Indian power sector lenders

FINANCIALS

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EQUITY RESEARCH

Gap estimate of "problem" SEBs

Closer look at SEB finances – Would this restructuring be a game changer

October 19, 2012

Expect operating breakeven for most "problem" SEBs post FRP

Following the recently announced financial restructuring plan (FRP) for SEB-Discoms (state electricity board distribution companies), our analysis (based on the recently published FY11 financial statements and the FY13 tariff orders of SEBs), indicates that the operating gap for a majority of the "problem" Discoms (Tamil Nadu (TN), Madhya Pradesh (MP), Andhra Pradesh (AP), Punjab and Haryana), is likely to turn positive due to a combination of lower interest expense derived from the FRP, tariff hikes and fixed cost rationalization. The UP regulator is expected to announce a tariff hike on the back of a 30% increase sought by the Discom; in our view, Rajasthan may need a 15-20% hike over the next three years to erase its operating losses. We expect PFC and REC to be major beneficiaries of these developments.

The FRP links central government incentives to a trajectory of 25% gap reduction every year, with FY11 as the benchmark year and FY13-15 as the eligible years. Using FY11 data and applying the FRP's 25% gap reduction assumption, we infer operating losses for these seven Discoms over this period, assuming adherence to this trajectory (Fig. 3) with a sensitivity analysis of operating losses to consumption growth and gap reduction (Exhibit 4). PFC and REC have committed to extend 170bn each of transition loans to tide over losses in the interim.

Implementation key to the potency of FRP — catalysts and caveats

As per recent discussion with lenders such as PFC, we believe the next steps for implementation of FRP include: 1) setting up a nodal bank for each Discom; 2) the filing of an application by each Discom with the Department of Financial Services; and 3) getting approval from the Ministry of Power. Based on our discussions, we think the window for FRP is likely to be extended beyond Dec 12. Regarding implementation, we see:

- Near-term catalysts: 1) Signing of FRPs by stressed Discoms by December 2012; 2) notification of new tariff orders by 30 April; 3) UP tariff hike.
- Key caveats: 1) near-term elections in states such as Rajasthan and MP could impact the ability to make commensurate tariff hikes; 2) a few states such as Punjab would need serious fiscal consolidation to fit FRP within FRBM mandates (Fig. 7, 8).

PFC and REC potential beneficiaries of FRP; reiterate Buy ratings

We are increasing our earnings estimates for PFC and REC by 16% and 17% respectively for FY13F. At our target prices, PFC and REC would trade at 1.4x and 1.5x average FY13F-14F P/ABV, respectively. We reiterate our Buy rating on both the names.

Anchor themes

We expect policy action in the power sector and at state utilities specifically to gradually improve the investment outlook for infrastructure financing companies. REC and PFC are focused investment vehicles on this theme with their concentrated power sector exposure and structural growth in power sector capex.

Nomura vs consensus

Our FY13 PAT estimates for PFC and REC are ~7% above consensus on stable asset quality.

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Contents

Fig. 1: Stocks for Action

Company name	Bloomberg ticker	Rating	Price target	Current price	Potential upside / downside (%)	Current FY13-14 P/ABV (X)	Implied FY13-14 P/ABV (X)
Power Finance Corp	POWF IN	Buy	240	197	21.8%	1.1	1.4
Rural Electric Corp	RECL IN	Buy	255	213	19.7%	1.2	1.5

Source: Nomura research

Estimate of operating gap for FY13; extrapolating potential operating losses over FY13-FY15F

We used the report by PFC (*Performance of State power utilities for 2010-11*) on the performance of state utilities as of FY11 as a basis to estimate the operating gap for each of the SEB Discoms in FY13F on a revenue per unit basis. We looked into the approved tariff orders for all states (except UP) to factor in the estimates for cost of power and subsidy earmarked by the respective state governments. We reduced the interest cost of half of their respective short-term liabilities (as given in the FRP notice) to estimate the opening gap for FY14F.

In addition to the tariff hikes done in FY12 and FY13 so far, tighter control on the delivered cost of power (largely fixed costs) is largely responsible for reductions in the SEB Discoms' operating gaps, in our view. The trend in cost control as shown by states like TN, Rajasthan and MP is evident even in actual data over FY09 to FY11.

While the actual delivered cost of power could vary compared to the tariff order, we think the gap has become more manageable for most of the states. While we think Rajasthan will need a longer trajectory to cut its close its operating gap, UP is expected to see a tariff hike over the next few weeks, as per our discussion with lenders such as PFC.

Fig. 2: Operating gap analysis on revenue per unit of sales as the base

SEB	Revenue Gap FY11A as % of per unit revenue (before subsidy)	Tariff hikes announced from FY11 to FY13 over FY11 base (%)	Increase in cost of power * per unit sales from FY11 to FY13F (%)	Calculated FY13E Gap on FY13 Revenue per unit base (%)	Calculated FY13E Gap post subsidy* on FY13 Revenue per unit base(%)	Opening FY14F gap after adjusting for lower interest outgo post retsructuring (%)
Rajasthan	134	45	1	62	52	39
UP #	36	-	16	58	38	32
TN	82	37	(16)	11	3	0
Haryana	45	19	5	27	(3)	(8)
Punjab	45	22	17	38	(1)	(6)
AP	30	20	5	14	(4)	(5)
MP	38	14	(9)	11	(5)	(5)

For UP, the numbers correspond to filed tariff revision petition,
Source: PFC report on State Power Utilities, SEB tariff orders, Nomura research

We used the operating gap as represented by the difference in ACS (average cost of supply) and ARR (average revenue realized) as given in the PFC report for FY11 as the likely benchmark for cost-reduction trajectory (as per the FRP notification). The FRP links central government incentives to a trajectory of 25% gap reduction every year with FY11 as the benchmark year and FY13-15F as the eligible years. We applied this discount to estimate the target gap for FY13F to be 25% lower than the benchmark (FY11A) and for FY14F and FY15F to be 25% lower than their preceding years for all the SEBs. We used the FY13 power consumption growth and subsidy per unit volume as per the respective tariff orders to extrapolate operating losses for FY13F, FY14F and FY15F.

On this basis, compared to the FY13F estimate (above), only UP shows a much larger deficit compared to the target gap for FY13, which could potentially get addressed post the impending tariff hike. Assuming all states adhere to the trajectory for FY14F and FY15F, only Rajasthan, UP and TN would likely report operating losses post subsidy.

