

Rural Electrification Corporation

ADD
Maintained

Difficult times negotiated well

Rs220

Target price Rs232

Earnings revision

(%)	FY13E	FY14E
NII	↑ 3.7	↑ 2.8
PPP	↑ 3.9	↑ 2.9
Net profit	↑ 3.9	↑ 2.8

Target price revision

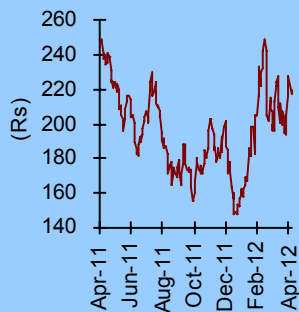
Rs232 from Rs217

Shareholding pattern

	Jun '11	Sep '11	Dec '11
Promoters	66.8	66.8	66.8
Institutional investors	24.2	25.1	24.8
MFs and UTI	2.7	2.9	2.8
Insurance Cos.	2.5	3.7	4.1
FII	19.0	18.5	17.9
Others	9.0	8.1	8.4

Source: NSE

Price chart



Reason for report: Updates from our Mumbai roadshow and earnings revision

We continue to retain our positive outlook on Rural Electrification Corporation (REC) post our roadshow in Mumbai with the top management yesterday. The management categorically stated that it would prefer maintaining a healthy asset quality rather than chase strong disbursement growth, a view we endorse and are comfortable with. Prospects of fructification of the current sanction pipeline (Rs1.5tn) into loans over the next three to five years seem brighter now. The management maintains a disbursement growth expectation of 15-20% over FY12-14. Given that improvements in the power sector, fuel supply and distribution reforms are progressing at a very slow pace, power sector financiers are bound to face asset quality headwinds. As per the REC management, the next couple of quarters are unlikely to see fresh NPA accretion. However, we retain our elevated credit costs over FY12-14E as we see real prospects of restructuring in the private as well as SEB segments. We maintain ADD on the stock, with a marginally revised target price of Rs232/share (owing to a 3.9% earnings upgrade for FY13E as discussed below).

- ▶ **Asset quality – further deterioration unlikely.** For H1FY13, none of the private power projects appear critical and are therefore unlikely to slip into NPA. Large private power producers have refinanced some loans with REC, hence the risk stands reduced. Currently, interest and principal servicing for top private exposures are as per schedule. Rajasthan SEB's discom exposure stands at ~Rs80bn, which is entirely government guaranteed. There could be an application for restructuring by this SEB in the near future. REC would not take any NPV hit in that case. Other SEBs continue to service their principal and interest on time.
- ▶ **Growth/spread targets maintained; we retain our positive stance.** We marginally increase our loan growth assumption for FY13 given higher comfort with disbursements from the current sanctions pipeline (Rs1.5tn). The liability mix is also set to tilt towards ECBs and refinancing of bank loans (~125bps higher cost than bonds). We pencil-in an expected ECB issuance of US\$750mn in FY13E versus our earlier expectation of US\$350mn. Together, the higher loan growth assumption and higher ECB raising lead to a 3.9% earnings upgrade for FY13E and a 2.8% upgrade for FY14E. Due to the earnings upgrade, our ABV multiple adjusts from ~1.3x to ~1.4x, which indicates a target price of Rs232/share and an upside of 6% from CMP. Maintain **ADD**.

Market Cap	Rs188.9bn/US\$4.1bn
Reuters/Bloomberg	RURL.BO/RECL IN
Shares Outstanding (mn)	987.5
52-week Range (Rs)	249/148
Free Float (%)	33.2
FII (%)	17.9
Daily Volume (US\$/'000)	21,235
Absolute Return 3m (%)	37.0
Absolute Return 12m (%)	(10.2)
Sensex Return 3m (%)	6.7
Sensex Return 12m (%)	(10.5)

