Rural Electrification Corporation

Attractive Risk-Reward

Rural Electrification Corporation (REC), a niche power sector financier, would be a prime beneficiary of the ongoing power sector reforms which over a period of time would enhance economic efficiency across the value chain and kick start the stalled investment cycle. While financial viability of SEBs is improving through the restructuring package under implementation, steps taken by the current government towards augmenting fuel supply is encouraging. REC's competitive position remains strong in the power financing space supported by its nodal agency status, ability to lend for longer tenures versus banks and benefit of lower funding cost due to Government's support.

REC having Rs170,000cr of loan assets, well distributed between generation and T&D segments, is likely to witness a pick-up in disbursements and asset growth over the coming three years. We estimate company's loan assets to grow at 17% pa during FY14-17 driven by faster growth in the private sector generation space. Company's NIM has significantly improved over the past few years aided by strengthened pricing power (banks have become risk averse), largely stable funding cost and material improvement in the lending yield driven by higher private sector generation share and decline in the contribution of lower yielding short term loans. Even if competition from banks were to increase in the medium term, REC's NIMs would remain steady cushioned by softening of borrowing cost.

While uncertainty around asset quality has been the key concern for a while, REC has not witnessed worrying accretion of stressed assets so far. The reform steps are only moderating the probability of a negative shock. However, credit cost will inch-up due to adherence to stricter regulatory requirements. Still, the company would deliver RoA above 3% and RoE in excess of 20% in the longer run.

The floor price (Rs315) of the OFS implies an inexpensive valuation of <1x FY17 P/ABV which we believe is an attractive entry point for long term investors. Recommend to subscribe in the OFS with 12m target of Rs392.

Financial summary

Y/e 31 Mar (Rs cr)	FY14	FY15E	FY16E	FY17E
Total operating income	7,082	8,484	9,743	11,286
yoy growth (%)	28.4	19.8	14.8	15.8
Operating profit (pre-provisions)	6,843	8,233	9,460	10,963
Net profit	4,683	5,586	6,376	7,328
yoy growth (%)	22.7	19.3	14.1	14.9
EPS (Rs)	47.4	56.6	64.6	74.2
Adj.BVPS (Rs)	205.7	242.1	288.3	341.1
P/E (x)	6.7	5.7	5.0	4.3
P/adj.BV (x)	1.6	1.3	1.1	0.9
ROE (%)	24.6	24.4	23.0	22.0
ROA (%)	3.3	3.3	3.3	3.2
CAR (%)	16.5	16.9	17.7	18.0

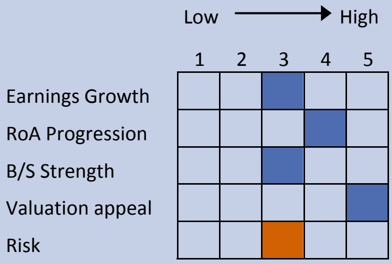
Source: Company, India Infoline Research

Rating:	BUY
Target:	Rs392
CMP:	Rs321
Upside:	22.1%

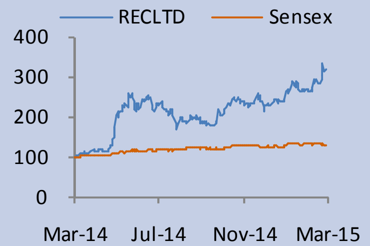
Sector:	Financials
Sector view:	Positive
Sensex:	28,847
52 Week h/l (Rs):	383 / 223
Market cap (Rscr) :	31,761
6m Avg vol ('000Nos):	6,288
Bloomberg code:	RECL IN
BSE code:	532955
NSE code:	RECLTD
FV (Rs):	10

Prices as on April 07, 2015

Company rating grid



Share price trend



Share holding pattern

	Sep-14	Dec-14	Mar-15
Promoters	65.6	65.6	65.6
Institutions	28.1	28.3	28.3
Others	6.3	6.1	6.1

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April 08, 2015

Revival is disbursements to drive healthy loan assets growth

Given REC's niche position in power sector financing, we believe an uptick in new project investments and resumption of activity on existing projects will bode well for company's loan disbursals during FY15-17. While the power financing pie would expand, the competition from commercial banks would continue to be limited in early part of the revival cycle. Although, in the Budget 2014-15 the banks were allowed to raise long term bonds (with exemption of CRR and SLR requirement) for infrastructure lending, one has not seen any significant activity on this front so far. The interest of PSU Banks in this business remains limited given their poor asset quality and weak capital position. On the other hand, private corporate lenders are focused on strengthening their retail franchise. Banks also have to comply with stringent credit concentration norms which limit their exposure to single projects and the overall space.