Fig. 3: Estimate of operating losses for FY13 to FY15

	FY11A Gap as per PFC report - Benchmark for FRP*	FY13F Gap As per data from Tariff orders for FY13	Target Gap as per FRP FY13F	Target Gap as per FRP FY14F	Target Gap as per FRP FY15F	FY13E Power purchase as per tariff orders (Bn units)	FY13E Power purchase Growth as per tariff orders %	Operating loss post subsidy FY13E (INR bn)	Operating loss post subsidy FY14E (INR bn)	Operating loss post subsidy FY15E (INR bn)
Rajasthan	2.29	1.75	1.72	1.29	0.97	52.4	8.7%	**71**	**51**	**36**
UP	0.82	1.64	0.62	0.46	0.35	79.0	12.0%	**71**	**(25)**	**(39)**
TN	2.39	0.44	1.79	1.34	1.01	70.8	2.5%	**4**	**4**	**4**
Haryana	1.04	0.89	0.78	0.59	0.44	38.9	11.3%	**(17)**	**(32)**	**(43)**
Punjab	1.11	1.08	0.83	0.62	0.47	42.9	5.7%	**(12)**	**(33)**	**(43)**
AP	0.77	0.46	0.58	0.43	0.32	90.4	12.1%	**(23)**	**(29)**	**(45)**
MP	0.92	0.31	0.69	0.52	0.39	44.6	11.8%	**(14)**	**(16)**	**(17)**

Source: PFC report on State Power Utilities, SEB Tariff orders, Nomura research

In Fig. 4, we present a sensitivity analysis of the operating losses to annual gap reduction trajectory and the growth in power purchased. An annual loss reduction rate within 10-20% and annual power purchase growth of around 10% puts the estimated loss at around INR300bn for these SEBs put together.

As per the FRP notice, banks are not allowed to provide short-term funding for cash losses of Discoms on an incremental basis, and a separate arrangement would be made between the state representatives, DoFS and MoP for financing these. Both PFC and REC have agreed to extend INR170bn each as a transitional finance on a three-year moratorium and five- to seven-year repayment term to help these Discoms in the interim, according to their management. PFC said that these loans would be extended to Discoms on a case-by-case basis and would be fully backed by state government guarantees.

Fig. 4: Sensitivity of operating losses post subsidy to gap reduction and volume growth

Operating losses in INRbn

		Annual gap reduction over FY13 to FY15				
		-10%	**0%**	**10%**	**20%**	**30%**
Power purchase growth Y-Y	**-5%**	1,026	696	406	153	(65)
	0%	1,086	732	422	153	(79)
	5%	1,148	769	438	152	(93)
	10%	1,212	807	455	152	(108)
	15%	1,278	847	473	151	(123)

Source: Nomura estimates

Comparison on state liabilities from FRP to their FRBM mandates

As per the FRP notice, state governments would need to take over half of the short-term liabilities (STL) of Discoms as of March 2012 in the form of state government bonds, in a phased manner as given below:

Fig. 5: STL phasing

INRbn

STL phasing						
	STL	FY13F	FY14F	FY15F	FY16F	FY17F
Rajasthan	198.5	26.5	35.0	39.9	45.4	51.8
UP	129.7	19.2	22.5	25.6	29.2	33.3
TN	95.7	8.8	25.3	28.8	32.8	
Haryana	78.6	25.2	25.0	28.5		
Punjab	58.2	8.8	10.0	11.5	13.1	14.9
AP	31.5	22.1	9.4			
MP	5.9	7.2	5.1			

Source: FRP Notification

In the absence of a statewide GDP forecast, we have used national GDP projections of our economics team for all the above states to arrive at an indicative fiscal deficit and liability to state-level GDP ratios including the planned swapping of the Discom bonds into state government bonds, as per the FRP notification.

Fig. 6: GDP growth assumption

GDP Growth Assumption						
	FY12F	FY13F	FY14F	FY15F	FY16F	FY17F
Rajasthan	11.0%	5.8%	6.6%	7.0%	7.5%	7.5%
UP	6.2%	5.8%	6.6%	7.0%	7.5%	7.5%
TN	12.4%	5.8%	6.6%	7.0%	7.5%	7.5%
Haryana	8.1%	5.8%	6.6%	7.0%	7.5%	7.5%
Punjab	5.8%	5.8%	6.6%	7.0%	7.5%	7.5%
AP	6.8%	5.8%	6.6%	7.0%	7.5%	7.5%
MP	8.2%	5.8%	6.6%	7.0%	7.5%	7.5%

For FY12F - the growth number is revised estimates (Rajasthan and MP are Budget estimates)
Source: Nomura estimates

We have kept the base deficit numbers the same as FY12 estimates. While the following tables present a very indicative comparison given the assumption involved, it is apparent that barring Punjab and Haryana, most states would be close to their FRBM mandates after taking up the Discom liabilities.

However, in absence of fiscal consolidation going forward, we expect the probability of these Discom bonds getting SLR (statutory liquidity ratio) status to be very low. In addition, lower indebted states like TN and Haryana would likely have very less headroom for capex-related borrowing as per the indicative trajectory below.

Fig. 7: Fiscal deficit / Gross state domestic product (%)

Fiscal Deficit / GSDP							
State		FY12 RE	FY13F	FY14F	FY15F	FY16F	FY17F
Rajasthan	FRBM Target	3.2	3.0	3.0	3.0		
	Projected	2.1	2.8	3.0	3.1	3.1	3.2
UP	FRBM Target	3.5	3.0	3.0	3.0		
	Projected	3.0	3.2	3.3	3.3	3.3	3.3
TN	FRBM Target	3.0	3.0	3.0	3.0		
	Projected	2.9	3.0	3.2	3.2	3.3	
Haryana	FRBM Target	3.0	3.0	3.0	3.0		
	Projected	2.5	3.3	3.4	3.5		
Punjab	FRBM Target	3.5	3.5	3.0	3.0		
	Projected	3.9	4.2	4.2	4.3	4.3	4.3
AP	FRBM Target	3.0	3.0	3.0	3.0		
	Projected	2.6	3.0	2.8			
MP	FRBM Target	3.4	3.0	3.0	3.0		
	Projected	3.0	3.2	3.2			

Source: Nomura estimates, FRP Notification

Fig. 8: Outstanding liabilities / Gross state domestic product (%)

