Macquarie
Equities Research

The Global Utilities Specialist

INDIA

RPWR IN Underperform

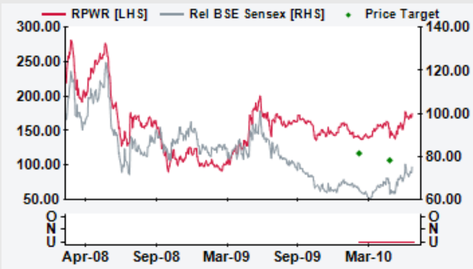
Price 2 Jul 10 Rs175.15

12-month target	**Rs**	**107.00**
Upside/Downside	**%**	**-38.9**
Valuation	**Rs**	**107.00**
- DCF (WACC 10.4%, beta 1.0, ERP 6.5%, RFR 7.5%)		
GICS sector		**Utilities**
Market cap	**Rsm**	**419,800**
30-day avg turnover	**US$m**	**9.8**
Market cap	**US$m**	**8,977**
Number shares on issue	**m**	**2,397**

Investment fundamentals

Year end 31 Mar		2010E	2011E	2012E	2013E
Total revenue	m	0	12,042	16,808	50,214
EBIT	m	-1003	4,058	6,950	19,855
EBIT growth	%	nmf	nmf	71.3	185.7
Recurring profit	m	8,395	6,761	5,674	7,108
Reported profit	m	7,239	5,789	4,961	5,182
Adjusted profit	m	7,239	5,789	4,961	5,182
EPS rep	Rs	3.02	2.42	2.07	2.16
EPS rep growth	%	nmf	-20.0	-14.3	4.5
EPS adj	Rs	3.02	2.42	2.07	2.16
EPS adj growth	%	nmf	-20.0	-14.3	4.5
PER rep	x	58.0	72.5	84.6	81.0
PER adj	x	58.0	72.5	84.6	81.0
Total DPS	Rs	0.00	0.00	0.00	0.00
Total div yield	%	0.0	0.0	0.0	0.0
ROA	%	-0.6	1.5	1.6	3.1
ROE	%	5.1	3.9	3.2	2.8
EV/EBITDA	x	-470.9	83.4	52.7	16.3
Net debt/equity	%	35.1	109.1	212.9	258.4
P/BV	x	2.9	2.8	2.6	2.0

RPWR IN rel BSE Sensex performance, & rec history



Note: Recommendation timeline - if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.

Source: FactSet, Macquarie Research, July 2010

(all figures in INR unless noted)

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5 July 2010

Reliance Power

Merger of necessity?

Event

- On Sunday, 4 July, the Boards of RPWR and Reliance Natural Resources Limited (RNRL, NR) approved a scheme of amalgamation of the companies in a 4 (RNRL) for 1 (RPWR) share swap. Our initial thought is that this transaction is done out of necessity rather than value creation. An investor call is being held before market tomorrow. We retain our Underperform.

Impact

- **Look like a defensive move, rather than value creation:** The recent RNRL-RIL Supreme Court decision highlighted that the Government has ultimate control of how gas supply in India is allocated. RNRL itself has no power projects of its own – it's essentially trading the gas – against the Government's desire to allocate gas to end users and not traders. Therefore in our view, the absence of any gas assets in RNRL meant that this transaction was done as a necessary step to ensure gas allocation, rather than for value creation.

- **Pro forma accounts – RPWR still expensive:** We provide a snapshot of pro-forma accounts of the transaction. The Price/Book Value (P/BV) after adjusting for the potential goodwill created from the transaction, sees the metric worsen to around 3.2x P/BV. Stripping out cash + investments implies a P/BV of 11.8x highlighting the early stage of the execution cycle for the combined RPWR-RNRL entity.

- **Other RNRL assets more speculative:** The only real fundamental value that RNRL could bring to RPWR shareholders, in our view, is the undeveloped gas assets. Again, it seems that RPWR has paid an enterprise value of ~US$1.4bn for this more speculative upside. We need to do more valuation work around these assets.

- **Finer details on conference call tomorrow morning:** at 8:15am (India time) to discuss the transaction. Call details within the note.

Earnings and target price revision

- No change.

Price catalyst

- 12-month price target: Rs107.00 based on a DCF methodology.
- Catalyst: Details of gas pact between RIL-RNRL within the next month.