REC's niche positioning to drive revival in loan disbursements and growth

Competition from PSU Banks to remain limited given their weak asset quality and capital position

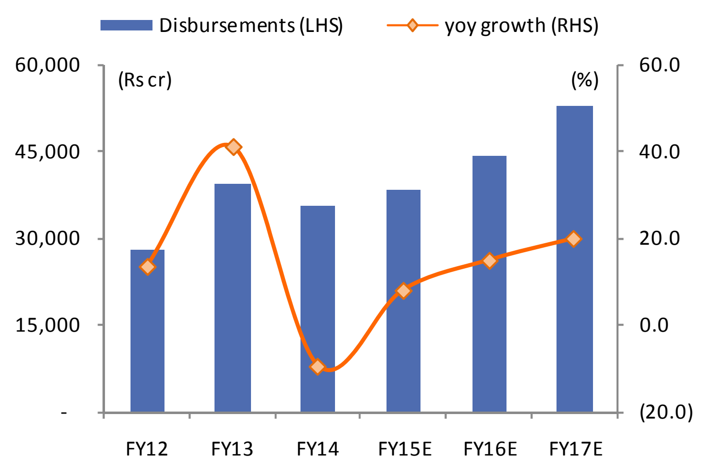
Various developments in the power sector would act as major tailwinds for REC going forward such as improving financial health of SEBs, fixing of fuel supply issues for thermal plants (higher production by Coal India and the recent coal blocks reallocation) and thrust on substantially augmenting renewable energy capacity. A capex of Rs75000cr is planned in expanding distribution in rural and urban areas as per the Integrated Power Development Scheme (IPDS) and Jyotigram Yojna which is particular would benefit REC given its historical focus on financing T&D investments.

Multiple tailwinds for REC 1) improving financial health of SEBs 2) fixing of fuel supply issues and 3) government thrust on investments

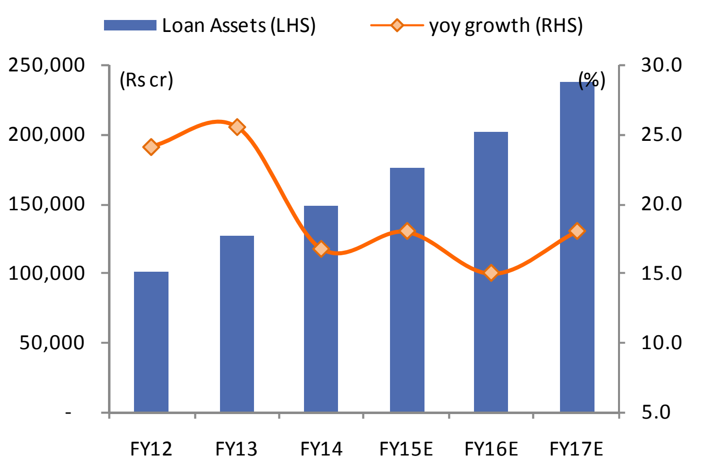
After declining by 9% in FY14, disbursements have witnessed a 10% growth during 9m FY15. We expect the disbursement growth to improve to 15% in FY16 and 20% in FY17. This would drive a 17% CAGR in loan assets over FY14-17. With Tier-1 capital at 14-15% currently and RoE much higher than asset growth, REC would not be required to raise equity capital to deliver the aforesaid asset growth.