Outstanding Liabilities / GSDP							
State		**FY12 RE**	**FY13F**	**FY14F**	**FY15F**	**FY16F**	**FY17F**
Rajasthan	FRBM Target	39.3	38.3	37.3	36.5		
	Projected	29.1	29.8	30.7	31.7	32.8	33.9
Uttar Pradesh	FRBM Target	46.9	45.1	43.4	41.9		
	Projected	37.6	37.9	38.2	38.5	38.9	39.2
Tamil Nadu	FRBM Target	24.5	24.8	25.0	25.2		
	Projected	21.6	21.7	22.1	22.5	22.9	
Haryana	FRBM Target	22.6	22.7	22.8	22.9		
	Projected	18.5	19.3	20.0	20.8		
Punjab	FRBM Target	41.8	41.0	39.8	38.7		
	Projected	33.4	33.7	34.1	34.5	34.9	35.3
Andhra Pradesh	FRBM Target	29.6	28.9	28.2	27.6		
	Projected	25.6	25.9	26.1			
Madhya Pradesh	FRBM Target	37.6	36.8	36.0	35.3		
	Projected	31.1	31.4	31.5			

Source: Nomura estimates, FRP notification

Balance Sheet composition of SEB-Discoms

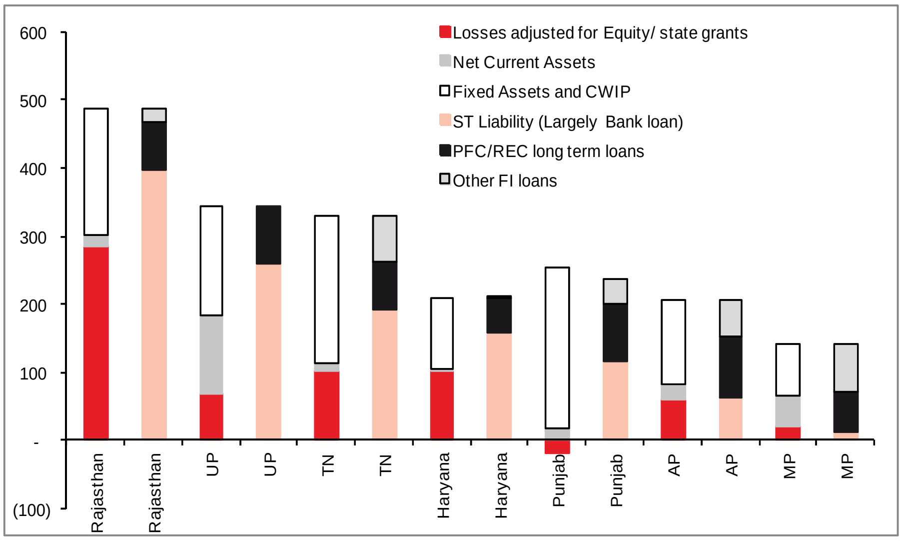
We used FY11 balance sheet data, details from tariff orders and the short-term liability data as of FY12 in the FRP note to arrive at an estimate of the balance sheet composition of these seven SEBs as of FY12.

In the chart below, the pair of bars for each state represents the composition of their assets and liabilities, respectively. The asset side is divided into fixed assets (including CWIP), net current assets (largely receivables) and accumulated losses adjusted for state equity infusion and state grants. While the liability side consists of short-term loans given by banks, long-term loans given by PFC/REC and long-term loans given by other FIs (like LIC, HUDCO).

As is evident in the figure below, our analysis shows short-term loans more than suffice for cash losses and receivables for the Discoms, while loans from PFC/REC and other FIs largely correspond to their fixed assets.

Fig. 9: Balance Sheet composition of various states FY12E

INR bn



Source: Nomura estimates, PFC Report on State Power Utilities, SEB Tariff orders

Rural Electrification Corporation

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Increasing TP on FY13F PAT increase of 17%

FRP improves the outlook for the biggest Discom lender

October 19, 2012

Rating Remains	**Buy**
Target price Increased from 245	INR 255
Closing price October 17, 2012	INR 213
Potential upside	+19.7%

Action: Reiterate Buy; TP increased to INR255

We believe that the recent financial restructuring plan (FRP) and the spate of tariff hikes over the past few months have strongly reduced the overhang on REC's SEB exposure (82% of its Q1FY13F loan book). We had earlier factored in a restructuring of 10% of REC's loans to stressed Discoms, which we don't see necessary any longer, although we have factored in a marginal NIM impact from extending shorter-term transition loans to some of these Discoms over the next few years. Our earnings estimates for FY13F and FY14F rise by 17% and 7%, respectively. We expect a loan book growth of 18.4% and 18.1% for FY13F and FY14F, respectively.

We expect the robust spreads to sustain the superior RoEs

REC's spreads have improved by 35bps over the past six months, helped by asset repricing, while NIMs have improved to 4.5% for Q1FY13. We expect NIMs to stay in the 4.35-4.4% range over FY14F despite factoring in marginally lower yields on higher short term loans. We also factor in INR4bn of slippage in FY13F and incremental provisions on existing NPLs.

Catalyst: Adoption of FRP by SEBs, tariff hike orders in UP and other states and developments on the coal linkage front

Valuation

REC currently trades at 1.2x our avg FY13-14F ABV estimate and 5.7x our avg FY13-14F EPS estimate. At our new TP of INR255, REC would trade at 1.5x our avg FY13-14F ABV estimate of INR172.4 and 6.9x EPS estimate of INR37.1, for FY13F ROA of 3.1% and ROE of 23%.

31 Mar	FY12		FY13F		FY14F		FY15F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	38,451	45,707	48,012	53,762	56,145		66,287
Reported net profit (mn)	28,170	29,570	34,742	35,970	38,524		45,623
Normalised net profit (mn)	28,170	29,570	34,742	35,970	38,524		45,623
FD normalised EPS	28.53	29.95	35.18	36.43	39.01		46.20
FD norm. EPS growth (%)	9.3	5.8	23.3	21.6	10.9		18.4
FD normalised P/E (x)	7.5	N/A	6.0	N/A	5.4	N/A	4.6
Price/adj. book (x)	1.5	N/A	1.3	N/A	1.2	N/A	1.0
Price/book (x)	1.4	N/A	1.2	N/A	1.1	N/A	0.9
Dividend yield (%)	4.1	N/A	5.4	N/A	6.9	N/A	8.1
ROE (%)	20.5	19.0	21.8	20.4	21.1		21.8
ROA (%)	3.0	2.7	3.1	2.9	3.0		3.1

Source: Company data, Nomura estimates

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

We expect policy action in the power sector and at state utilities specifically, to gradually improve the investment outlook for infrastructure financing companies. REC and PFC are focused investment vehicles on this theme with their concentrated power sector exposure and structural growth in power sector capex.