Year to March	2011	2012E	2013E	2014E
NII (Rs mn)	35,239	41,465	50,458	57,962
Net Profit (Rs mn)	25,699	28,453	34,695	40,380
EPS (Rs)*	25.2	29.4	35.6	41.4
% Chg YoY	24.1	16.9	21.1	16.2
P/E (x)	8.7	7.5	6.2	5.3
P/BV (x)	1.7	1.5	1.3	1.1
Net NPA (%)	129.4	148.8	172.9	200.9
Dividend Yield (%)	3.4	3.6	4.3	5.0
RoA (%)*	3.3	3.1	3.1	3.1
RoE (%)*	20.8	21.2	22.2	22.2

* EPS, RoA and RoE are calculated on recurring profits

Abhishek Murarka

 abhishek.murarka@icicisecurities.com
 +91 22 6637 7351

Shashin Upadhyay

 shashin.upadhyay@icicisecurities.com
 +91 22 6637 7572

Digant Haria

 digant.haria@icicisecurities.com
 +91 22 6637 7314

Power sector: Lenders' firmness to accelerate reform

Incremental sanctions/disbursements to SEBs/private companies require the borrower to compulsorily have FSA/PPA/environmental clearances, etc. Disbursements to SEBs are under the condition that a tariff hike petition will have to be necessarily filed and a tariff hike undertaken. Inclination of incremental disbursements is clearly towards States that are serious about reducing SEB losses (Maharashtra/Gujarat/Karnataka/Bihar) whereas REC is consciously staying away from States where seriousness seems lacking.

New projects are not attracting many bids from private participants due to lack of clarity on input costs. To this end, the fuel supply policy needs to be finalised quickly, else the bidding process and consequent award of projects will be slow.

Our sense from yesterday's discussions is that current thinking in policy circles is veering towards asking States to take over the short-term liability (working capital loans) of SEBs. This could greatly reduce the interest burden on SEBs, free-up cash flows and hence improve servicing of loans from term lenders like REC/PFC.

Assets unlikely to slip in the near term; restructurings possible

In the next one to two quarters, none of the private sector accounts seem critical or likely to turn NPA. There is a possibility that some accounts are restructured over the next 12-18 months if the current impasse on fuel supply and cost escalation pass-through continues for long. However, there is unlikely to be any NPV hit on account of these restructurings.

Table 1: Projects-specific updates

Project	Exposure (Rs mn)	Comment
Konaseema Gas	2,230	Lack of gas supply and tariff dispute with Andhra Pradesh discom. Tariff might be increased by Rs0.7 in the near future which could be a relief.
Shree Maheshwar Hydel Power Corp.	2,500	Facing multiple issues such as promoter/lead arranger unable to bring in equity infusion, environmental issues, huge outstanding interest burden, and operating at a current PLF of ~20%. Expectation is that this will continue to remain an NPA.
Rajasthan discom	81,000	Entirely state government guaranteed. Rajasthan SEB may apply for restructuring of ~Rs15bn-25bn (not likely to have an NPV hit).
Malana II	4,000	Project commissioned and running well. However, there is a dispute between the State government and the SPV on project cost escalation pass-through, which is affecting cashflow and power offtake. This is unlikely to slip into NPA in in Q1FY13.

