

MAY 24, 2011

RESULT, CHANGE IN RECO.

Coverage view: **Attractive**

Price (Rs): **202**

Target price (Rs): **250**

BSE-30: **18,012**

**Strong performance, inexpensive valuations; upgrade to ADD.** REC reported PAT of Rs7 bn, up 25% yoy and 7% above estimates. Business traction was robust—loan growth accelerated to 25% (from 21% in 3Q) and NIMs were strong. Though macro issues concern us, business performance in the medium term will likely remain on track. REC has corrected by 14% in the past one month and the risk-reward tradeoff now favors investors. We upgrade REC to ADD (from REDUCE) with a price target of Rs250 (unchanged). We believe that the stock will trade up from the current levels, but upside may be capped due to the overhang of macro issues.

#### Company data and valuation summary

Rural Electrification Corp.

Stock data		Forecasts/Valuations			
		2011	2012E	2013E	
52-week range (Rs) (high,low)	414-200	EPS (Rs)	26.0	29.3	32.8
Market Cap. (Rs bn)	199.8	EPS growth (%)	15.5	12.7	12.2
Shareholding pattern (%)		P/E (X)	7.8	6.9	6.2
Promoters	66.8	NII (Rs bn)	32.6	36.7	41.3
FIs	20.8	Net profits (Rs bn)	25.7	28.9	32.4
MFs	1.8	BVPS	129.4	147.2	167.2
Price performance (%)		P/B (X)	1.6	1.4	1.2
Absolute	1M (13.8) 3M (7.5) 12M (26.7)	ROE (%)	21.5	21.2	20.9
Rel. to BSE-30	(6.2) (9.4) (33.0)	Div. Yield (%)	3.7	4.9	5.4

#### QUICK NUMBERS

- PAT up 25% yoy to Rs7 bn
- Loan growth up 24%

#### Higher disbursements and lower repayments buoyed loan growth in 4QFY11

REC's reported NII was up 27% yoy to Rs9.7 bn, largely on the back of 24% loan growth.

- ▶ Loan approvals moved up to Rs226 bn from Rs108 bn in 3QFY11, driven by the generation sector. Disbursements increased by 40% yoy and 40% qoq—on a qoq basis generation and T&D segments had a similar contribution to growth. The quarterly repayment rate declined to 3.1%. Notably, the repayment rate had increased to 4.3% in 3QFY11, somewhat higher than 2.1% and 2.7% in 1QFY11 and 2QFY11, respectively. Consequently, loan growth accelerated to 24% from 21% in 3QFY11.
- ▶ We are modeling 20% loan growth CAGR in the next two years. The management has guided for 25% disbursement growth and 25% loan growth in FY2012E. We believe that private sector participation in the power sector will slow down in light of limited access to fuel and decline in merchant tariff rates. Growth for state utilities will likely be muted in cases where their financials are weak.

#### Spreads remain strong, current scenario poses pressure on NIMs

REC reported margins of 4.34% during the quarter, somewhat below 4.56% reported in 3QFY11 and 4.45% in 4QFY10. NIMs (as per KS estimates) were almost stable at 4.9%. While borrowings cost was stable qoq, the yield on loans declined by about 25 bps—the reason for yield decline is not very clear.

In 2HFY11, REC raised forex debt of US\$400 mn, of which US\$200 mn was hedged. REC recognized MTM gain of Rs559 mn—reflected in other income. One-time fees for raising forex debt (Rs139 mn) increased the reported borrowings cost (this is adjusted in our spread calculation).

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REC has raised lending rates by 1% in the past two months. The management has highlighted that their ALM is marginally positive in next 12 months and about Rs110 bn of assets and Rs90 bn of liabilities are due for re-pricing in the next one year. REC does not see any impact of asset and liability re-pricing as the incremental interest rates are similar to the outstanding rates on these loans. We are worried that power projects may not be able to absorb further rate hikes (incremental lending rates are now 12%+). REC will likely find NIM pressure in case rates inch up further despite favorable ALM and loan re-pricing. We are modeling about 40 bps NIM decline in FY2012E.

#### Asset quality performance stable

REC's gross NPLs remained stable at 0.02%. Consequently, NPL cost was nil. While REC's NPLs have been low, we remain concerned about the asset quality of state utilities. Private players who don't have adequate fuel supplies but have contracted to supply fixed price power are also a cause of concern.

