

**FPO Note**
**Power Finance Corporation**

<b>Recommendation</b>	<b>SUBSCRIBE</b>	
<b>Price Band</b>	<b>Rs. 193-203</b>	
<b>Bidding Date</b>	<b>10<sup>th</sup> May – 13<sup>th</sup> May</b>	
<b>Book Running Lead Manager</b>	<b>BofA Merill Lych, Goldman Sachs, ICICI Sec, JM Financial</b>	
<b>Registrar</b>	<b>Karvy</b>	
<b>Sector</b>	<b>NBFC</b>	
<b>Retail Application- Detail At Cut off Price</b>		
Number of Shares	980	
Application Money	Rs. 198,940	
Amount Payable	Rs. 198,940	
Discount to retail	5%	
<b>Financials (Rs Crs)</b>	<b>FY10</b>	<b>FY11</b>
Total Income (NII+ OI)	3,164.6	3,668.1
PBT	3,013.5	3,543.3
PAT	2,357.2	2,618.8
<b>Valuations</b>	<b>Lower Band</b>	<b>Upper Band</b>
EPS*	19.0	19.0
Book Value*	144.1	145.7
P/E ratio*	10.15	10.68
P/BV*	1.34	1.39
*calculated on diluted equity		
<b>Post Issue Shareholding Pattern</b>		
Promoters	73.7%	
Institutions	8.9%	
Public	17.4%	
<b>Offer structure for different categories</b>		
QIB (Including Mutual Fund)	50.0%	
HNI	15.0%	
Retail	35.0%	
Post issue Equity (Rs. crs)	1377.3	
Issue Size (Rs. crs)	4,430-4,660	
Face Value (Rs.)	10	
<b>Silky Jain – Research Analyst</b> <b>Ph – (022) – 39268178</b> <b>Email: silky.jain@nirmalbang.com</b>		

**Background**

Power Finance Corporation Limited (PFC) is a Navratna Public Sector Unit, established in July 1986. PFC is one of the leading power sector public financial institutions and provides fund as well as non fund based finances for entire gamut of power related activities. Apart from this it also provides technical and management advisory and consultancy services in the power sector. PFC has more than 20% share in the power financing business of the country.

**➤ Demand to remain strong in power sector**

PFC is one of the key players for the financing of power projects. Owing to huge demand-supply gap in power sector the government is focusing on the development of more power projects which in turn would boost the business of PFC. A tentative capacity addition of approximately 100,000 MW has been envisaged for the 12th Plan.

**➤ Disbursals to witness strong growth**

PFC enjoys a leadership position in the power financing space. In our view PFC is well placed to leverage the strong demand for financing in the power sector. PFC has an outstanding sanction book of Rs 171,000 crs as on December 2010. We believe that the outstanding sanctions will convert into disbursements in the near to medium term.

**➤ High interest margins**

PFC has reported a consistent improvement in its interest spreads and margins in the last few years due to upward re-pricing of yields on its asset portfolio coupled with a sharp decline in wholesale fund rates. We believe the Infrastructure Finance Company (IFC) status would help the company to stabilize its interest spread and NIM.

**➤ Healthy asset quality**

Despite its concentration on single sector and significant exposure to State Electricity Board (SEB's), PFC has managed to keep its net NPAs at nearly zero percent resulting from its strong credit quality and sufficient asset coverage. PFC's asset quality has remained healthy without any major slippages in the past few years.