Action and recommendation

- Underperform, with the stock trading at approximately a 40% premium to our valuation. With financial closure only achieved for 17% of its project pipeline, we believe there is still a long way to go regarding project execution.

Details of the merger

- On Sunday, 4 July, the Board of Directors of RPWR and Reliance Natural Resources Limited (RNRL) approved a scheme of amalgamation of the two companies, subject to the necessary approvals.
- **Merger ratio 4:1:** The Boards approved an exchange ratio of 1 share of Reliance Power for every 4 shares of RNRL. The exchange ratio is based on the valuation made by KPMG. We understand the weighted averages of several different methodologies (Book Value, current market prices, etc) were used for both RPWR and RNRL.
- **Conference call tomorrow pre-market:** at 8:15am India time. Dial in numbers below.

Fig 1 Conference Call details

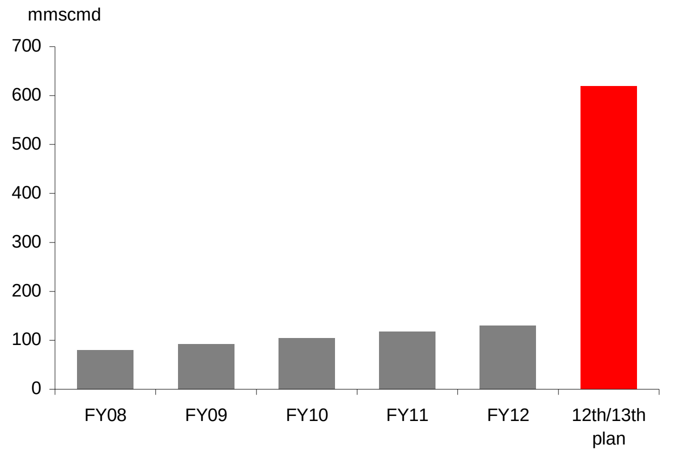
Dial in numbers	
India	+91 22 30360400 / 180030131313
Hong Kong	800901420
Singapore	8001011906
UK	080-8168-1758
US/Canada	18663944523
Password	**86394973**

Source: Company data, Macquarie Research, July 2010

A merger of necessity – the merged entity will be the end user of gas

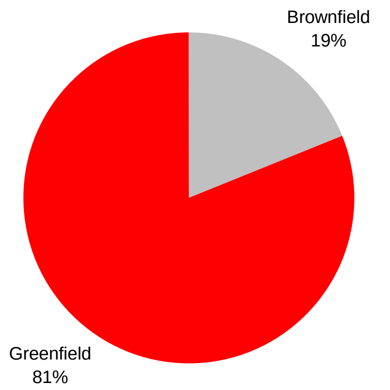
- **Getting gas is competitive – many wanting it:** We stress that the lack of domestic gas supply is the main constraint for gas-fired power generation in India. As highlighted by a recent Infraline report, the total gas requirement for the proposed gas-fired power projects in the 12th (FY13-FY17) and 13th (FY18-FY22) plan projects is ~490mmscmd. The report noted a likely overall shortage of gas for the 11th and 12th plan to be around 168mmscmd.

Fig 2 Gas demand for power sector – 490mmscmd of projects seeking gas in 12th/13th plan



Source: Infraline, Macquarie Research, July 2010

Fig 3 Brownfield vs greenfield gas-fired capacity in 12th/13th plan projects



Source: Infraline, Macquarie Research, July 2010

- **Government the boss:** The recent RNRL-RIL Supreme Court decision highlighted that the Government has ultimate control of how gas supply in India is allocated.
- **RNRL has no power projects**: We believe RNRL itself has no power projects of its own – it's essentially trading the gas – against the Government's desire to allocate gas to end users and not traders. Therefore to support an allocation of gas in a highly competitive environment, the merged entity will have a portfolio of gas-fired power capacity that could support such an allocation. ***Therefore we believe that an RNRL-RPWR is more a merger of necessity than of value creation.***

The merged entity: US$10.5bn market cap – difficult to see value creation

- On current trading prices, the combined market cap of both RPWR and RNRL would be ~US$10.5bn. FY10 balance sheets haven't been disclosed for both companies, but as at 31 March 2009, pro forma balance sheets (on our numbers) are reflected below.