#### Recapitulating from our meetings with bureaucrats in the power sector

- ▶ We note that absence of tariff revisions for 4-5 years is among the key reasons for the deteriorating financial health of state distribution companies (this is more specifically observed in case of UP, Rajasthan and Tamil Nadu). The policymakers were, however, optimistic about the current situation. Notably, a couple of states have effected substantial tariff increases in the recent past.
- ▶ Schemes such as APDRP and a National Electricity Fund, which offer grants/subsidies for improving the viability of the distribution segment against proven reduction in losses, can deliver promising results, according to policymakers. As such, financier may not face defaults on their loans to state utilities. There have been rumors about a bailout package for state utilities.
- ▶ Lack of availability of coal remains a larger issue for the sector due to Coal India's inability to match the improved execution rate by the power sector. The problem is compounded by the lack of logistics infrastructure—both railways and ports—that hinders the transport of imported as well as domestically produced coal.

#### Tweak estimates, upgrade to ADD

We are tweaking our estimates to factor somewhat lower loan growth and NIM. We expect REC to deliver about 19% loan growth CAGR over the next two years. We are modeling muted (12%) earnings CAGR on the back of NIM decline of 40 bps in FY2012E and 20 bps in FY2013E. We are now modeling spreads of 2.7% in FY2014E—this is marginally above 2.6% reported in FY2004, i.e. the lowest in the ten-year period post FY2003. Despite the rollover to FY2013E, our price target of Rs250 remains unchanged to factor lower earnings growth in medium term. Upgrade to ADD on inexpensive valuations.

**Rural Electrification Corporation - Quarterly data**  
 4QFY10-4QFY11 (Rs mn)

	4Q10	1Q11	2Q11	3Q11	4Q11	YoY (%)	4Q11E
<b>Income statement</b>							
Interest income	17,959	18,771	19,877	20,860	21,581		
Other income	360	225	555	560	1,180		
Interest costs	10,685	11,012	12,076	12,380	13,043		
Net interest income	7,634	7,984	8,356	9,040	9,718	27	8,841
Other operational income	377	292	390	360	303	(20)	258
Net total income	8,011	8,275	8,746	9,400	10,021	25	9,100
Provisioning expenses	-	-	1	-	1	-	1
Net income (post provisions)	8,011	8,275	8,744	9,400	10,020	25	9,098
Operating expenses	482	343	385	390	561	16	561
Staff expenses	373	261	260	390	468	26	413
Other operating expenses	98	75	118	-	85	(14)	141
Depreciation expenses	11	7	8	-	8	(28)	7
PBT before extraordinary	7,529	7,933	8,360	9,010	9,459	26	8,538
Extraordinary expenses	-	-	-	-	-	-	-
PBT post extraordinary	7,529	7,933	8,360	9,010	9,459	26	8,538
Tax	1,917	2,059	2,178	2,370	2,457	28	2,023
Provision for DTL	-	-	-	-	-	-	-
PAT	5,612	5,874	6,182	6,640	7,002	25	6,515
EPS (Rs)	5.8	6.0	6.3	6.7	7.1	23.1	6.6
Tax rate (%)	25	26	26	26	26	-	-
<b>Balance sheet</b>							
<b>Assets</b>							
Loans	664,520	697,910	735,433	764,550	821,321	24	800,931
Investments	9,100	9,330	10,321	8,850	8,124	(11)	
Fixed assets	900	890	889	880	881	(2)	
Current assets	(4,310)	(16,590)	18,123	(16,560)	34,575	(902)	
Total assets	670,210	691,540	764,766	757,720	864,900	29	
<b>Liabilities</b>							
Borrowings	559,480	574,930	604,277	632,245	700,038	25	
Deferred tax liability	(70)	(70)	(77)	-	-	(100)	
Current liabilities and provisions	-	-	37,707	-	36,976	-	
Total liabilities	559,410	574,860	641,907	632,250	737,014	32	
Shareholders funds	110,800	116,680	122,859	125,470	127,886	15	
<b>Key operating parameters (%)</b>							
Approvals (Rs bn)	33	228	103	108	226		
YoY(%)	-53	51	-37	2	590		
Disbursements (Rs mn)	60	46	56	60	83		
YoY(%)	14	28	1	-1	39		
Interest yield (KS - calc)	11.04	11.02	11.09	11.13	10.89		
Interest cost (KS- calc)	7.85	7.77	7.96	7.79	7.75		
Spreads (KS- calc)	3.20	3.26	3.14	3.34	3.14		
NIMs (KS- calc)	4.69	4.69	4.66	4.82	4.90		4.52
Opex/ net income (post provisions)	6.01	4.14	4.40	4.15	5.59		
Yield on loans	11.03	11.10	11.20	11.24	10.96		
Borrowings cost	7.67	7.75	7.95	7.80	7.76		
NIMs	4.45	4.59	4.40	4.56	4.34		
Reported spreads	3.36	3.35	3.25	3.44	3.20		
Gross NPLs (Rs mn)	200	200	200	200	200		
Net NPLs (Rs mn)	20	20	20	20	20		
Gross NPLs (%)	0.03	0.03	0.03	0.03	0.02		
Net NPLs (%)	0.00	0.00	0.00	0.00	-		
Debt/ equity (X)	5.05	4.93	4.92	5.04	5.47		
RoE (reported)	23.17	20.66	20.65	21.39	22.11		