**Objects of the Issue**

- Augment its capital base to ensure compliance with requisite capital adequacy norms and to meet its future capital requirements arising out of growth in business
- General corporate purpose

**Company overview**

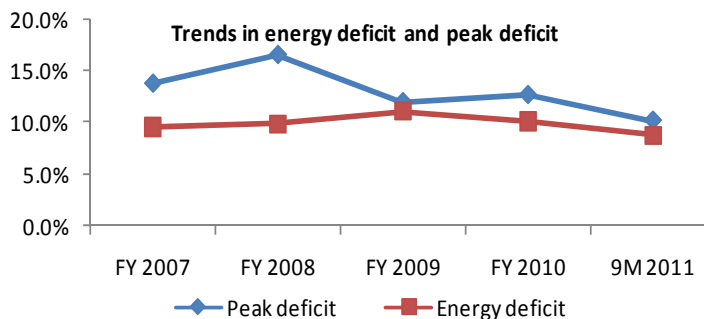
Power Finance Corporation Limited (PFC) is a Navratna Public Sector Unit, established in July 1986. PFC is one of the leading power sector public financial institutions and provides fund as well as non fund based finances for entire gamut of power related activities. In July 2010, the RBI granted 'Infrastructure Finance Company' status to the company. PFC is engaged in power financing and provides project term loans, lease financing, direct discounting of bills, and short term loans. Apart from this, it also provides technical and management advisory and consultancy services in the power sector. PFC has more than 20% share in the power financing business of the country.

For 9MFY11, PFC sanctioned loans worth Rs 61, 077 crs while its total disbursements were Rs.22,270 crs. Its loan book stood at Rs 99,571 crs as on March 2011. The company has major focus on generation which constituted almost 85% of the loan book as on March 2011.

**Investment Rationale**

✓ **Demand to remain strong in power sector**

India has historically witnessed shortages in energy and peak power requirement. According to the Central Electricity Authority's ("CEA") monthly review of the power sector ("CEA Monthly Review") published in February 2011, the total energy deficit and peak power deficit for February 2011 was approximately 7.8% and 10.2% respectively.



Source: Ministry of Power, Nirmal Bang Research

In order to cope with the country's rising power requirement and to upgrade transmission and distribution (T&D) infrastructure, significant investments are required in the 12th five year plans. A tentative capacity addition of approximately 100,000 MW has been envisaged for the 12th Plan. Out of this an estimated 74,000 MW is expected from thermal power; 20,000 MW from hydro power; 3,400 MW from nuclear power and 2,500 MW from lignite respectively. The total fund required in order to achieve the targeted capacity addition will be approximately Rs 11,000 bn.

Estimated investment

Generation	Rs 4,950 bn
Transmission	Rs 2,400 bn
Distribution	Rs 3,710 bn

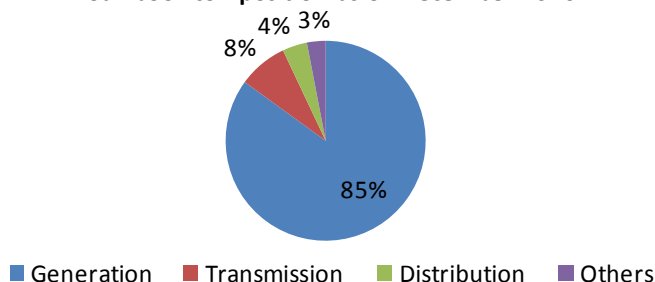
Source: Company data, Ministry of Power

PFC is one of the key players for the financing of power projects. Due to the huge demand-supply gap in power sector and massive requirement of power, the government is focusing on the development of more power projects which in turn would boost the business of PFC. The low per capita consumption of electricity in India compared to the world average presents significant potential for sustainable growth in the demand for electric power in India.

✓ **Disbursals to witness strong growth**

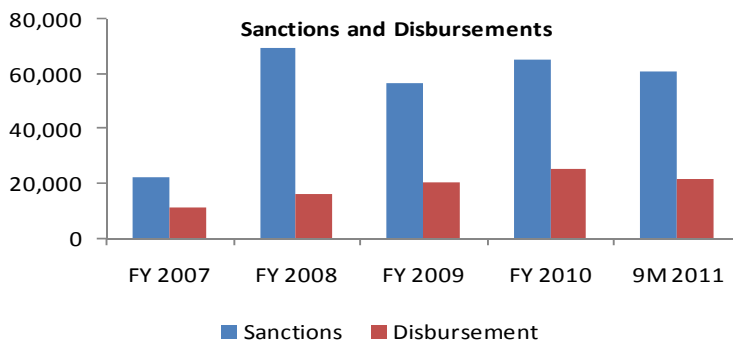
PFC enjoys a leadership position in the power financing space. In our view PFC is well placed to leverage the strong demand for financing in the power sector. The company finances both Generation and Transmission & Distribution (T&D) projects but it enjoys a higher market share in generation projects. Generation projects constitute approximately 85% of PFCs loan book as on December 2010.