Fig 4 FY09 Pro Forma Balance Sheet

FY09 Balance Sheet	RPWR FY09 A	RNRL FY09 B	Equity Issue C*	Merged Entity A+B+C
Cash / Investments	103,389	21,195		124,584
PPE / CWIP	49,659	3,687		53,346
Other assest	1,996	9,080	53,570	64,646
Total assets	**155,043**	**33,962**	**53,570**	**242,576**
Debt	13,325	15,216		28,541
Other liabilities	3,927	745		4,672
Total Liabilities	**17,252**	**15,961**	**0**	**33,212**
Total Equity	**137,792**		**71,572**	**209,364**
Market Cap/Promoter Interest				
Shares	2,397	1,633	408	2,805
Promoter Interest	85%	45%	45%	79%
Current Price	175	64	175	175
INR Market Cap	420,159	103,949	71,572	491,731
USD Market Cap	8,940	2,212		10,462
Metrics				
Price/Book Value	3.0x	5.8x	1.0x	2.3x
Price/Book Value less Intangibles	3.0x	5.8x	0.0x	3.2x
Price/Book Value less (Intangibles + Cash/Invest)	9.2x			11.8x
Debt/(Debt + equity)	9%	46%		12%

*Goodwill on consolidation has been added to the merged entity (difference between acquisition price and book equity of RNRL), assuming no upward asset revaluation.
Source: Company data, Macquarie Research, July 2010

- We note that on face value, the Price/Book Value (P/BV) of the merged entity will be reduced as RNRL's equity will likely be consolidated at market value. We go an extra step to strip out the potential goodwill created from the transaction, which sees valuation worsen to around 3.2x P/BV. Stripping out cash + investments implies a P/BV of 11.8x highlighting the early stage of the execution cycle for the combined RPWR/RNRL entity.
- On our numbers, pro forma earnings for the combined entity would have been Rs7,804m (US$170m) for FY10 (shown below) – slightly dilutionary for equity holders. Note earnings are essentially driven by investment revenue, not operational earnings and largely irrelevant. Practically, both groups still represent un-invested cash/investments.

Fig 5 FY10 Pro Forma Profit and Loss

FY10 Pro Forma	RPWR	RNRL	Merged P+L
Operational Revenues	207	2,984	3,191
Expenditure	1,280	2,891	4,172
EBIT	**-1,073**	**92**	**-981**
Other income	**8,227**	1,868	10,095
Profit before interest	7,153	1,961	9,114
Interest	70	889	959
PBT	**7,083**	**1,072**	**8,155**
Tax	187	164	351
NPAT	**6,896**	**908**	**7,804**
EPS	**2.9**		**2.8**
Accretion/Dilution			**-3%**

Source: Company data, Macquarie Research, July 2010

Value drivers of the transaction: CBM resource upside, but a lot to pay

The media release highlighted several positives from the transaction:

- *"Reliance Power to derive substantial benefit from RNRL's Gas Supply Master Agreement (GSMA) with RIL"*

  ⇒ **Our view:** Agreed – the gas supply may allow the construction of up to 8,000MW of new gas-fired capacity. But much of the potential value of this gas supply has been reduced since the Supreme Court decision suggests a price of at least US$4.20/mmbtu for the gas. In our view, this is adequately reflected in the price. Also, we still don't know exactly where this gas capacity will be build – high risk to execution.

- *"Prospects for gas from RNRL's Coal Bed Methane (CBM) blocks, comprising of 45% interest in 4 CBM blocks with an acreage of 3,251 sq. kms and estimated resources of about 193 billion cubic metres; and a 10% share in an oil and gas block in Mizoram, with an acreage of 3,619 sq kms and reserve potential of up to 28 billion cubic metres."*

  ⇒ **Our view:** Admittedly, we have to do more work around these assets regarding valuation. But in our view – this is the only real fundamental upside for RPWR shareholders from the transaction. Therefore it seems that RPWR has paid an enterprise value of around US$1.4bn for these assets. We have previously done a lot of work around CBM assets globally and will need to know a lot more about the coals in the CBM blocks (namely permeability, thickness, depth and flow rates/profiles) before coming to a conclusion, but note a total resource base can mean very little.

- *"Enhanced reliability and cost efficiency for Reliance Power through RNRL's coal supply logistics and shipping business."*

  ⇒ **Our view:** We haven't considered value downside from coal supply logistics/shipping and are already factoring in low costs of coal production at RPWR's coal blocks.

