CESC

ADD

Results below expectations; downgrading to ADD CMP: Rs275 Target Price: Rs311

- ☐ Corporate development
- ☐ Earnings estimate change
- ☑ Target price change
- ☑ Rating change

CESC's Q2FY13 results were below expectations, with PAT up 19.3% yoy to Rs1.36bn, vs. estimate of Rs1.68bn, due to delay in passing of tariff order. Revenue grew 8.3% yoy to ~Rs13.2bn, driven by higher tariff realization and moderate demand in Kolkata, while EBITDA increased 20.2% yoy to Rs2.9bn. Spencer's cash losses amounted to Rs60mn/month and should achieve its target of Rs50mn/month by March 2013. However, we believe the Firstsource acquisition is likely to be negative for the company in the short term. Downgrade to Add.

Moderate demand growth in Kolkata: CESC reported generation growth of 3.0% and PLF of ~90%, as against 88% in Q2FY12. Demand in the Kolkata license area saw a moderate growth of 1.7% yoy. PLFs improved across all the base load stations. Tariffs were up 8.3% yoy, partly due to rising coal costs and fixed charge approval from WBERC in March 2012. Consequently, overall revenue was up 8.3% yoy to Rs13.2bn.

EBITDA margin improves: Despite rise in coal costs, CESC managed to report marginal savings in fuel costs by increasing generation from base load stations and curtailing generation in its peak load stations that consumes expensive A grade coal. However, power purchase cost was up 33% yoy, due to steep rise in imported power rates. Despite this, EBITDA rose 20% yoy, aided partly by a lower Q2FY12 base, as the increase in fixed costs was allowed as pass through only in Q4FY12. Other income declined 6% yoy, as the company deployed cash for the Haldia and Chandrapur projects. PAT stood at Rs1.36bn, vs. our estimate of Rs1.68 bn, due to delay in issue of tariff order for FY13.

Outlook: Adjustments to tariff relating to escalation in fixed costs, is likely to be allowed in Q3/Q4FY13, after WBERC issues a new tariff order. Chandrapur project should be commissioned in April 2013 and the FSA with CIL is likely to be signed by Dec 2012. Haldia project is progressing as per schedule and monthly losses of Spencer's Retail are down to Rs60mn, in line to meet target of Rs50mn by FY13 end.

Valuation: Power business will continue to generate stable cashflows, though the Firstsource acquisition will increase its debt burden. CESC will also be foraying into a new business in which it lacks prior experience. We cut our target price by 26% to Rs311 and downgrade the stock to Add.

KEY FINANCIALS (Rs mn)

Y/E 31 March	2011	2012	2013E	2014E
Revenue	39,398	46,485	51,436	55,897
EBITDA	10,013	10,334	11,418	11,828
EBITDA margin (%)	25.4	22.2	22.2	21.2
PAT	4,884	5,159	5,761	6,100
FDEPS (Rs)	39.1	41.3	46.1	48.8
% growth	12.7	5.6	11.7	5.9
P/E (x)	7.0	6.7	6.0	5.6
RoCE avg (%)	10.1	9.6	9.7	8.4

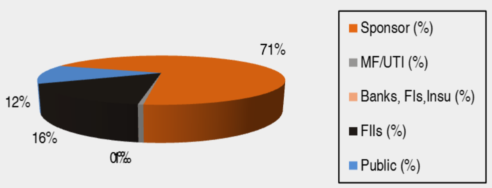
Source: Company, BRICS Research

KEY DATA

Bloomberg	CESC IN
Reuters	CESC.BO
52-wk H/L (Rs)	346.5/186.3
6-m avg trd value	US$2.3mn
Market cap	Rs34.4bn/US$0.6bn
Shares o/s	124.9mn
Face value	Rs10

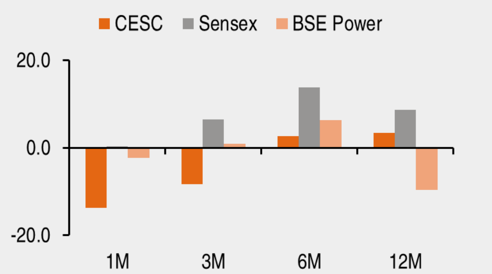
Source: Bloomberg

SHAREHOLDING (%)