Loan assets to witness 17% CAGR over FY14-17; sufficient Tier-1 capital at ~15%

Disbursement growth to improve further



... underpinning healthy loan book growth



Source: Company, India Infoline Research

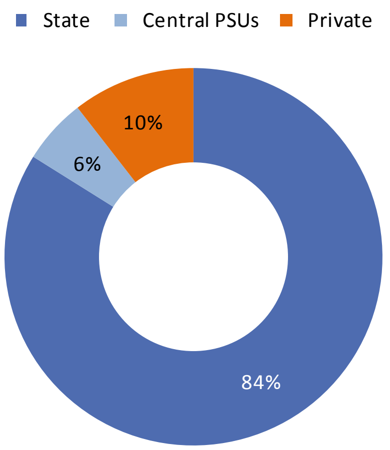
Incremental loan book to come via private generation projects

REC's loan composition has been moving in the favour of private sector. The share of private sector loans has increased from 10% at the end of FY12 to 17% currently thus growing much faster than the overall portfolio. Segment-wise, while the share of generation has been stable at 44%, the contribution of T&D has significantly increased from 49% as at end FY12 to 56% at present. This could be attributable to significant transitional finance disbursements (cumulative Rs17,758cr so far) to SEBs under the financial restructuring package. Markedly, the share of short term loans (including debt refinancing and bridge loans) has come-off from 6% in FY12 to just 1%. The company is focused on growing largely through private sector generation projects.

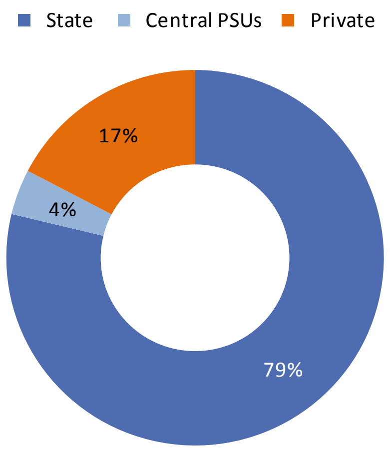
REC's loan composition has been moving in the favor of private sector