- *"RNRL shareholders to benefit from Reliance Power's diversified generation portfolio of 37,000MW and substantial coal reserves"*

  ⇒ **Our view:** Of the 37,000MW of power projects in the pipeline, only 600MW are under operation. As highlighted in our previous reports, RPWR has spent only ~5% of the potential capex required to roll out its growth pipeline and that financial closure has been achieved for only 17% of its projects, we believe there is still a long way to go regarding execution.

Reliance Power (RPWR IN, Underperform, Target Price: Rs107.00)

Quarterly Results		**4Q/10E**	**1Q/11E**	**2Q/11E**	**3Q/11E**
Revenue	**m**	**0**	**1,204**	**2,408**	**3,613**
Gross Profit	**m**	**0**	**669**	**1,337**	**2,006**
Cost of Goods Sold	m	0	536	1,071	1,607
EBITDA	**m**	**-257**	**564**	**1,128**	**1,692**
Depreciation	m	0	158	317	475
Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	0	0	0	0
EBIT	**m**	**-257**	**406**	**812**	**1,217**
Net Interest Income	m	0	-210	-419	-629
Associates	m	0	0	0	0
Exceptionals	m	0	0	0	0
Forex Gains / Losses	m	0	0	0	0
Other Pre-Tax Income	m	1,790	480	960	1,439
Pre-Tax Profit	**m**	**1,533**	**676**	**1,352**	**2,028**
Tax Expense	m	-210	-97	-194	-291
Net Profit	**m**	**1,324**	**579**	**1,158**	**1,737**
Minority Interests	m	0	0	0	0
Reported Earnings	**m**	**1,324**	**579**	**1,158**	**1,737**
Adjusted Earnings	**m**	**1,324**	**579**	**1,158**	**1,737**
EPS (rep)		0.55	0.24	0.48	0.72
EPS (adj)		0.55	0.24	0.48	0.72
EPS Growth yoy (adj)	%	227.7	-78.0	-40.5	30.0
EBITDA Margin	%	nmf	46.8	46.8	46.8
EBIT Margin	%	nmf	33.7	33.7	33.7
Earnings Split	%	18.3	10.0	20.0	30.0
Revenue Growth	%	0.0	nmf	nmf	nmf
EBIT Growth	%	45.7	nmf	nmf	nmf

Profit & Loss		**2010E**	**2011E**	**2012E**	**2013E**
Revenue	**m**	**0**	**12,042**	**16,808**	**50,214**
Gross Profit	**m**	**0**	**6,686**	**10,025**	**30,058**
Cost of Goods Sold	m	0	5,356	6,782	20,157
EBITDA	**m**	**-1,000**	**5,642**	**8,934**	**28,917**
Depreciation	m	4	1,583	1,984	9,062
Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	0	0	0	0
EBIT	**m**	**-1,003**	**4,058**	**6,950**	**19,855**
Net Interest Income	m	0	-2,095	-2,367	-12,747
Associates	m	0	0	0	0
Exceptionals	m	0	0	0	0
Forex Gains / Losses	m	0	0	0	0
Other Pre-Tax Income	m	9,398	4,798	1,091	0
Pre-Tax Profit	**m**	**8,395**	**6,761**	**5,674**	**7,108**
Tax Expense	m	-1,157	-971	-712	-1,925
Net Profit	**m**	**7,239**	**5,789**	**4,961**	**5,182**
Minority Interests	m	0	0	0	0
Reported Earnings	**m**	**7,239**	**5,789**	**4,961**	**5,182**
Adjusted Earnings	**m**	**7,239**	**5,789**	**4,961**	**5,182**
EPS (rep)		3.02	2.42	2.07	2.16
EPS (adj)		3.02	2.42	2.07	2.16
EPS Growth (adj)	%	nmf	-20.0	-14.3	4.5
PE (rep)	x	58.0	72.5	84.6	81.0
PE (adj)	x	58.0	72.5	84.6	81.0
Total DPS		0.00	0.00	0.00	0.00
Total Div Yield	%	0.0	0.0	0.0	0.0
Weighted Average Shares	m	2,397	2,397	2,397	2,397
Period End Shares	m	2,397	2,397	2,397	2,397