Nomura vs consensus

Our FY13F PAT estimate is 7% above consensus as we build in stable asset quality.

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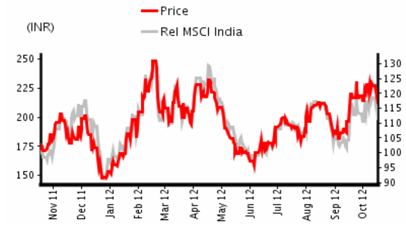
Key data on Rural Electrification Corporation

Profit and Loss (INRmn)

Year-end 31 Mar	FY11	FY12	FY13F	FY14F	FY15F
Interest income	81,088	102,640	126,053	147,522	172,621
Interest expense	-48,510	-63,788	-77,242	-89,970	-105,097
Net interest income	32,578	38,852	48,811	57,552	67,524
Net fees and commissions	1,481	736	1,099	1,228	1,389
Trading related profits	54	0	0	0	0
Other operating revenue	2,330	1,189	387	236	416
Non-interest income	3,865	1,925	1,486	1,465	1,806
Operating income	36,443	40,777	50,297	59,017	69,329
Depreciation	0	0	0	0	0
Amortisation	0	0	0	0	0
Operating expenses	-371	-616	-564	-627	-735
Employee share expense	-1,275	-1,710	-1,721	-2,245	-2,307
Op. profit before provisions	34,797	38,451	48,012	56,145	66,287
Provisions for bad debt	-2	-491	-635	-1,095	-1,095
Other provision charges	0	-32	-12	-16	-16
Operating profit	34,795	37,929	47,365	55,034	65,176
Other non-operating income	0	0	0	0	0
Associates & JCEs	0	0	0	0	0
Pre-tax profit	34,795	37,929	47,365	55,034	65,176
Income tax	-9,027	-9,758	-12,623	-16,510	-19,553
Net profit after tax	25,768	28,170	34,742	38,524	45,623
Minority interests	0	0	0	0	0
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	25,768	28,170	34,742	38,524	45,623
Extraordinary items	-32	0	0	0	0
Reported NPAT	25,736	28,170	34,742	38,524	45,623
Dividends	-8,621	-8,607	-11,362	-14,399	-17,052
Transfer to reserves	17,115	19,563	23,380	24,125	28,571
Valuation and ratio analysis					
Reported P/E (x)	8.2	7.5	6.0	5.4	4.6
Normalised P/E (x)	8.1	7.5	6.0	5.4	4.6
FD normalised P/E (x)	8.1	7.5	6.0	5.4	4.6
FD normalised P/E at price target (x)	9.8	8.9	7.2	6.5	5.5
Dividend yield (%)	4.1	4.1	5.4	6.9	8.1
Price/book (x)	1.6	1.4	1.2	1.1	0.9
Price/adjusted book (x)	1.7	1.5	1.3	1.2	1.0
Net interest margin (%)	4.24	4.01	4.23	4.30	4.31
Yield on interest earning assets (%)	10.56	10.60	10.91	11.03	11.03
Cost of interest bearing liabilities (%)	7.70	7.97	8.10	8.22	8.26
Net interest spread (%)	2.86	2.63	2.81	2.81	2.77
Non-interest/operating income (%)	10.6	4.7	3.0	2.5	2.6
Cost to income (%)	4.5	5.7	4.5	4.9	4.4
Effective tax rate (%)	25.9	25.7	26.7	30.0	30.0
Dividend payout (%)	33.5	30.6	32.7	37.4	37.4
ROE (%)	21.6	20.5	21.8	21.1	21.8
ROA (%)	3.44	3.01	3.12	3.02	3.08
Operating ROE (%)	29.2	27.6	29.8	30.1	31.1
Operating ROA (%)	4.65	4.05	4.26	4.31	4.40
Growth (%)					
Net interest income	29.3	19.3	25.6	17.9	17.3
Non-interest income	39.7	-50.2	-22.8	-1.4	23.3
Non-interest expenses	24.2	66.3	-8.5	11.1	17.2
Pre-provision earnings	31.3	10.5	24.9	16.9	18.1
Net profit	28.7	9.3	23.3	10.9	18.4
Normalised EPS	28.7	9.3	23.3	10.9	18.4
Normalised FDEPS	28.7	9.3	23.3	10.9	18.4

Source: Company data, Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	2.0	10.6	22.1
Absolute (USD)	4.1	15.0	12.9
Relative to index	1.3	1.2	13.4
Market cap (USDmn)	3,966.1		
Estimated free float (%)	33.2		
52-week range (INR)	252/143.5		
3-mth avg daily turnover (USDmn)	9.16		
Major shareholders (%)			
Govt. of India	66.8		

Source: Thomson Reuters, Nomura research

Notes

We expect spreads of 3.2% for FY13F

Balance Sheet (INRmn)