Source: Company, Kotak Institutional Equities estimates

REC- Quarterly data  
4QFY10-4QFY11 (Rs mn )

	4Q10	1Q11	2Q11	3Q11	4Q11
<b>Other loan book details</b>					
<b>Loan book</b>	<b>659,790</b>	<b>692,170</b>	<b>728,990</b>	<b>757,440</b>	<b>817,250</b>
Generation	239,580	285,490	306,620	314,620	346,100
T&D	367,230	353,370	372,610	391,590	417,740
Short term loan	52,980	53,310	49,760	51,230	53,410
State	555,740	595,050	626,710	633,100	680,920
Central	61,450	51,340	54,070	55,350	58,530
Private	42,600	45,780	48,220	68,990	77,800
<b>Disbursements</b>	<b>59,860</b>	<b>46,440</b>	<b>55,470</b>	<b>60,080</b>	<b>83,200</b>
Generation	25,100	32,390	27,590	21,850	35,710
T&D	31,760	12,050	19,880	25,230	39,370
Short term loan	3,000	2,000	8,000	13,000	8,120
<b>Approvals</b>	<b>32,930</b>	<b>228,820</b>	<b>103,880</b>	<b>105,910</b>	<b>225,600</b>
Generation	5,860	111,770	47,960	63,250	180,770
T&D	24,070	112,050	44,920	32,660	34,750
Short term loan	3,000	5,000	11,000	10,000	10,080
<b>Borrowings o/s</b>	<b>559,480</b>	<b>574,930</b>	<b>604,280</b>	<b>632,349</b>	<b>700,040</b>
Capital gains	99,490	108,390	102,650	105,410	113,160
Institutional bonds	309,090	319,300	338,800	369,970	398,790
Banks	105,640	102,700	107,640	110,350	112,260
Foreign currency	20,760	21,540	40,690	44,020	75,830
Commercial paper	24,500	23,000	14,500	2,599	-
Average cost (%)	7.75	7.76	7.96	7.8	7.76
<b>Funds raised</b>					
<b>Capital gain bonds</b>					
Amt	13,580	9,250	10,930	11160	19110
Rate (%)	6.3	6.0	6.0	6	6
<b>Taxable bonds</b>					
Amt	24,540	12,500	20,000	38040	31160
Rate (%)	8.2	6.9	7.8	8.65	9.16
<b>Banks, Fls etc</b>					
Amt	21,590	9,000	22,000	11260	5000
Rate (%)	6.4	5.1	8.1	8.52	8.14
<b>Foreign currency</b>					
Amt	2,100	1,000	19,420	3580	32980
Rate (%)	7.0	6.1	7.0	3	3.44
<b>Total</b>					
Amt	61,810	31,750	72,350	64040	9042
Rate (%)	7.2	6.1	7.4	7.84	6.32

Source: Company

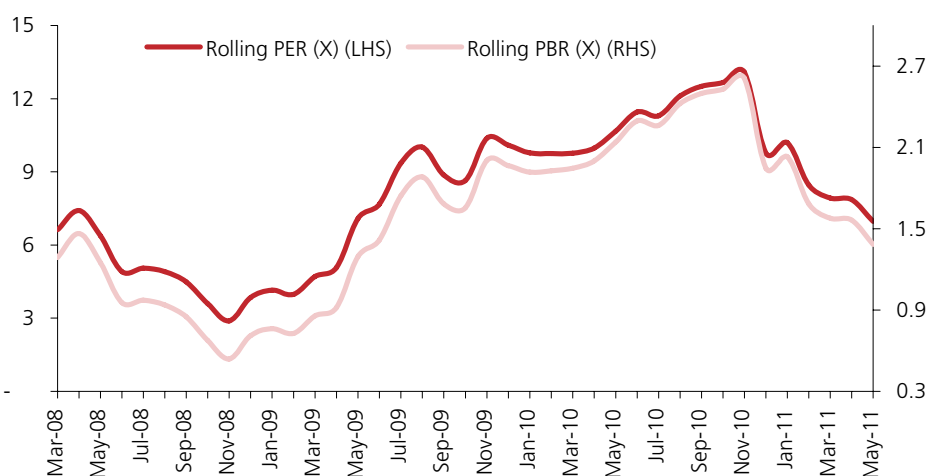
**REC, old and new estimates**

March fiscal year-ends, 2012-2013E (Rs mn)