Profit and Loss Ratios		**2010E**	**2011E**	**2012E**	**2013E**
Revenue Growth	%	nmf	nmf	39.6	198.8
EBITDA Growth	%	nmf	nmf	58.4	223.7
EBIT Growth	%	nmf	nmf	71.3	185.7
Gross Profit Margin	%	nmf	55.5	59.6	59.9
EBITDA Margin	%	nmf	46.8	53.2	57.6
EBIT Margin	%	nmf	33.7	41.4	39.5
Net Profit Margin	%	nmf	48.1	29.5	10.3
Payout Ratio	%	0.0	0.0	0.0	0.0
EV/EBITDA	x	-470.9	83.4	52.7	16.3
EV/EBIT	x	-469.2	116.0	67.7	23.7
Balance Sheet Ratios					
ROE	%	5.1	3.9	3.2	2.8
ROA	%	-0.6	1.5	1.6	3.1
ROIC	%	-0.6	1.8	1.9	2.9
Net Debt/Equity	%	35.1	109.1	212.9	258.4
Interest Cover	x	nmf	1.9	2.9	1.6
Price/Book	x	2.9	2.8	2.6	2.0
Book Value per Share		60.5	62.9	67.3	86.8

Cashflow Analysis		**2010E**	**2011E**	**2012E**	**2013E**
EBITDA	**m**	**-1,000**	**5,642**	**8,934**	**28,917**
Tax Paid	m	-1,157	-971	-712	-1,925
Chgs in Working Cap	m	82	-546	-269	-1,644
Net Interest Paid	m	0	-2,095	-2,367	-12,747
Other	m	9,398	4,798	1,091	0
Operating Cashflow	**m**	**7,324**	**6,827**	**6,676**	**12,600**
Acquisitions	m	0	0	0	0
Capex	m	-65,980	-178,510	-215,597	-247,747
Asset Sales	m	0	0	0	0
Other	m	20,792	58,142	24,238	0
Investing Cashflow	**m**	**-45,188**	**-120,368**	**-191,359**	**-247,747**
Dividend (Ordinary)	m	0	0	0	0
Equity Raised	m	0	0	5,580	41,412
Debt Movements	m	45,188	118,309	167,794	193,735
Other	m	0	0	0	0
Financing Cashflow	**m**	**45,188**	**118,309**	**173,374**	**235,147**
Net Chg in Cash/Debt	**m**	**7,324**	**4,768**	**-11,308**	**0**
Free Cashflow	**m**	**-58,656**	**-171,683**	**-208,920**	**-235,147**

Balance Sheet		**2010E**	**2011E**	**2012E**	**2013E**
Cash	m	7,540	12,308	1,000	1,000
Receivables	m	1,893	1,893	1,893	1,893
Inventories	m	0	0	0	0
Investments	m	82,380	24,238	0	0
Fixed Assets	m	115,637	292,563	506,176	744,861
Intangibles	m	0	0	0	0
Other Assets	m	104	1,093	1,481	4,231
Total Assets	**m**	**207,554**	**332,097**	**510,551**	**751,985**
Payables	m	3,754	4,198	4,317	5,423
Short Term Debt	m	0	0	0	0
Long Term Debt	m	58,513	176,822	344,616	538,351
Provisions	m	255	255	255	255
Other Liabilities	m	0	0	0	0
Total Liabilities	**m**	**62,522**	**181,275**	**349,188**	**544,029**
Shareholders' Funds	m	145,032	150,821	161,362	207,956
Minority Interests	m	0	0	0	0
Other	m	0	0	0	0
Total S/H Equity	**m**	**145,032**	**150,821**	**161,362**	**207,956**
Total Liab & S/H Funds	**m**	**207,554**	**332,096**	**510,551**	**751,985**

All figures in INR unless noted.
Source: Company data, Macquarie Research, July 2010

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South - South Africa
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie - Canada
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Macquarie - USA
Outperform (Buy) – return >5% in excess of Russell 3000 index return
Neutral (Hold) – return within 5% of Russell 3000 index return
Underperform (Sell)– return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Australian/NZ/Canada stocks only

Recommendations – 12 months
Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 30 June 2010

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	50.55%	64.29%	54.41%	45.63%	65.08%	50.26%	(for US coverage by MCUSA, 4.58% of stocks covered are investment banking clients)
Neutral	35.16%	17.15%	38.24%	47.91%	30.69%	35.16%	(for US coverage by MCUSA, 5.56% of stocks covered are investment banking clients)
Underperform	14.29%	18.56%	7.35%	6.46%	4.23%	14.58%	(for US coverage by MCUSA, 0.00% of stocks covered are investment banking clients)

Company Specific Disclosures:

Important disclosure information regarding the subject companies covered in this report is available at www.macquarie.com/research/disclosures.

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