As at 31 Mar	FY11	FY12	FY13F	FY14F	FY15F
Cash and equivalents	6,261	1	2,479	4,137	3,195
Inter-bank lending	22,058	53,114	11,115	12,992	15,128
Deposits with central bank	0	0	0	0	0
Total securities	8,368	7,576	6,869	6,232	5,659
Other interest earning assets	0	0	0	0	0
Gross loans	824,165	1,022,052	1,211,021	1,430,967	1,665,399
Less provisions	-178	-640	-1,275	-2,370	-3,465
Net loans	823,988	1,021,412	1,209,746	1,428,596	1,661,934
Long-term investments	0	0	0	0	0
Fixed assets	683	785	785	785	785
Goodwill	0	0	0	0	0
Other intangible assets	0	0	0	0	0
Other non IEAs	-33,561	-35,859	-53,527	-75,284	-100,534
Total assets	827,797	1,047,029	1,177,467	1,377,457	1,586,167
Customer deposits	0	0	0	0	0
Bank deposits, CDs, debentures	188,093	186,660	197,668	267,058	303,604
Other interest bearing liabilities	511,945	713,020	809,071	915,546	1,059,138
Total interest bearing liabilities	700,038	899,680	1,006,739	1,182,604	1,362,742
Non interest bearing liabilities	-128	-101	-101	-101	-101
Total liabilities	699,910	899,580	1,006,638	1,182,503	1,362,642
Minority interest	0	0	0	0	0
Common stock	9,875	9,875	9,875	9,875	9,875
Preferred stock	0	0	0	0	0
Retained earnings	118,012	137,575	160,954	185,080	213,651
Reserves for credit losses	0	0	0	0	0
Proposed dividends	0	0	0	0	0
Other equity	0	0	0	0	0
Shareholders' equity	127,886	147,449	170,829	194,954	223,525
Total liabilities and equity	827,797	1,047,029	1,177,467	1,377,457	1,586,167
Non-performing assets (INR)	195	4,900	9,050	9,664	10,296
Balance sheet ratios (%)					
Loans to deposits	na	na	na	na	na
Equity to assets	15.4	14.1	14.5	14.2	14.1
Asset quality & capital					
NPAs/gross loans (%)	0.0	0.5	0.7	0.7	0.6
Bad debt charge/gross loans (%)	0.00	0.05	0.05	0.08	0.07
Loss reserves/assets (%)	0.02	0.06	0.11	0.17	0.22
Loss reserves/NPAs (%)	90.9	13.1	14.1	24.5	33.7
Tier 1 capital ratio (%)	15.0	15.5	15.9	15.5	15.4
Total capital ratio (%)	15.8	16.4	16.8	16.5	16.5
Growth (%)					
Loan growth	24.0	24.0	18.4	18.1	16.3
Interest earning assets	25.5	26.6	13.5	17.9	16.2
Interest bearing liabilities	25.1	28.5	11.9	17.5	15.2
Asset growth	23.5	26.5	12.5	17.0	15.2
Deposit growth	na	na	na	na	na
Per share					
Reported EPS (INR)	26.06	28.53	35.18	39.01	46.20
Norm EPS (INR)	26.10	28.53	35.18	39.01	46.20
Fully diluted norm EPS (INR)	26.10	28.53	35.18	39.01	46.20
DPS (INR)	8.73	8.72	11.51	14.58	17.27
PPOP PS (INR)	35.24	38.94	48.62	56.86	67.13
BVPS (INR)	129.51	149.32	173.00	197.43	226.36
ABVPS (INR)	123.48	139.83	160.99	183.80	210.60
NTAPS (INR)	129.51	149.32	173.00	197.43	226.36

Source: Company data, Nomura estimates

Notes

We expect loan book growth of 18% for both FY13F and FY14F

Key changes to our FY13 estimates

Fig. 10: Key changes to our FY13 estimates

Key estimate changes for FY13	Old	New
Loan book	1,184,387	1,209,746
Loan growth % y/y	18.5%	18.4%
Sanctions	550,029	599,630
Disbursals	292,360	279,194
PAT	29,586	34,742
PAT growth % y/y	5.9%	23.3%
Spreads	2.9%	3.2%
Gross NPL	17,420	9,050
RoA	2.73%	3.12%
RoE	20.3%	23.4%

Source: Nomura estimates

Valuation

REC is still trading close to 1 std deviation below its five-year mean despite the recent run-up in the share price. We maintain our Buy rating on the stock; as we revise our earnings estimates, we raise our TP to INR255. REC currently trades at 1.2x our avg FY13-14F ABV estimate and 5.7x our avg FY13-14F EPS estimate. We arrive at our target price of INR255 using a three-stage residual-income valuation method using following assumptions: 1) 18.8% CAGR in interest earning asset for FY12-FY15F, 2) 22.8% avg RoE for FY12-FY15F, 3) discount rate of 14.5% for FY12 to FY15F, 12.5% for FY15F to FY20F and terminal discount rate of 10%.

At our TP of INR255, REC would trade at 1.5x our avg FY13-14F ABV estimate of INR172.4 and 6.9x EPS of INR37.1, for FY13F ROA of 3.1% and ROE of 23%.

Fig. 11: REC – P/ABV

Source: Bloomberg, Nomura estimates

Fig. 12: REC – P/E

Source: Bloomberg, Nomura estimates

Key risks to our estimates and TP

A sharp deterioration in the asset quality of private sector developers and non-adherence to the trajectory recommended in the FRP by SEBs could impact the company's earnings outlook.

Power Finance Corporation

PWFC.NS POWF IN

FINANCIALS

NOMURA
EQUITY RESEARCH

Increasing FY13F PAT by 16%; reiterate Buy

Key beneficiary of a stronger SEB outlook

October 19, 2012

Rating Remains	**Buy**
Target price Remains	INR 240
Closing price October 17, 2012	INR 197
Potential upside	+21.8%

Action: Reiterate Buy; TP unchanged at INR240

We believe the recent financial restructuring plan (FRP) and the spate of tariff hikes over the past few months have strongly reduced the overhang on PFC's SEB exposure (71% of its Q1FY13 loan book). As per management, some of the stressed Discoms have already started showing improved timeliness in loan repayments. We had earlier budgeted for restructuring of 8% of PFC's loans to the stressed Discoms, which we don't see necessary any longer, although we have factored in marginal NIM impacts from extending shorter-term transition loans to some of these Discoms over the next few years. Our earnings estimate for FY13F and FY14F go up by 16% and 6%, respectively. We expect loan book growth of 18% and 16% for FY13F and FY14F, respectively.

Expect strong spreads and stable asset quality to sustain ROA

PFC's spreads have improved by 50bps over past six months helped by asset repricing and we expect it to come down by 15bps to 2.45% by FY14F. We expect asset quality to hold over FY13-14F, although we are factoring in incremental provisions on the existing NPLs.

Catalysts: Adoption of FRP by SEBs, tariff hike orders in UP and other states and developments on the coal linkage front

Valuation

PFC trades at 1.1x our avg FY13-14F ABV and 6.4x our FY13F EPS. At our TP of INR240, PFC would trade at 1.4x our avg FY13-14F ABV of INR173 and 7.8x EPS of INR30.8, for FY13F ROA of 2.7% and 19% ROE.