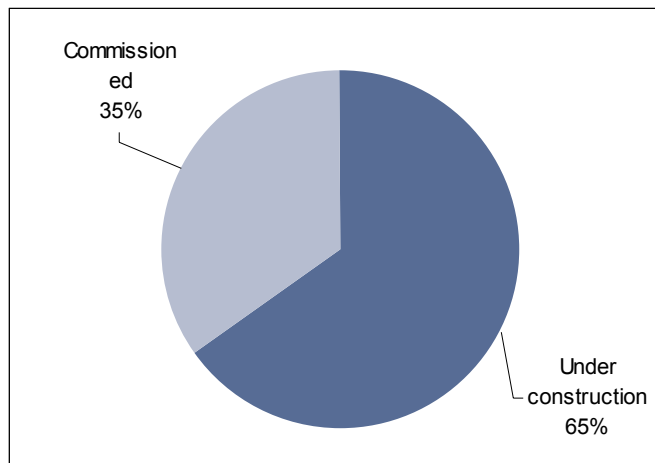
Source: Company data, I-Sec research

Better comfort on loan growth; disbursements to be healthy

The REC management categorically stated that it was willing to forego growth in favour of maintaining asset quality. Nevertheless, it expects a 15-20% YoY disbursement growth in FY13 and a similar loan growth trajectory. Current outstanding sanctions of Rs1.5tn are likely to fructify into loans of ~Rs1.2tn over the next three to five years while the management expects overall sanctions to remain flat in FY13 over FY12 (~Rs550bn sanctioned in FY12E).

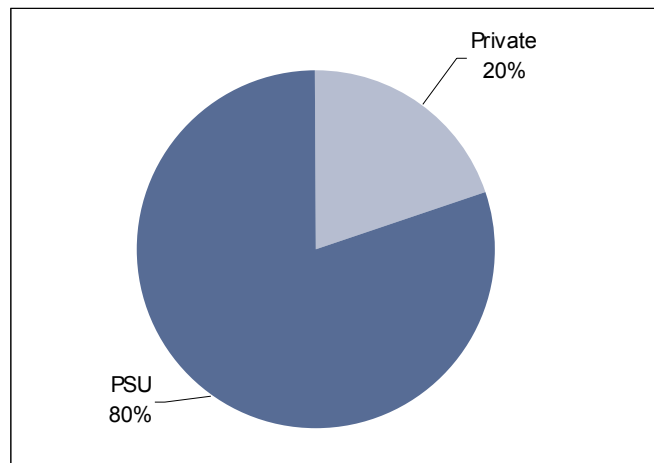
We remain positive on the management's loan growth expectation over FY12-14E and build-in slightly higher growth at 20% CAGR over FY11-14E (19% earlier) as we believe that a number of sanctions will fructify into loans. Given the incrementally higher participation expected from private power producers, we expect the loan mix to tilt further towards the private sector. Hence, we increase the proportion of loans for the private sector to 15% by FY14E from 12% of the book as of Q3FY12.

Chart 1: Generation projects (Rs428bn as of Q3FY12) – Project status wise break-up



Source: Company data, I-Sec research

Chart 2: Generation projects (Rs428bn as of Q3FY12) – segment wise break-up



Source: Company data, I-Sec research

Table 2: Project concentration in the loan book as of Q3FY12

Segment	Loans outstanding (%)
Exposure to top-3 private players (% of total private sector exposure)	~41
Exposure to top-3 SEBs (% of total State sector exposure)	~44

Source: Company data, I-Sec research

Table 3: Latest SEB exposures

Segment	Loans outstanding (Rs bn)
Maharashtra SEB	168
Tamil Nadu SEB	92
Rajasthan SEB	107
Andhra Pradesh SEB	53
Uttar Pradesh SEB	81
Punjab SEB	75

Source: Company data, I-Sec research

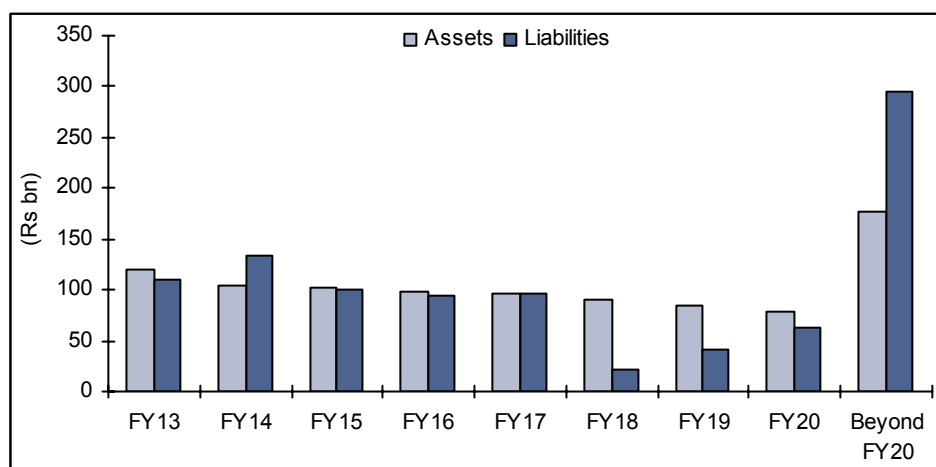
Liability mix and ALM are strong pillars aiding spreads