Contribution of short term loans has declined

Loan composition by Borrower as of FY12

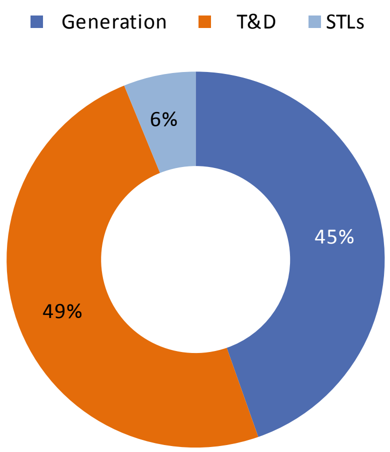


Loan composition by Borrower as of 9m FY15

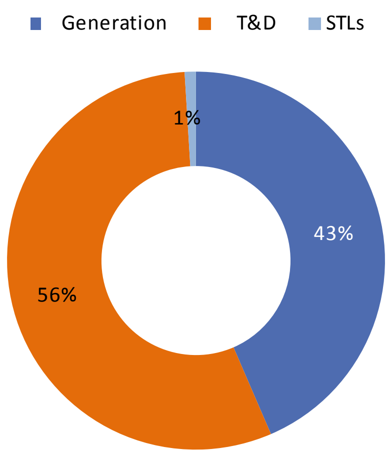


Source: Company, India Infoline Research

Loan composition by Discipline as of FY12



Loan composition by Discipline as of 9m FY15



Source: Company, India Infoline Research

After improving, NIMs to remain stable

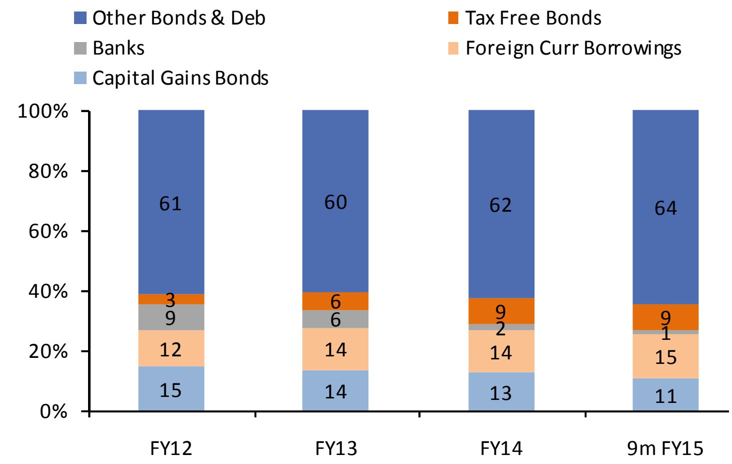
Over the past three years, REC's NIM has been consistently improving owing to a decline in competition from banks leading to improved pricing power, increase in the share of private sector financing where yields are higher than average and decline in the contribution of lower-yielding short term loans. The reported blended yield on the loan portfolio has improved from 12.1% in FY12 to 13.1% in 9m FY15. On the liability side, the cost of borrowing has not increased substantially for the company during the recent years despite material hardening of bond yields. REC has a robust funding franchise characterized by capital gains bonds costing 6%, low-cost foreign currency borrowings and negligible exposure to relatively higher costing bank borrowings. Domestic bonds and subordinated debt comprise 62% of the total borrowings. Aided by a strong credit rating of AAA and easing in the long term G-Sec yields, the incremental cost of domestic bond funding for REC has been declining. This trend is likely to continue in the medium term and drive overall cost of funds lower. In case of foreign currency borrowings, REC hedges ~85% of its foreign currency exposure and hence, it does not carry high exchange rate risk like PFC. Though NIM currently is at peak levels of 5.1%, it is unlikely to come-off over the next couple of years. Expected moderation in borrowing cost and further increase in the share of private generation segment is likely to offset any intensification of competitive pressures.

REC's NIMs has consistently improved owing to multiple factors

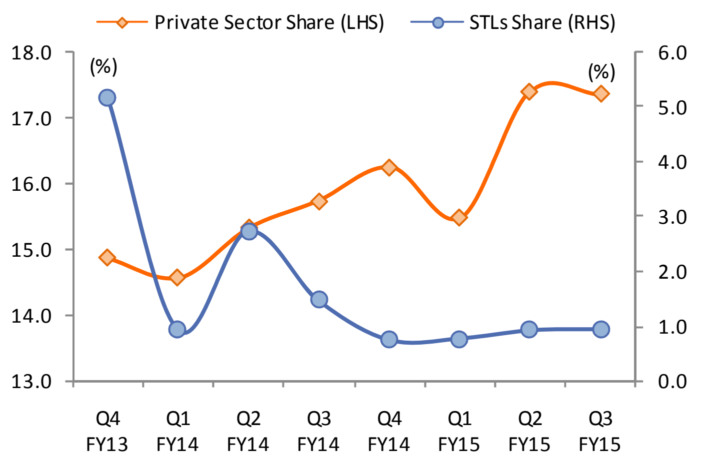
Co's funding franchise is robust

Strong credit rating and easing of long term G-Sec yields driving incremental cost of funds lower