31 Mar	FY12		FY13F		FY14F		FY15F
Currency (INR)	Actual	Old	New	Old	New	Old	New
PPOP (mn)	42,462	52,345	54,854	59,170	62,003		70,280
Reported net profit (mn)	30,317	33,838	39,190	39,272	42,137		47,933
Normalised net profit (mn)	30,309	33,838	39,190	39,272	42,137		47,933
FD normalised EPS	22.96	25.64	29.69	29.75	31.92		36.31
FD norm. EPS growth (%)	0.6	10.7	29.3	16.1	7.5		13.8
FD normalised P/E (x)	8.6	N/A	6.6	N/A	6.2	N/A	5.4
Price/adj. book (x)	1.4	N/A	1.2	N/A	1.1	N/A	0.9
Price/book (x)	1.3	N/A	1.1	N/A	1.0	N/A	0.9
Dividend yield (%)	3.5	N/A	4.8	N/A	5.1	N/A	5.8
ROE (%)	16.9	15.4	17.8	16.1	17.0		17.2
ROA (%)	2.6	2.4	2.7	2.5	2.5		2.5

Source: Company data, Nomura estimates

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

We expect policy actions in the power sector and at state utilities specifically to gradually improve the investment outlook for infrastructure financing companies. REC and PFC are focused investment vehicles on this theme with their concentrated power sector exposure and structural growth in power sector capex.

Nomura vs consensus

Our FY13F PAT estimate is 7% above consensus as we build-in stable asset quality.

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

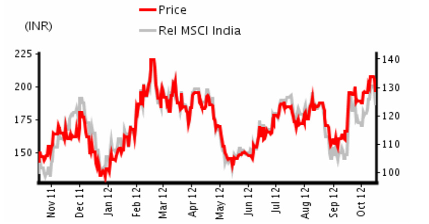
Key data on Power Finance Corporation

Profit and Loss (INRmn)

Year-end 31 Mar	FY11	FY12	FY13F	FY14F	FY15F
Interest income	97,605	126,025	164,039	190,426	214,927
Interest expense	-64,606	-84,940	-108,003	-128,339	-144,957
Net interest income	32,999	41,085	56,036	62,087	69,970
Net fees and commissions	2,590	1,488	1,653	1,921	1,992
Trading related profits	0	0	0	0	0
Other operating revenue	1,147	1,182	-1,307	-296	216
Non-interest income	3,737	2,670	346	1,625	2,208
Operating income	36,736	43,756	56,383	63,712	72,178
Depreciation	0	0	0	0	0
Amortisation	0	0	0	0	0
Operating expenses	-306	-573	-695	-772	-867
Employee share expense	-671	-721	-834	-938	-1,031
Op. profit before provisions	35,759	42,462	54,854	62,003	70,280
Provisions for bad debt	-289	-1,188	-1,518	-1,804	-1,801
Other provision charges	-28	-240	-2	-3	-3
Operating profit	35,442	41,034	53,334	60,196	68,476
Other non-operating income	0	0	0	0	0
Associates & JCEs	0	0	0	0	0
Pre-tax profit	35,442	41,034	53,334	60,196	68,476
Income tax	-9,246	-10,725	-14,144	-18,059	-20,543
Net profit after tax	26,197	30,309	39,190	42,137	47,933
Minority interests	0	0	0	0	0
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	26,197	30,309	39,190	42,137	47,933
Extraordinary items	-1	8	0	0	0
Reported NPAT	26,196	30,317	39,190	42,137	47,933
Dividends	-6,986	-9,204	-12,359	-13,288	-15,116
Transfer to reserves	19,210	21,113	26,831	28,849	32,817
Valuation and ratio analysis					
Reported P/E (x)	8.6	8.6	6.6	6.2	5.4
Normalised P/E (x)	8.6	8.6	6.6	6.2	5.4
FD normalised P/E (x)	8.6	8.6	6.6	6.2	5.4
FD normalised P/E at price target (x)	10.5	10.5	8.1	7.5	6.6
Dividend yield (%)	3.1	3.5	4.8	5.1	5.8
Price/book (x)	1.5	1.3	1.1	1.0	0.9
Price/adjusted book (x)	1.6	1.4	1.2	1.1	0.9
Net interest margin (%)	3.60	3.51	3.90	3.70	3.67
Yield on interest earning assets (%)	10.65	10.77	11.41	11.36	11.29
Cost of interest bearing liabilities (%)	8.40	8.64	8.94	9.04	9.00
Net interest spread (%)	2.25	2.12	2.47	2.31	2.29
Non-interest/operating income (%)	10.2	6.1	0.6	2.6	3.1
Cost to income (%)	2.7	3.0	2.7	2.7	2.6
Effective tax rate (%)	26.1	26.1	26.5	30.0	30.0
Dividend payout (%)	26.7	30.4	31.5	31.5	31.5
ROE (%)	18.4	16.9	17.8	17.0	17.2
ROA (%)	2.87	2.61	2.74	2.53	2.53
Operating ROE (%)	24.9	22.9	24.2	24.2	24.5
Operating ROA (%)	3.89	3.53	3.73	3.61	3.62
Growth (%)					
Net interest income	13.9	24.5	36.4	10.8	12.7
Non-interest income	66.4	-28.5	-87.0	369.0	35.9
Non-interest expenses	-28.0	87.3	21.4	11.0	12.4
Pre-provision earnings	18.7	18.7	29.2	13.0	13.4
Net profit	11.1	15.7	29.3	7.5	13.8
Normalised EPS	11.1	0.6	29.3	7.5	13.8
Normalised FDEPS	11.1	0.6	29.3	7.5	13.8

Source: Company data, Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	8.7	6.7	35.1
Absolute (USD)	10.9	11.0	25.0
Relative to index	8.0	-2.6	26.4
Market cap (USDmn)	4,916.1		
Estimated free float (%)	26.3		
52-week range (INR)	224.7/131.05		
3-mth avg daily turnover (USDmn)	12.29		
Major shareholders (%)			
Govt. of India	73.7		

Source: Thomson Reuters, Nomura research

Notes

We expect spreads to decline 15bps by FY14F

Balance Sheet (INRmn)