Loan book composition as on December 2010



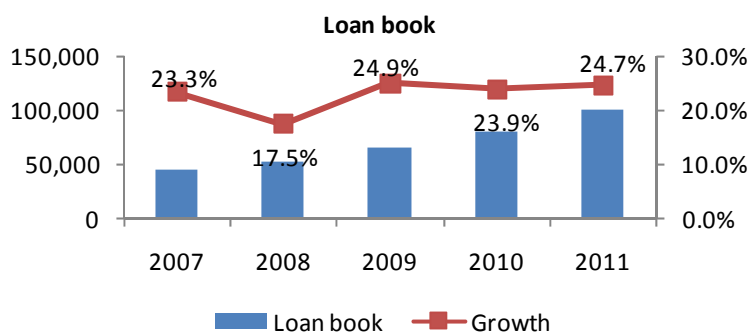
Source: Company data, Nirmal Bang Research

PFC has grown its loan book at a CAGR of 23% over FY06-FY11 whereas its sanctions and disbursements have grown at a CAGR of 27% and 24% respectively. We believe that loan demand would remain strong for PFC driven by robust investments planned in the power sector for the 12th plan. PFC has an outstanding sanction book of Rs 171,000 crs as on December 10. We believe that the outstanding sanctions will convert in disbursements in the near to medium term. Post dilution, PFC's debt to equity ratio will be around 3.8 times from current 5.3 times which will provide significant growth opportunities to PFC. In addition, the company's capital adequacy ratio is expected to improve from current 15.94% which will enable the company to grow at a higher rate.



Source: Company data, Nirmal Bang Research

However, delays in obtaining environment clearances, constraints in fuel linkages, inability to acquire land and poor SEB financial health is likely to restrict the investment growth in the power sector and particularly for PFC.

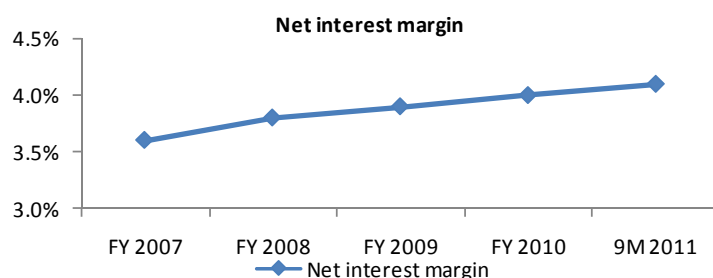


Source: Company data, Nirmal Bang Research

✓ **High interest margins**

PFC has reported a consistent improvement in its interest spreads and margins in the last few years due to upward re-pricing of yields on its asset portfolio coupled with a sharp decline in wholesale fund rates. PFC's interest spreads have improved from 1.94% in FY07 to 2.76% in 9MFY11 whereas its margins have improved from 3.5% in FY07 to 4.1% in 9MFY11. Management has indicated that spreads will improve to 3.0% in FY12 from 2.76% in 9MFY11.