	Old estimates		New estimates		% change	
	2012E	2013E	2012E	2013E	2012E	2013E
Net interest income	37,474	42,810	36,702	41,316	(2)	(3)
Loan growth (%)	21	21	21	19		
NIM (%)	4.2	4.0	4.0	3.8	(4.6)	(5.1)
NPL provisions	3	4	3	4		
Other operational income	3,362	3,870	4,156	4,749		
Other income (forex etc)	-	-	-	-		
Operating expenses	1,943	2,252	1,931	2,239	(1)	(1)
Employee	1,522	1,750	1,466	1,686	(4)	(4)
Others	422	502	465	553		
PBT	38,889	44,424	38,924	43,822	0	(1)
Tax	10,014	11,550	10,023	11,394	0	(1)
PAT	28,875	32,874	28,901	32,428	0	(1)

Source: Kotak Institutional Equities estimates

**Rural Electrification Corporation – Rolling PBR and PER**  
March 2008-May 2011 (X)



Source: Kotak Institutional Equities

Rural Electrification Corporation, key ratios  
March fiscal year-ends, 2008-2013E (%)

	2008	2009	2010E	2011E	2012E	2013E
<b>Growth in key parameters (%)</b>						
Interest income	28.5	32.6	37.9	26.1	25.9	17.5
Interest costs	17.5	39.8	35.0	24.0	34.9	20.2
Net interest income	48.5	22.4	42.5	29.3	12.7	12.6
PAT	30.3	47.9	57.3	28.4	12.4	12.2
Disbursements	19.3	34.0	23.2	16.0	11.1	11.3
Loans	22.5	30.7	29.3	23.6	21.1	19.3
Borrowings	13.2	31.1	24.5	26.3	22.1	20.0
Shareholders funds	33.8	15.3	79.0	15.4	13.7	13.6
<b>Key ratios (%)</b>						
Interest yield	9.85	10.29	10.92	10.92	11.25	11.00
Interest cost	6.42	7.31	7.75	7.66	8.34	8.29
<b>Spreads</b>	<b>3.43</b>	<b>2.97</b>	<b>3.16</b>	<b>3.25</b>	<b>2.91</b>	<b>2.71</b>
<b>NIMs</b>	<b>4.05</b>	<b>3.90</b>	<b>4.28</b>	<b>4.39</b>	<b>4.04</b>	<b>3.79</b>
Tax rate	29	26	24	26	26	26
Debt/ equity+DTL (X)	5.5	6.3	5.1	5.5	5.9	6.3
<b>Du Pont analysis</b>						
(% of average assets)						
Net interest income	3.7	3.6	4.0	4.2	3.8	3.6
Other income	0.1	0.5	0.4	0.5	0.4	0.4
Credit costs	0.1	0.0	—	—	—	—
Operating expnses	0.3	0.2	0.2	0.2	0.2	0.2
PBT post extraordinary	3.3	3.9	4.2	4.5	4.1	3.8
1-tax rate	0.7	0.7	0.8	0.7	0.7	0.7
<b>RoA</b>	<b>2.2</b>	<b>2.6</b>	<b>3.2</b>	<b>3.3</b>	<b>3.0</b>	<b>2.8</b>
Average assets / average equity (X)	8.4	8.6	7.3	6.5	7.0	7.4
<b>RoE</b>	<b>18.3</b>	<b>22.0</b>	<b>23.2</b>	<b>21.5</b>	<b>21.1</b>	<b>20.9</b>

Source: Company, Kotak Institutional Equities estimates

Rural Electrification Corporation, key financials,  
March fiscal year-ends, 2008-2013E (Rs mn)