As at 31 Mar	FY11	FY12	FY13F	FY14F	FY15F
Cash and equivalents	39	35	2,561	4,687	531
Inter-bank lending	23,462	19,840	16,815	19,478	21,722
Deposits with central bank	0	0	0	0	0
Total securities	539	592	592	592	592
Other interest earning assets	0	0	0	0	0
Gross loans	996,068	1,302,148	1,539,689	1,783,178	1,991,678
Less provisions	-361	-1,430	-2,580	-3,927	-5,313
Net loans	995,707	1,300,718	1,537,109	1,779,251	1,986,365
Long-term investments	0	0	0	0	0
Fixed assets	767	765	765	765	765
Goodwill	0	0	0	0	0
Other intangible assets	0	0	0	0	0
Other non IEAs	-7,357	-8,986	-10,976	-14,478	-17,283
Total assets	1,013,158	1,312,964	1,546,866	1,790,294	1,992,691
Customer deposits	0	0	0	0	0
Bank deposits, CDs, debentures	291,009	256,547	258,770	293,350	307,930
Other interest bearing liabilities	569,495	848,474	1,053,360	1,233,360	1,388,360
Total interest bearing liabilities	860,504	1,105,021	1,312,130	1,526,710	1,696,290
Non interest bearing liabilities	829	868	830	830	830
Total liabilities	861,333	1,105,889	1,312,960	1,527,540	1,697,120
Minority interest	0	0	0	0	0
Common stock	11,478	13,199	13,199	13,199	13,199
Preferred stock	0	0	0	0	0
Retained earnings	140,347	193,876	220,707	249,555	282,372
Reserves for credit losses	0	0	0	0	0
Proposed dividends	0	0	0	0	0
Other equity	0	0	0	0	0
Shareholders' equity	151,825	207,075	233,906	262,754	295,571
Total liabilities and equity	1,013,158	1,312,964	1,546,866	1,790,294	1,992,691
Non-performing assets (INR)	2,307	13,580	14,182	14,434	14,841
Balance sheet ratios (%)					
Loans to deposits	na	na	na	na	na
Equity to assets	15.0	15.8	15.1	14.7	14.8
Asset quality & capital					
NPAs/gross loans (%)	0.2	1.0	0.9	0.8	0.7
Bad debt charge/gross loans (%)	0.03	0.09	0.10	0.10	0.09
Loss reserves/assets (%)	0.04	0.11	0.17	0.22	0.27
Loss reserves/NPAs (%)	15.6	10.5	18.2	27.2	35.8
Tier 1 capital ratio (%)	14.7	15.4	17.0	16.6	16.8
Total capital ratio (%)	15.7	16.3	18.0	17.7	17.9
Growth (%)					
Loan growth	24.7	30.6	18.2	15.8	11.6
Interest earning assets	25.5	29.6	17.7	15.7	11.6
Interest bearing liabilities	27.0	28.4	18.7	16.4	11.1
Asset growth	25.0	29.6	17.8	15.7	11.3
Deposit growth	na	na	na	na	na
Per share					
Reported EPS (INR)	22.82	22.97	29.69	31.92	36.31
Norm EPS (INR)	22.82	22.96	29.69	31.92	36.31
Fully diluted norm EPS (INR)	22.82	22.96	29.69	31.92	36.31
DPS (INR)	6.09	6.97	9.36	10.07	11.45
PPOP PS (INR)	31.16	32.17	41.56	46.97	53.25
BVPS (INR)	132.28	156.88	177.21	199.07	223.93
ABVPS (INR)	123.70	143.78	162.48	183.80	207.63
NTAPS (INR)	132.28	156.88	177.21	199.07	223.93

Source: Company data, Nomura estimates

Notes

We expect loan book growth of 18% and 16% for FY13F and FY14F, respectively

Key changes to our FY13F estimates

Fig. 13: Key changes to our FY13F estimates

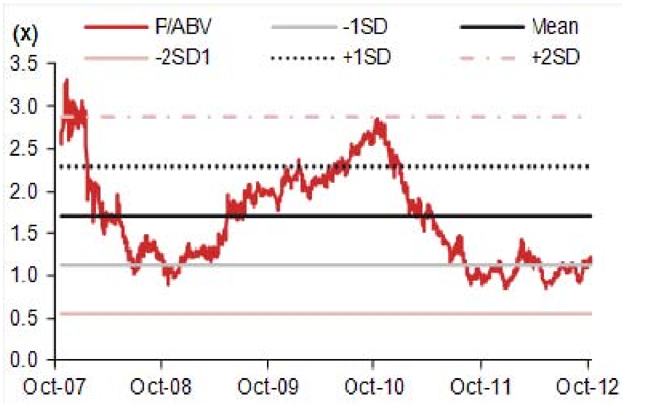
	Old	New
Loan book	1,491,963	1,537,109
Loan growth % y/y	19.0%	18.2%
Sanctions	570,630	449,433
Disbursals	360,805	388,174
PAT	33,978	39,190
PAT growth % y/y	11.3%	29.3%
Spreads	2.4%	2.6%
Gross NPL	22,111	14,182
RoA	2.45%	2.74%
RoE	16.9%	19.4%

Source: Nomura estimates

Valuation

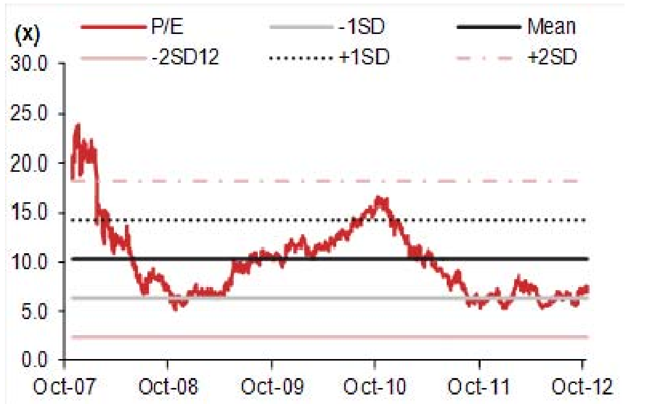
PFC is still trading close to 1 std deviation below its five-year mean despite the recent run-up. We maintain our Buy rating on the stock. We have arrived at our target price of INR240 using a three-stage residual-income valuation method that assumes the following: 1) a 17.9% CAGR for interest earning assets for FY12-15F, 2) an 18.7% avg ROE for FY12-15F, and 3) discount rates of 14.5% for FY12-15F and 12.5% for FY15-20F and a terminal discount rate of 10%. PFC currently trades at 1.1x our avg FY13-14F ABV and 6.4x our FY13F EPS. At our TP of INR240, PFC would trade at 1.4x our avg FY13-14F ABV of INR173 and 7.8x EPS of INR30.8, for FY13F ROA of 2.7% and 19% ROE.