Borrowing profile of REC skewed towards bonds

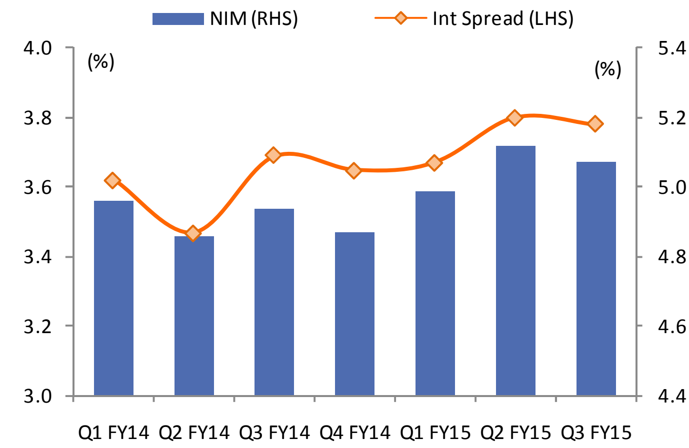


Changes in loan composition has aided margins

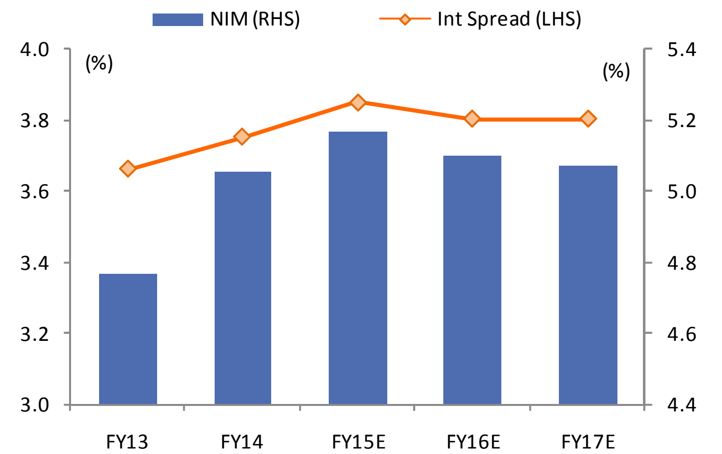


Source: Company, India Infoline Research

NIM and spread has improved in recent quarters



… to stabilize near the current elevated levels



Source: Company, India Infoline Research

Some deterioration likely in asset quality in the near term

Defying the wide perception of substantial stress in the portfolio, REC has not reported an alarming deterioration is its asset quality. The gross NPL and net NPL ratio stand at manageable 0.8% and 0.65% currently. Only a couple of accounts have slipped since the start of FY14. Even the restructured book at 2-3% of loan assets is not very disturbing. REC has high exposure to SEBs where the credit risk has reduced post the implementation of financial restructuring package. The cash flow situation of SEBs is improving due to a combination of tariff hikes and declining T&D losses. Nearly all major SEBs have hiked tariffs by an average 10% pa since FY10 and still several states are seeking further hikes of 20%+. On T&D front, losses have come down from ~25% in 2010 to ~22% in 2014 with efforts directed towards loss reduction.

Dross NPL and net NPL ratio stand at manageable 0.8% and 0.65% currently

Restructured book at 2-3% of loan assets is not very disturbing

We believe that perceived high risk around company's asset quality may not materialize in a big way given that constructive reform actions would provide support. However, we do expect an increase in the gross NPL level to 1.5% by FY17 which along with increasing standard assets and restructured assets provisioning should drive elevated credit costs over the next couple of years.

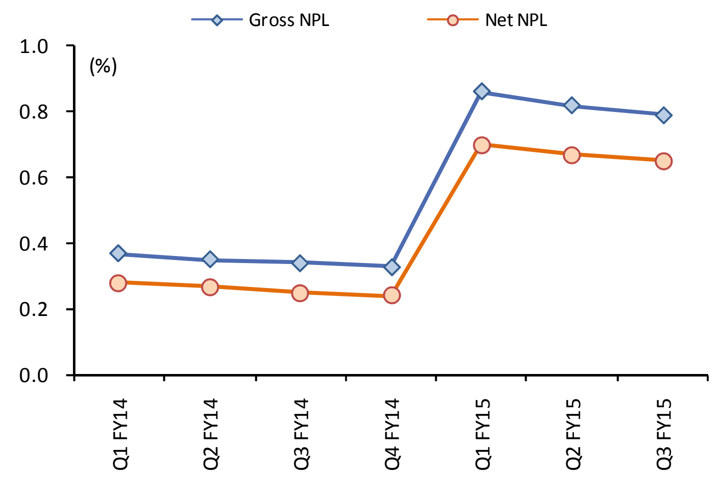
Perceived high risk around co's asset quality may not materialize in big way