REC's liability mix is witnessing higher utilisation of the ECB limits. It has raised ~US\$450mn via yen-borrowing in Q4FY12 (currently unhedged) and has further approval of US\$750mn ECBs over FY13. This, coupled with the tax free and capital gains tax exempt bonds, are likely to keep the overall funding costs lower than peers and competitive vis-à-vis banks. Further, in line with other NBFCs, REC has repaid ~Rs50bn of bank borrowings with market borrowings. Incremental domestic market borrowing costs are ~9.5-9.75%, whereas ECBs cost between 7.30-7.75% on a fully hedged basis. Bank borrowings currently cost in excess of 10.75%.

We factor a higher ECB issuance at US\$750mn into our numbers (from US\$350mn earlier) and lower the proportion of bank loans in the overall borrowing mix. This reduces overall costs, thereby adding 3.7% to FY13E and 2.8% to FY14E NII estimates. We expect reported spreads to stay in the 3.2-3.3% range over FY12-14.

The asset liability stands well matched with average asset duration of 5.72 years and average liability duration of five years. There is a marginal negative gap in the FY13-FY14 bucket of ~Rs30bn, which is easy to bridge given REC's current market borrowing capability.

Chart 3: Well-matched ALM profile



Source: Company data, I-Sec research

Valuation methodology and key risks

We maintain our **ADD** rating on REC and marginally revise the valuation multiple to 1.4x FY13E ABV (from 1.3x earlier), which translates into a target price of Rs232/share. Slowdown in the SEB reform process and inability on the part of private players to complete their ongoing power plants in time remain the key risks to our call.

Table 4: Earnings revision

(Rs mn)

	FY13E			FY14E		
	New	Old	% chg	New	Old	% chg
NII	50,458	48,649	3.7	57,962	56,376	2.8
PPP	48,789	46,980	3.9	56,085	54,500	2.9
Net profit	34,695	33,393	3.9	40,380	39,283	2.8

Source: I-Sec research

Financial summary

Table 5: Profit and Loss statement

(Rs mn, year ending March 31)

	FY11	FY12E	FY13E	FY14E
Interest earned	83,749	105,546	123,804	143,115
Interest expended	48,510	64,081	73,346	85,153
Net interest income	35,239	41,465	50,458	57,962
Other income	350	472	614	749
Operating expenses	1,644	1,906	2,283	2,626
Employee costs	1,275	1,555	1,866	2,146
Pre-provisioning profit	33,946	40,032	48,789	56,085
Depreciation	30	30	40	50
Provision for bad & doubtful debt	2	473	873	800
Profit before tax	33,913	39,528	47,876	55,235
Income taxes	9,067	10,475	12,687	14,361
Minority Interest	-	-	-	-
Net profit (ex-forex gains / loss)	24,846	29,053	35,189	40,874
Exchange losses (+) or gains(-)	(853)	600	494	494
Net profit	25,699	28,453	34,695	40,380

Source: Company data, I-Sec research

Table 6: Balance sheet

(Rs mn, year ending March 31)