Fig. 14: PFC – P/ABV chart



Source: Bloomberg, Nomura estimates

Fig. 15: PFC – P/E chart



Source: Bloomberg, Nomura estimates

Key risks to our estimates

Sharp deterioration in the asset quality of private sector developers and non adherence to the trajectory recommended in the FRP by SEBs could impact the earnings outlook.

Appendix A-1

Analyst Certification

We, Abhishek Bhattacharya, Vijay Sarathi and Amit Nanavati, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

suer Specific Regulatory Disclosures

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Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Power Finance Corporation	POWF IN	INR 197	17-Oct-2012	Buy	Not rated	A7,A13
Rural Electrification Corporation	RECL IN	INR 212	17-Oct-2012	Buy	Not rated	A6,A7,A13

A6 A Nomura Group Company expects to receive or intends to seek compensation for investment banking services from the issuer in the next three months.

A7 A Nomura Group Company has managed or co-managed a publicly announced or 144A offering of the issuer's securities or related derivatives in the past 12 months.

A13 A Nomura Group Company has a significant financial interest (non-equity) in the issuer.

Previous Rating

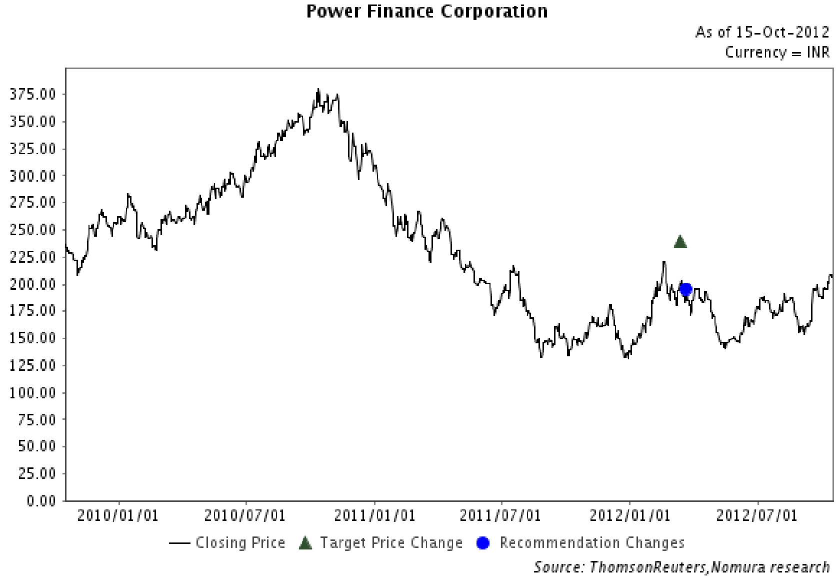
Issuer name	Previous Rating	Date of change
Power Finance Corporation	Not Rated	12-Mar-2012
Rural Electrification Corporation	Not Rated	12-Mar-2012

Rating and target price changes

	Ticker	Old stock rating	New stock rating	Old target price	New target price
Rural Electrification Corporation	RECL IN	Buy	Buy	INR 245	INR 255

Power Finance Corporation (POWF IN) **INR 197 (17-Oct-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
12-Mar-12	Buy		201.25
12-Mar-12		240.00	201.25

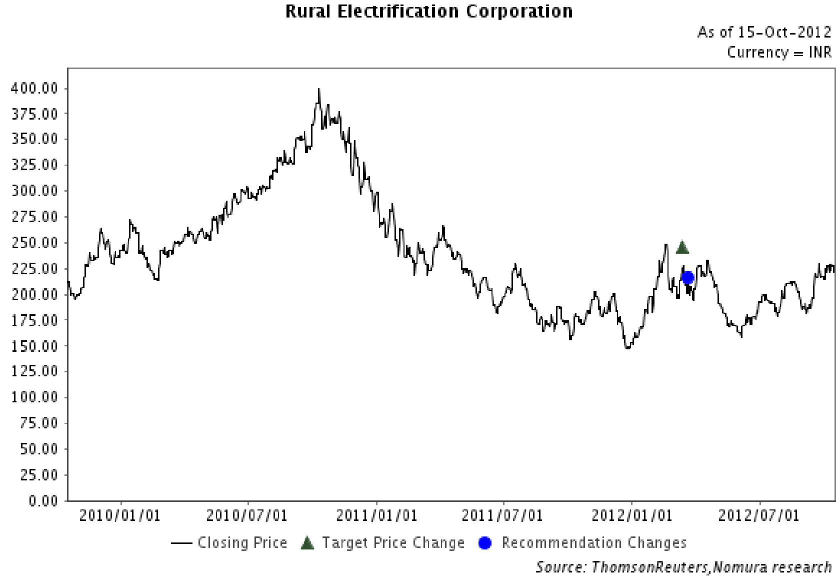
For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We have arrived at our target price of INR240 using a three-stage residual-income valuation method that assumes the following: 1) a 17.9% CAGR for interest earning assets for FY12-15F, 2) an 18.7% avg ROE for FY12-15F, and 3) discount rates of 14.5% for FY12-15F and 12.5% for FY15-20F and a terminal discount rate of 10%. At our TP of INR240, PFC would trade at 1.4x our avg FY13-14F ABV of INR173 and 7.8x EPS of INR30.8, for FY13F ROA of 2.7% and 19% ROE.

Risks that may impede the achievement of the target price Sharp deterioration in the asset quality of private sector developers and non adherence to the trajectory recommended in the FRP by SEBs could impact the earnings outlook.

Rural Electrification Corporation (RECL IN) **INR 212 (17-Oct-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
12-Mar-12	Buy		222.30
12-Mar-12		245.00	222.30

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We have arrived at our target price of INR255 using a three-stage residual-income valuation method using following assumptions: 1)18.8% CAGR in interest earning asset for FY12-FY15F, 2) 22.8% avg RoE for FY12-FY15F,3) discount rate of 14.5% for FY12 to FY15F, 12.5% for FY15F to FY20F and terminal discount rate of 10%. At our TP of INR255, REC would trade at 1.5x our avg FY13-14F ABV of INR172.4 and 6.9x EPS of INR37.1, for FY13F ROA of 3.1% and ROE of 23.4%.

Risks that may impede the achievement of the target price Sharp deterioration in asset quality of private sector developers and non adherence to the trajectory recommended in the FRP by SEBs could impact the earnings outlook.

Important Disclosures

Online availability of research and conflict-of-interest disclosures

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STOCKS

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STOCKS

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