Provisioning Schedule for REC

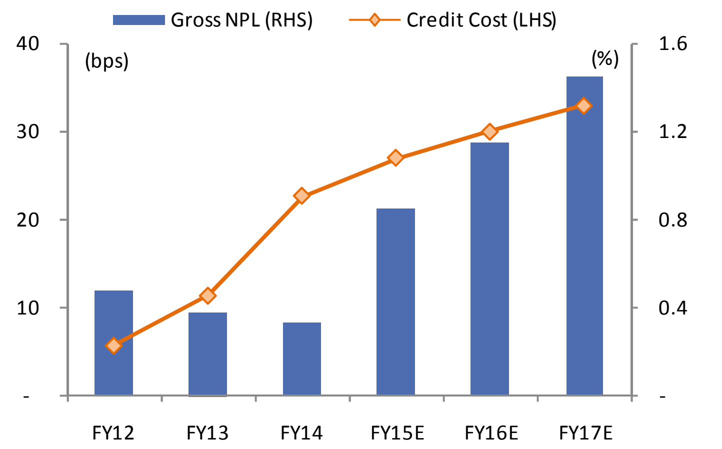
Particulars	Provisioning Requirements
On restructured loans as at 31st Mar 2015	
-as of 31st Mar 2015	2.75%
-as of 31st Mar 2016	3.50%
-as of 31st Mar 2017	4.25%
-as of 31st Mar 2018	5%
On restructured loans post Mar 2015	***5%***
On Standard Assets	
-as of 31st Mar 2016	0.30%
-as of 31st Mar 2017	0.35%
-as of 31st Mar 2018	0.40%

Source: RBI

Uptick in NPL levels in recent quarters



Further increase to drive elevated provisioning



Source: Company, India Infoline Research

Risk-reward quite favourable; Subscribe in the OFS

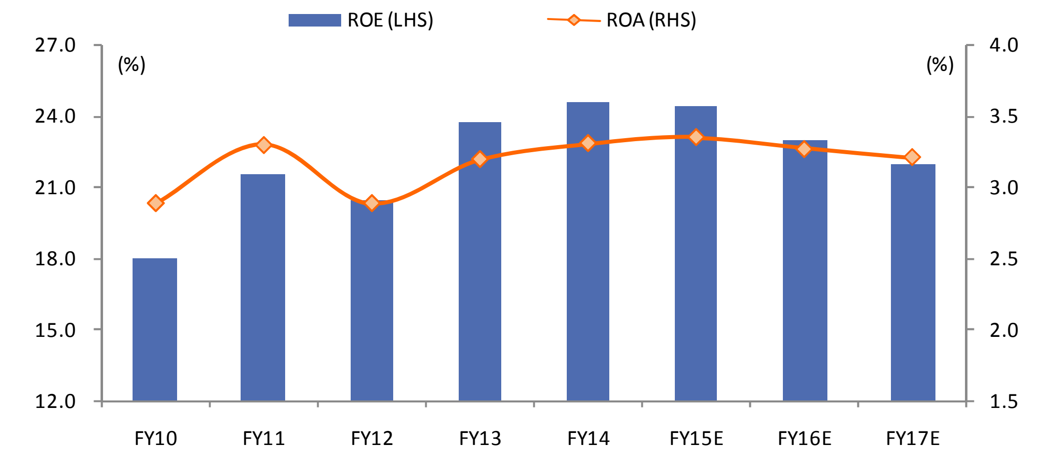
We expect REC to deliver earnings CAGR of 16.1% over FY14-17 almost mirroring the asset growth. RoA and RoE are estimated to be sustained at 3%+ and 20%+ respectively during the period. The floor price (Rs315) of the OFS implies an undemanding valuation of 0.9x FY17 P/ABV on our estimates. On a 1-year rolling forward ABV, the stock valuation stands at 1.1x which is also the historical four-year average. The modest valuation seems to be fully discounting the risk factors while not factoring any improvement in the operating environment for the company. Thus we think that risk-reward is quite favourable for long term investors to participate in the OFS. Based on a target multiple of 1.15x FY17 P/ABV, we arrive at a 12-month target price of Rs392. Further, at the current price the stock offers a healthy dividend yield of 3%+.