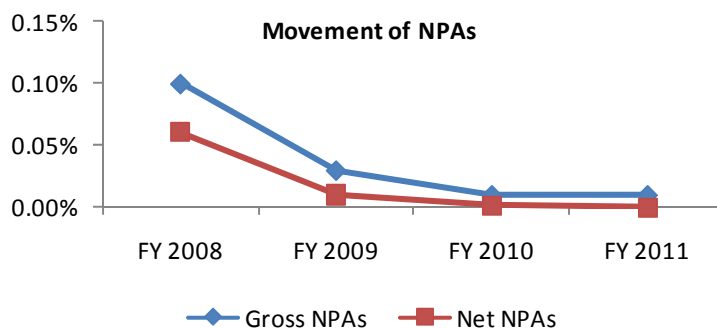
PFC has been classified as Infrastructure Finance Company (IFC) in July 2010. As a result PFC is now eligible to issue infrastructure bonds and foreign borrowings; which in turn would facilitate PFC to borrow funds at lower cost. Hence we believe the IFC status would help the company to stabilize its interest spread and NIM.



Source: Company data

✓ **Healthy asset quality**

Despite its concentration on single sector and significant exposure to State Electricity Board (SEB's), PFC has managed to keep its net NPAs at nearly zero percent resulting from its strong credit quality and sufficient asset coverage. PFC's asset quality has remained healthy without any major slippages in the past few years. GNPA and NNPA have remained at almost minimal levels in the last five years. At present the gross NPA for the company is 0.02% while the net NPA is 0.01%. However, there may be some pressures on the company's asset quality in the near to medium term as 65% of PFC's loan book is to State Electricity Boards (SEB) which may result in NPA's going forward.



Source: Company data

✓ **CARE and CRISIL Rating**

PFC enjoys the highest credit ratings of "AAA" and "LAAA" for its long-term domestic borrowings and "P1+" and "A1+" for its short-term borrowings from CRISIL and ICRA respectively. International credit rating agencies Moody's, Fitch and Standard & Poor's have granted long-term foreign currency issuer ratings of "Baa3", "BBB-" and "BBB-", respectively, which are at par with the sovereign ratings for India.

✓ **Increasing exposure to private players to mitigate risk from SEBs**

PFC's exposure to private players is likely to increase going forward, with rising proportion of investments from the private sector. As on 31 December 2010 PFC has provided 7.1% of its total loan book to private sectors. PFC has started increasing its exposure to private sector due to probable losses from SEB's. 65% of PFC's loan book is to SEB which are currently suffering from poor commercial performance and poor socio political environment. Rising SEB losses for execution in some power projects is likely to raise the risk profile of PFCs balance sheet.

Being a wholesale financier to large power projects, the ticket size of PFC's loan disbursements is high. PFC's exposure norms to SEBs are also relaxed as it is not required to follow RBI norms as far as SEBs are concerned.

Overall we believe that the balance sheet risk of PFC is well placed in the short term as underlying projects are viable and the state government is likely to support SEBs. However, increasing exposure to private players would further increase the risk profile of its balance sheet due to lack of support from the state government for private sector utilities in adverse conditions.

#### Key Concerns

- ✓ **Risk involved in repayment of loans**  
Large capital outlay and long repayment cycles makes power projects susceptible to changes in various factors such as interest rates, regulations and policies and execution delays which may have an impact on the company's projects' viability which will further impact the repayment of loans.
- ✓ **Losses from SEBs**  
Any financial instability of SEBs or State power utilities (SPUs) could have an adverse impact on asset quality of PFC as it lends approximately 65% of its total outstanding loan to state sector. However we believe that as SEBs/SPUs are backed by government body; hence there should not be any major adverse effect on its operations.
- ✓ **Increase in borrowing cost**  
Increase in interest rate would increase the interest cost of the company as it borrows a huge sum at market rates. If the company could not pass on the increased burden due to higher interest rate, then it would impact the company's profitability.

