and ROA: Higher yield on advances enables NBFCs maintain higher spreads, and efficient deployment of funds held helps maintain higher ROA than banks, which have to invest in low-yielding assets as part of their regulatory requirements.

Low NPA ratios: This could be partly because most NBFCs recognize an asset as an NPA once it is 180 days past the due date whereas banks follow a more stringent norm of recognizing an asset as an NPA once it is 90 days past the due date.

Capital adequacy requirements- NBFCs, especially deposit-taking ones, have to maintain higher CRAR of 12-15 %, which is substantially higher than banks. Even non-deposit-taking NBFCs with an asset size of INR1 billion and above have to maintain a CRAR of 10%, vis-à-vis 9% requirement in case of banks.

Annexure 3- Comparison of Power finance companies with other NBFC's

Non-banking Finance Companies (NBFCs) have been competing with and complementing the services of commercial banks. Although initially their role entailed catering to the needs of small savers and investors, NBFCs have evolved into institutions that can provide services similar to banks. The two broad NBFC categories are: NBFC-Deposit taking (NBFC-D) and NBFCs-Non Deposit Taking (NBFC-ND). NBFCs comprise 9.1% of assets of the total financial system.

However, NBFCs are distinct from banks. Regulation and supervision for NBFCs is much lighter than for banks. For instance, they are not subject to complex regulatory requirements as is the case for banking (CRR/SLR, and Priority Lending Requirement). Furthermore, they have a wider reach. The core strength of an NBFC lies in strong customer relationship, good understanding of regional dynamics, and ability to reach out to customers where banks are not able to reach.

FY 2008	All NBFC average	PFC	REC
Cost of Funds	9.0	8.0	6.5
Yield on Income	12.3	10.1	9.7
Spreads	3.3	2.1	3.2
Return on Assets	2.4	2.5	2.3
RONW	20.1	14.6	18.3
Net NPA ratio	0.8	0.0	0.6
PE	14.1	13.9	9.4
PBV	2.6	1.9	2.3
Source: Capitaline, RBI, ACMIIL Research			

Advantages of PFC and REC over other NBFCs

- GoI-owned companies and nodal agency for various activities related to power sector permitting focused lending.
- Access to low cost funds similar to banks due to issuing capital gains bonds (only REC)
- High ratings provided by the rating agencies, underpinned by GoI support, brings REC and PFC's credit rating on par with the country's sovereign rating, enabling these companies to source funds at lower costs
- Lending institutions such as PFC, REC that are engaged in lending to power projects are at an advantage over Banks and NBFCs since they are not required to comply with regulatory norms such as CRR, SLR stipulations and the NPA provisioning norms do not apply to them. Further, unlike Banks and NBFCs, they have greater access to long-term funds. (Maturity pattern of term deposits of bank suggests that 70% of deposits have maturity of 1-5 years).
- Lending goes to GoI companies or departments with escrow cover in place in most cases. This helps the company to continue with disbursements comfortably even in these stressed times when other lenders are forced to exercise caution.

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1. Analyst ownership of the stock	NO
2. Broking Relationship with the company covered	NO
3. Investment Banking relationship with the company covered	NO
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