RoA and RoE are estimated to be sustained at 3%+ and 20%+

OFS floor price implies undemanding valuation of 0.9x FY17 P/ABV

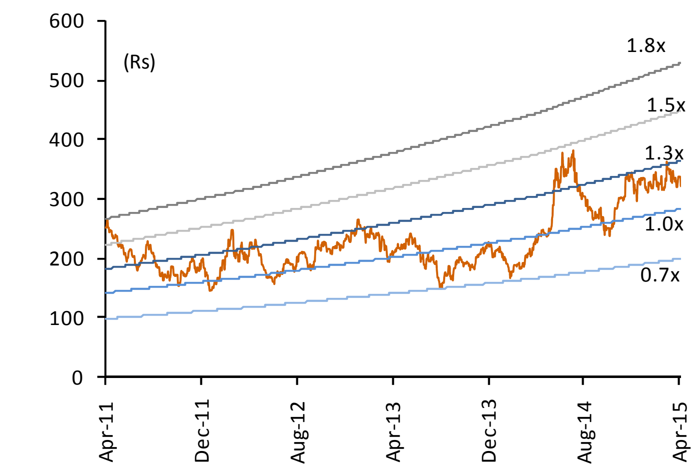
12-month target price of Rs392; healthy dividend yield of 3%+

RoA and RoE trends to remain strong

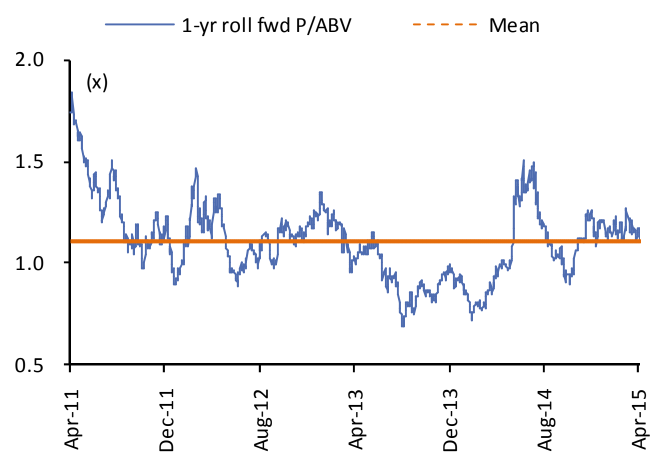


Source: Company, India Infoline Research

Trading at inexpensive 1.1x one-year fwd P/ABV



… which is also the four year mean



Source: Bloomberg, India Infoline Research

Financials

Income statement

Y/e 31 Mar (Rs cr)	FY14	FY15E	FY16E	FY17E
Income from Operations	17,018	20,304	23,252	26,673
Interest expense	(10,038)	(11,928)	(13,628)	(15,518)
Net interest income	**6,980**	**8,376**	**9,624**	**11,155**
Non-interest income	103	108	119	131
Total op income	**7,082**	**8,484**	**9,743**	**11,286**
Total op expenses	(239)	(251)	(283)	(323)
Op profit (pre-prov)	**6,843**	**8,233**	**9,460**	**10,963**
Provisions	(312)	(474)	(605)	(785)
Exceptional Items	(0)	0	0	0
Profit before tax	**6,530**	**7,759**	**8,855**	**10,178**
Taxes	(1,847)	(2,173)	(2,479)	(2,850)
Net profit	**4,683**	**5,586**	**6,376**	**7,328**