	FY11	FY12E	FY13E	FY14E
Share Capital	9,875	9,875	9,875	9,875
Reserves and surplus	118,012	137,222	160,941	188,612
Deferred tax liability	(128)	(128)	(128)	(128)
Borrowings	700,038	876,380	1,046,186	1,224,560
Total liabilities & stockholders' equity	827,797	1,023,349	1,216,874	1,422,920
Fixed Assets, net	652	913	1,142	1,313
Investments & Capital work-in-progress	8,352	7,935	8,252	8,665
Net current assets	(2,529)	(3,936)	(4,460)	(5,029)
Advances	821,321	1,018,438	1,211,941	1,417,971
Total assets	827,797	1,023,349	1,216,874	1,422,920

Source: Company data, I-Sec research

Table 7: Key ratios

(Year ending March 31)

	FY11	FY12E	FY13E	FY14E
Per share data (Rs)				
Period end shares outstanding (mn)	987.5	987.5	987.5	987.5
Basic EPS*	25.2	29.4	35.6	41.4
Diluted EPS	25.2	29.4	35.6	41.4
Book value per share	129.4	148.8	172.9	200.9
Adjusted book value per share	129.4	144.5	165.4	190.1
Growth ratios (%)				
Advances	23.6	24.0	19.0	17.0
Borrowings	25.1	25.2	19.4	17.0
Book value	15.4	15.0	16.1	16.2
EPS	24.1	16.9	21.1	16.2
Valuation ratios (x)				
P/PPP (pre-provisioning profit)	6.4	5.4	4.5	3.9
P/E	8.7	7.5	6.2	5.3
P/BV	1.7	1.5	1.3	1.1
P/ABV	1.7	1.5	1.3	1.2
Dividend yield (%)	3.4	3.6	4.3	5.0
Operating ratios (%)				
Operating cost to income	4.6	4.5	4.5	4.5
Operating expenses/ Avg. assets	0.2	0.2	0.2	0.2
Profitability ratios (%)				
Spread	3.4	3.2	3.4	3.3
Net interest margin	4.6	4.3	4.4	4.3
Return on avg. assets*	3.3	3.1	3.1	3.1
Return on avg net worth*	20.8	21.2	22.2	22.2
Asset quality and capital (%)				
Gross NPA	0.02	0.41	0.62	0.77
Net NPA	0.00	0.42	0.61	0.75
CAR	19.1	16.8	16.5	15.9

*EPS, RoA and RoE are calculated on recurring profits

Source: Company data, I-Sec research

Table 8: DuPont model

(Year ending March 31)

	FY11	FY12E	FY13E	FY14E
Interest earned	11.2	11.4	11.1	10.8
Interest expended	6.5	6.9	6.5	6.5
Gross Interest Spread	4.7	4.5	4.5	4.4
Provisioning for NPAs	0.0	0.1	0.1	0.1
Net Interest Spread	4.7	4.4	4.4	4.3
Operating cost	0.2	0.2	0.2	0.2
Lending spread	4.5	4.2	4.2	4.1
Fee based income	0.0	0.1	0.1	0.1
Operating spread	4.5	4.3	4.3	4.2
Tax	1.2	1.1	1.1	1.1
ROA (ex-forex gains)	3.3	3.1	3.1	3.1
Exchange loss (+) or gains (-)	-0.1	0.1	0.0	0.0
ROA (reported)	3.4	3.1	3.1	3.1
Effective leverage	6.3	6.7	7.1	7.2
RoE	20.8	21.2	22.2	22.2

Source: Company data, I-Sec research

This report may be distributed in Singapore by ICICI Securities, Inc. (Singapore branch). Any recipients of this report in Singapore should contact ICICI Securities, Inc. (Singapore branch) in respect of any matters arising from, or in connection with, this report. The contact details of ICICI Securities, Inc. (Singapore branch) are as follows: Address: 30 Cecil Street #15-29 Prudential Tower, Singapore 049712, Tel: +65 6232 2451 and email: ashvin_patil@icicisecuritiesinc.com, Rishi_agrawal@icicisecuritiesinc.com.