Source: Ace equity

PRICE PERFORMANCE



Source: Bloomberg

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Exhibit 1: Q2FY13 results

Particulars (Rs Mn)	Q2FY13 Actual	Q2FY13 Estimate	Difference %	Q2FY12	YoY %	Q1FY13	QoQ %
Sales	13,240	14,357	(7.8)	12,230	8.3	14,040	(5.7)
EBITDA	2,910	3,298	(11.8)	2,420	20.2	2,740	6.2
EBITDA %	22.0	23.0	(99.0)	19.8	219.1	19.5	246.3
Depreciation	760	790	(3.8)	720	5.6	770	(1.3)
Other income	440	410	7.3	470	(6.4)	370	18.9
PBT	1,700	2,098	(19.0)	1,420	19.7	1,560	9.0
Tax	340	420	(19.0)	280	21.4	310	9.7
PAT	1,360	1,678	(19.0)	1,140	19.3	1,250	8.8
EPS	10.9	13.4	(19.0)	9.1	19.3	10.0	8.8

Source: Company, BRICS Research

CESC's acquisition of First Source marks second venture into non-power business

In Q2FY13, CESC decided to acquire a controlling stake in FSL, a BPO firm, through its wholly-owned subsidiary, SpenLiq, for about Rs6.5 bn. The company will acquire a 34.5% stake through fresh equity for Rs2.78 bn, while the acquisition of an additional 15% stake from ICICI, Fidelity and Temasek (5% each) will be worth about Rs1.2 bn. This will be followed by an open offer to acquire an additional 26% stake, as per SEBI's takeover regulations. The open offer price will be Rs12.10 per share, according to SEBI's guidelines, thereby taking the overall deal value to Rs6.5bn and valuing FSL at Rs8bn.

First Source acquisition likely to be financed largely through debt

CESC has cash and cash equivalents of ~Rs10bn in its balance sheet. Additionally, the company generates operating cash flow of ~Rs7bn. However, the yearly capex for the Kolkata license business alone stands at about Rs6.5bn. Further, CESC has two projects in the construction stage at Chandrapur and Haldia of 600MW each, in which the company's equity contribution is likely to be about Rs18bn. These projects are expected to be commissioned by March 2013 and June 2014 respectively. Consequently, the company will have to resort to further debt to fund the FSL acquisition.

CESC's record in non-power business not very encouraging

This is the second time that CESC is diversifying into a non-power business. The company's first attempt was its foray into retail with the acquisition of Spencer Retail in 2006, which proved unsuccessful, with Spencer continuing to incur a cash loss of about Rs700 mn. Management is convinced that the BPO business will provide impressive returns to CESC, though we remain sceptical, given the company's past record in the retail business and management's lack of experience in the BPO business.

Reduce TP and downgrade to ADD

We have reduced our target price by 26% to Rs311 after factoring in the cash outflow of Rs6.5bn for FSL. We are not assigning any value to FSL for the time being. Until the time we see the BPO business generate impressive returns, we prefer being conservative in our valuations. Despite the core power business likely to generate stable cash flows, we believe the sentiments surrounding the stock are likely to remain negative in the short term, given the company's performance in the retail business. Downgrade to Add

Exhibit 2: SOTP valuation

Division	*Value (Rs mn)*	*Comments*	*Per share*
Kolkata generation and distribution	48,216		
Debt (Rs mn)	27,982		
Value of equity (Rs mn)	20,233	FCFF, WACC 11.3%, terminal growth rate 2.0%	161
Haldia (600MW)	5,692	FCFE, Cost of equity 13.4%	45
Chandrapur (600MW)	9,447	FCFE, Cost of equity 13.4%	75
Real estate	485	FCFE, Cost of equity 13.4%	4
Retail value of retail (Rs mn)	3,254	Valuations at 70% discount to market cap/sales for key retain companies	26
Total (Rs mn)	39,111		
No of shares (mn)	126		
Price per share (Rs)	**311**	**Total**	**311**

Source: BRICS Research

Financial summary

Income statement

(Rs mn)

Y/E 31 March	2011	2012	2013E	2014E
Revenue	39,398	46,485	51,436	55,897
Revenue growth (%)	19.6	18.0	10.7	8.7
Operating exp	29,386	36,151	40,018	44,069
EBITDA	10,013	10,334	11,418	11,828
EBITDA margin (%)	25.4	22.2	22.2	21.2
Depreciation	2,674	2,747	2,908	3,072
EBIT	7,339	7,586	8,510	8,756
MTM profit / (loss)	—	—	—	—
Other income	1,524	1,303	1,039	1,123
Interest paid	2,721	2,441	2,348	2,254
PBT	6,143	6,449	7,201	7,625
Tax	1,259	1,290	1,440	1,525
PAT	4,884	5,159	5,761	6,100
Minority interest	—	—	—	—
EO income	—	—	—	—
APAT	4,884	5,159	5,761	6,100
PAT growth (%)	12.7	5.6	11.7	5.9
Shares o/s (mn)	125	125	125	125
Fully diluted o/s shrs (mn)	125	125	125	125
FDEPS (Rs) recurring	39.1	41.3	46.1	48.8

Cash flow statement

(Rs mn)