**Valuation and Peer Comparison**

	<b>PFC (9MFY11)</b>	<b>REC (9MFY11)</b>
Net interest income (Rs crs)	2,680	2,404
Net profit (Rs crs)	2,012	1,870
EPS* (Rs)	19.0	25.2
Networth (diluted)	20,072	12,547
Current BVPS (diluted)	145.7	127.1
Price (Upper Band)	203	223
P/E	10.7	8.8
P/BV	1.4	1.8
RoE	20.4%	21.1%
NIMs	4.1%	4.5%
Gross NPAs	0.01%	0.03%
Loan book (Rs crs)	92,118	76,455
Borrowings (Rs crs)	76,447	63,225
Sanctions (Rs crs)	61,077	43,861
Disbursements (Rs crs)	22,270	16,199
Debt/Equity	3.8	5.0
Interest spread	2.8%	3.4%

Source: Company data

\* EPS is considered on actual net income of FY2011 considering post issue number of shares for PFC while for REC EPS is annualized taking 9M FY11 EPS.

We have compared PFC with Rural Electrification Corporation (REC). PFC is larger in size as compared to REC with total loan assets at 92,118 crs. PFC's loan sanctions and disbursements are significantly higher than REC during 9M 2011. PFC's NIM and RoE are marginally lower than REC. However, going forward the spreads are likely to increase given the IFC status enjoyed by the company. Management has indicated that spreads will improve to 3% in FY12 from 2.76% in 9MFY11. Post dilution, PFC's debt to equity ratio will be around 3.8 times which is quite attractive as compared to REC and will provide significant growth opportunities to PFC.

On valuation front, at the price band of Rs 193-203, PFC is priced at 10.15x/10.68x P/E of its FY11 EPS of Rs 19.0 whereas 1.34x/1.39x P/BV of its post issue book value of Rs 144.1/145.7 respectively. Whereas its closest competitor REC is trading at 1.76x P/BV of its BV of Rs. 127.06. PFC is trading at 1.2x P/BV of the consensus FY12 estimates and 1.0x P/BV of FY13 consensus estimates, which makes it attractive at current levels.

Considering the larger size, leadership position in power financing, strong brand image, good track record of management and attractive valuations we recommend investors to **'SUBSCRIBE'** to the issue with a medium to long-term perspective.

**FPO Note**

**Power Finance Corporation**

**Balance Sheet**

Rs in crs	FY 2009A	FY 2010A	FY 2011A
Capital	1,148	1,148	1,148
Reserves and Surplus	10,360	12,113	14,264
<b>Net worth</b>	<b>11,508</b>	<b>13,261</b>	<b>15,412</b>
Short term loans	1,400	2,325	2,240
Long term loans	50,760	64,783	83,893
<b>Total liabilities and equity</b>	<b>64,632</b>	<b>81,080</b>	<b>101,545</b>
Fixed assets	75	74	77
Loans	64,429	79,856	99,571
Investments	36	31	54
Net current assets	92	1,118	1,844
<b>Total assets</b>	<b>64,632</b>	<b>81,080</b>	<b>101,545</b>

(Source: Company and Nirmal Bang Research)

**Income Statement**

Rs in crs	FY 2009A	FY 2010A	FY 2011A
Interest income	6,557	8,002	10,128
Interest expended	4,433	4,912	6,492
<b>Net interest income</b>	<b>2,124</b>	<b>3,090</b>	<b>3,636</b>
Non interest income	26	75	32
Operating income	2,151	3,165	3,668
Operating expenses	158	152	125
Profit before tax	1,990	3,013	3,543
Tax	21	656	924
<b>Profit after tax</b>	<b>1,970</b>	<b>2,357</b>	<b>2,619</b>

(Source: Company and Nirmal Bang Research)

**Ratio Analysis**

	FY 2009A	FY 2010A	9MFY11
NIMs	3.9%	4.1%	3.9%
Return on average networkth	18.9%	19.2%	20.4%
Return on average assets	3.2%	3.1%	2.8%
Capital adequacy	17.3%	16.3%	16.2%
Yield on assets	10.9%	10.7%	11.2%
Cost of funds	8.4%	8.1%	8.4%
Interest spreads	2.5%	2.6%	2.8%
Debt/Equity ratio	4.5	5.2	4.7

(Source: Company and Nirmal Bang Research)

**NOTE**

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