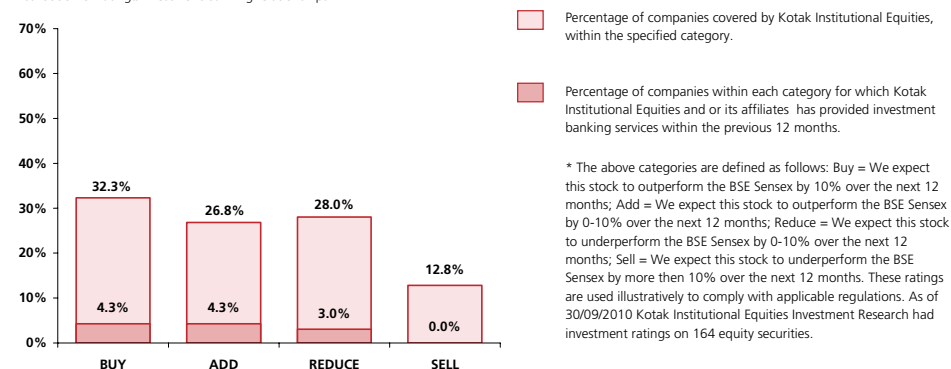
	2008	2009	2010	2011E	2012E	2013E
<b>Income statement (Rs mn)</b>						
Interest income	35,174	46,650	64,309	81,090	102,132	119,955
Interest costs	(20,728)	(28,970)	(39,112)	(48,510)	65,430	78,639
<b>Net interest income</b>	<b>14,447</b>	<b>17,680</b>	<b>25,197</b>	<b>32,580</b>	<b>36,702</b>	<b>41,316</b>
Other income	202	2,660	2,768	3,860	4,156	4,749
Fees	177	1,740	1,189	1,480	1,776	2,131
<b>Net total income</b>	<b>14,649</b>	<b>20,340</b>	<b>27,965</b>	<b>36,440</b>	<b>40,858</b>	<b>46,065</b>
Provisioning expenses	(400)	(20)	(2)	(3)	3	4
<b>Net income (post provisions)</b>	<b>14,249</b>	<b>20,320</b>	<b>27,962</b>	<b>36,437</b>	<b>40,855</b>	<b>46,061</b>
<b>Operating expenses</b>	<b>(1,119)</b>	<b>(1,120)</b>	<b>(1,470)</b>	<b>(1,666)</b>	<b>1,931</b>	<b>2,239</b>
<b>PBT before extraordinaries</b>	<b>13,130</b>	<b>19,200</b>	<b>26,492</b>	<b>34,772</b>	<b>38,924</b>	<b>43,822</b>
Extraordinary income	(6)	—	—	—	—	—
<b>PBT post extraordinaries</b>	<b>13,124</b>	<b>19,200</b>	<b>26,492</b>	<b>34,772</b>	<b>38,924</b>	<b>43,822</b>
Tax	(3,749)	(5,070)	(6,473)	(9,121)	10,023	11,394
Provision for DTL	(774)	(1,410)	(5)	54	-	1
<b>PAT</b>	<b>8,602</b>	<b>12,720</b>	<b>20,014</b>	<b>25,705</b>	<b>28,901</b>	<b>32,427</b>
<b>PAT (add. back DTL)</b>	<b>9,376</b>	<b>14,130</b>	<b>20,019</b>	<b>25,650</b>	<b>28,901</b>	<b>32,428</b>
EPS (adding back DTL) (Rs)	11	16	20	26	29	33
BVPS (adding back DTL) (Rs)	72	83	112	129	147	167
ABVPS (adding back DTL) (Rs)	69	83	112	129	137	155
<b>Balance sheet (Rs mn)</b>						
<b>Assets</b>						
Loans	393,165	513,810	664,520	821,321	994,586	1,186,409
Investments	11,474	10,060	9,100	8,124	8,124	8,124
Fixed assets	779	810	900	881	1,013	1,165
Current assets	23,725	34,890	20,837	34,447	40,650	48,040
<b>Total assets</b>	<b>429,143</b>	<b>559,570</b>	<b>695,357</b>	<b>864,773</b>	<b>1,044,373</b>	<b>1,243,738</b>
<b>Liabilities</b>						
Borrowings	342,828	449,360	559,480	706,836	862,830	1,035,237
Deferred tax liability	8,170	9,570	(70)	(124)	(124)	(123)
Current liabilities and provisions	24,468	38,740	25,147	30,176	36,212	43,454
<b>Total liabilities</b>	<b>375,466</b>	<b>497,670</b>	<b>584,557</b>	<b>736,888</b>	<b>898,918</b>	<b>1,078,568</b>
Share capital	8,586	8,586	9,874	9,874	9,874	9,874
Reserves and surplus	45,090	53,314	100,926	118,011	135,582	155,297
<b>Shareholders funds</b>	<b>53,676</b>	<b>61,900</b>	<b>110,800</b>	<b>127,885</b>	<b>145,456</b>	<b>165,171</b>

Source: Company, Kotak Institutional Equities estimates

"I, Nischint Chawathe, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

#### Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of March 31, 2011

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**BUY.** We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

**ADD.** We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

**REDUCE.** We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

**SELL.** We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

### Other definitions

**Coverage view.** The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

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