Y/E 31 March	2011	2012	2013E	2014E
PBT	6,143	6,449	7,201	7,625
Depreciation	3,349	3,409	3,557	3,708
Amortisation	—	—	—	—
Interest paid	2,721	2,441	2,348	2,254
Tax paid	1,259	1,290	1,440	1,525
Chg in working capital	(3,352)	(2,873)	(1,276)	(671)
Int/div in other income	—	—	—	—
Other operations	(1,372)	(1,303)	(1,039)	(1,123)
CF from operations (a)	6,230	6,833	9,351	10,268
Capital expenditure	(5,989)	(4,684)	(4,805)	(4,825)
Chg in investments	(4,258)	(549)	(6,540)	(3,150)
Other investing act	—	—	—	—
Int/div in other income	—	—	—	—
CF from investments (b)	(10,247)	(5,233)	(11,345)	(7,975)
Free cash flow (a+b)	(4,016)	1,600	(1,994)	2,293
Equity raised/(repaid)	—	—	—	—
Debt raised/(repaid)	2,049	(1,092)	(1,092)	(1,092)
Interest paid	(2,721)	(2,441)	(2,348)	(2,254)
Dividend (incl tax)	(581)	(581)	(581)	(581)
Other fin activities	2,460	2,574	2,011	2,058
CF from financing (c)	1,207	(1,540)	(2,009)	(1,869)
Net chg in cash (a+b+c)	(2,809)	60	(4,003)	424
Opening balance	11,198	8,388	8,449	4,446
Closing balance	8,388	8,449	4,446	4,870

Balance sheet

(Rs mn)

Y/E 31 March	2011	2012	2013E	2014E
Net fixed assets	64,858	66,795	68,692	70,445
Investments	10,843	11,259	17,672	20,701
Current assets	28,929	32,929	30,986	32,895
Inventories	2,944	4,408	4,800	5,138
Sundry debtors	5,709	6,736	7,454	8,100
Cash & bank balance	8,388	8,449	4,446	4,870
Loans & advances	11,758	13,208	14,158	14,658
Other current assets	129	129	129	129
Total assets	104,694	111,040	117,399	124,084
Net worth	43,036	48,182	53,654	59,456
Share capital	1,249	1,249	1,249	1,249
Reserves & surplus	41,787	46,933	52,404	58,207
Minority interest	—	—	—	—
Total debt	30,166	29,074	27,982	26,891
Secured loans	26,419	25,577	24,735	23,894
Unsecured loans	3,747	3,497	3,247	2,997
Current liabilities & prov	16,989	18,056	18,840	19,654
Current liabilities	15,609	16,677	17,460	18,274
Provisions	1,380	1,380	1,380	1,380
Net deferred tax liab	—	—	—	—
Total liabilities	104,688	111,034	117,393	124,077

Key ratios

Y/E 31 March	2011	2012	2013E	2014E
Valuation ratios				
PE (x)	7.0	6.7	6.0	5.6
CEPS (Rs)	60.5	63.3	69.4	73.4
PCE (x)	4.5	4.3	4.0	3.7
BVPS (Rs)	344	386	429	476
Price/Book (x)	0.8	0.7	0.6	0.6
EV/EBITDA (x)	6.3	6.0	5.1	4.8
EV/Revenue (x)	1.6	1.3	1.1	1.0
Dividend yield (%)	1.7	1.7	1.7	1.7
Cash flow yield (%)	(11.7)	4.7	(5.8)	6.7
Performance ratios				
Raw material to sales (%)	53.1	58.4	59.3	60.8
SGA to sales (%)	9.2	8.3	7.9	7.7
Effective tax rate (%)	20.5	20.0	20.0	20.0
PAT margin (%)	12.4	11.1	11.2	10.9
DPS (Rs)	4.6	4.6	4.6	4.6
Dividend payout ratio (%)	12	11	10	10
Return ratios				
RoE avg (%)	12.0	11.3	11.3	10.8
RoCE avg (%)	10.1	9.6	9.7	8.4
Fixed asset turnover (x)	0.6	0.7	0.8	0.8
Working capital ratios				
Inventory (days)	27	35	34	34
Payable (days)	52	49	49	48
Receivable (days)	53	53	53	53
Working capital (days)	28	38	38	38
Leverage ratios				
Interest cost (%)	9.3	8.2	8.2	8.2
Net debt/equity (x)	0.7	0.6	0.4	0.4
Interest coverage (x)	2.7	3.1	3.6	3.9

BRICS RECOMMENDATION SCALE

BUY:	More than 15% upside
ADD:	Upside up to 15% (between 0% and 15%)
REDUCE:	Downside up to 15% (between 0% and –15%)
SELL:	More than 15% downside

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