Balance sheet

Y/e 31 Mar (Rs cr)	FY14	FY15E	FY16E	FY17E
Equity Capital	987	987	987	987
Reserves	19,682	24,142	29,333	35,390
Shareholder's funds	**20,669**	**25,129**	**30,321**	**36,378**
Long-term borrowings	110,162	129,710	149,167	176,017
Deferred tax liabilities	174	174	174	174
Other Long-term liabilities	24	26	28	31
Long-term provisions	442	486	535	589
Total Non-current liabilities	**110,802**	**130,396**	**149,904**	**176,811**
Short Term Borrowings	2,540	2,991	3,439	4,058
Current Maturity of LT Debt	0	0	0	0
Other current liabilities	18,584	21,881	25,164	29,693
Short term provisions	258	284	312	343
Total Current liabilities	**21,382**	**25,156**	**28,915**	**34,095**
Total Equities and Liabilities	**152,853**	**180,682**	**209,140**	**247,283**
Assets				
Fixed Assets	82	90	99	109
Non-current investments	1,661	1,661	1,661	1,661
Long-term loans and advances	135,899	160,361	184,415	217,610
Other non-current assets	32	32	32	32
Total Non-current assets	**137,674**	**162,144**	**186,207**	**219,411**
Current Maturity of LT Loans	47	57	68	81
Cash and cash equivalents	1,193	2,578	5,349	7,631
Short-term loans and advances	382	450	518	611
Other current assets	13,558	15,456	17,001	19,552
Total Current assets	**15,179**	**18,541**	**22,936**	**27,875**
Total Assets	**152,853**	**180,682**	**209,140**	**247,283**

Key ratios

Y/e 31 Mar	FY14	FY15E	FY16E	FY17E
Growth matrix (%)				
Net interest income	28.0	20.0	14.9	15.9
Total op income	28.4	19.8	14.8	15.8
Op profit (pre-provision)	29.2	20.3	14.9	15.9
Net profit	22.7	19.3	14.1	14.9
Advances	16.7	18.0	15.0	18.0
Borrowings	17.1	17.7	15.0	18.0
Total assets	17.1	18.2	15.8	18.2
Profitability Ratios (%)				
NIM	5.1	5.2	5.1	5.1
Non-int inc/Total inc	1.5	1.3	1.2	1.2
Return on Avg Equity	24.6	24.4	23.0	22.0
Return on Avg Assets	3.3	3.3	3.3	3.2
Per share ratios (Rs)				
EPS	47.4	56.6	64.6	74.2
Adj.BVPS	205.7	242.1	288.3	341.1
DPS	9.3	9.8	10.3	11.0
Valuation Ratios (x)				
P/E	6.7	5.7	5.0	4.3
P/adj.BV	1.6	1.3	1.1	0.9
Other key ratios (%)				
Loans/Borrowings	1.2	1.2	1.2	1.2
Cost/Income	3.4	3.0	2.9	2.9
CAR	16.5	16.9	17.7	18.0
Tier-I capital	14.7	15.1	15.9	16.2
Gross NPLs/Loans	0.3	0.9	1.2	1.5
Credit Cost	0.2	0.3	0.3	0.3
Net NPLs/Net loans	0.2	0.7	0.9	1.1
Tax rate	28.3	28.0	28.0	28.0
Dividend yield	2.9	3.0	3.2	3.4

‘Best Broker of the Year’ – by Zee Business for contribution to broking

Nirmal Jain, Chairman, IIFL, received the award for The Best Broker of the Year (for contribution to broking in India) at India's Best Market Analyst Awards 2014 organised by the Zee Business in Mumbai. The award was presented by the guest of Honour Amit Shah, president of the Bharatiya Janata Party and Piyush Goel, Minister of state with independent charge for power, coal new and renewable energy.

'Best Equity Broker of the Year' – Bloomberg UTV, 2011

IIFL was awarded the 'Best Equity Broker of the Year' at the recently held Bloomberg UTV Financial Leadership Award, 2011. The award presented by the Hon'ble Finance Minister of India, Shri Pranab Mukherjee. The Bloomberg UTV Financial Leadership Awards acknowledge the extraordinary contribution of India's financial leaders and visionaries from January 2010 to January 2011.

'Best Broker in India' – Finance Asia, 2011

IIFL has been awarded the 'Best Broker in India' by Finance Asia. The award is the result of Finance Asia's annual quest for the best financial services firms across Asia, which culminated in the Country Awards 2011

Other awards

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +15%

Accumulate – Absolute return between 0% to +15%

Reduce – Absolute return between 0% to -10%

Sell – Absolute return below -10%

Call Failure - In case of a Buy report, if the stock falls 20% below the recommended price on a closing basis, unless otherwise specified by the analyst; or, in case of a Sell report, if the stock rises 20% above the recommended price on a closing basis, unless otherwise specified by the analyst

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