New I-Sec investment ratings (all ratings based on absolute return)

BUY: >15% return; ADD: 5% to 15% return; REDUCE: Negative5% to positive5% return; SELL: < negative 5% return

ANALYST CERTIFICATION

We //, *Abhishek Murarka, PGDM, MBA (Finance); Shashin Upadhyay, MBA; Digant Haria, MBA* research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report. Analysts aren't registered as research analysts by FINRA and might not be an associated person of the ICICI Securities Inc

Disclosures:

ICICI Securities Limited (ICICI Securities) and its affiliates are a full-service, integrated investment banking, investment management and brokerage and financing group. We along with affiliates are leading underwriter of securities and participate in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationship with a significant percentage of companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. ICICI Securities generally prohibits its analysts, persons reporting to analysts and their dependent family members from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover.

The information and opinions in this report have been prepared by ICICI Securities and are subject to change without any notice. The report and information contained herein is strictly confidential and meant solely for the selected recipient and may not be altered in any way, transmitted to, copied or distributed, in part or in whole, to any other person or to the media or reproduced in any form, without prior written consent of ICICI Securities. While we would endeavour to update the information herein on reasonable basis, ICICI Securities, its subsidiaries and associated companies, their directors and employees ("ICICI Securities and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance or other reasons that may prevent ICICI Securities from doing so. Non-rated securities indicate that rating on a particular security has been suspended temporarily and such suspension is in compliance with applicable regulations and/or ICICI Securities policies, in circumstances where ICICI Securities is acting in an advisory capacity to this company, or in certain other circumstances.

This report is based on information obtained from public sources and sources believed to be reliable, but no independent verification has been made nor is its accuracy or completeness guaranteed. This report and information herein is solely for informational purpose and may not be used or considered as an offer document or solicitation of offer to buy or sell or subscribe for securities or other financial instruments. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. ICICI Securities will not treat recipients as customers by virtue of their receiving this report. Nothing in this report constitutes investment, legal, accounting and tax advice or a representation that any investment or strategy is suitable or appropriate to your specific circumstances. The securities discussed and opinions expressed in this report may not be suitable for all investors, who must make their own investment decisions, based on their own investment objectives, financial positions and needs of specific recipient. This may not be taken in substitution for the exercise of independent judgement by any recipient. The recipient should independently evaluate the investment risks. The value and return of investment may vary because of changes in interest rates, foreign exchange rates or any other reason. ICICI Securities and affiliates accept no liabilities for any loss or damage of any kind arising out of the use of this report. Past performance is not necessarily a guide to future performance. Actual results may differ materially from those set forth in projections. Forward-looking statements are not predictions and may be subject to change without notice.

ICICI Securities and its affiliates might have managed or co-managed a public offering for the subject company in the preceding twelve months. ICICI Securities and affiliates might have received compensation from the companies mentioned in the report during the period preceding twelve months from the date of this report for services in respect of public offerings, corporate finance, investment banking or other advisory services in a merger or specific transaction. It is confirmed that *Abhishek Murarka, PGDM, MBA (Finance); Shashin Upadhyay, MBA; Digant Haria, MBA* research analysts and the authors of this report have not received any compensation from the companies mentioned in the report in the preceding twelve months. Our research professionals are paid in part based on the profitability of ICICI Securities, which include earnings from Investment Banking and other business.

ICICI Securities or its subsidiaries collectively do not own 1 or more of the equity securities of the Company mentioned in the report as of the last day of the month preceding the publication of the research report.

It is confirmed that *Abhishek Murarka, PGDM, MBA (Finance); Shashin Upadhyay, MBA; Digant Haria, MBA* research analysts and the authors of this report or any of their family members does not serve as an officer, director or advisory board member of the companies mentioned in the report.

ICICI Securities may have issued other reports that are inconsistent with and reach different conclusion from the information presented in this report. ICICI Securities and affiliates may act upon or make use of information contained in the report prior to the publication thereof.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject ICICI Securities and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

This report has not been prepared by ICICI Securities, Inc. However, ICICI Securities, Inc. has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed.