CLSA
ASIA-PACIFIC MARKETS

Power Finance

Rs211.00 - OUTPERFORM

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India
Financial services

Reuters	PWFC.BO
Bloomberg	POWF IB

Priced on 9 May 2011
India Sensex @ 18,529.0

12M hi/lo Rs383.00/205.75

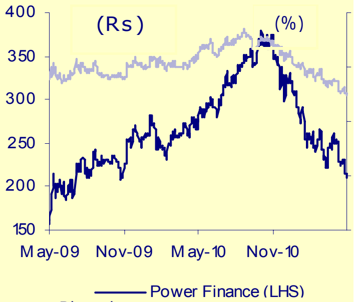
12M price target	Rs225.00
±% potential	+7%
Target set on	10 May 11
Shares in issue	1,147.8m
Free float (est.)	10.2%
Market cap	US$5,415m

3M average daily volume
Rs211.2m (US$4.7m)

Major shareholders
Govt. of India 89.8%
FII 3.5%

Stock performance (%)

	1M	3M	12M
Absolute	(17.6)	(17.6)	(20.5)
Relative	(13.5)	(21.7)	(28.0)
Abs (US$)	(18.8)	(16.1)	(19.0)



Source: Bloomberg

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Limited upside

Downgrade earnings & recommendation

As PFC looks to raise ~US$750m through FPO along with a divestment by government, 2 key questions that investors face are on growth and asset quality. Our interaction with PFC's management and industry sources indicates that progress on current projects is on-track, but new sanctions have slowed and may put growth in FY13 at risk. While PFC's near zero NPA levels are unique, we see potential risks going forward especially in exposure to private sector (7% of loans). We are cautiously lowering our earning estimates for FY12-13 by 7-14% as we lower loan growth and raise provisioning. In spite of the cut, ROE remains healthy at ~18% and in that context valuations are reasonable at 1.4x FY12 adjusted PB. But with near term triggers not clear, we lower reco to O-PF; target of Rs225.

Risks to growth even as government makes some right moves

Various factors have posed risks to investment plans in power generation (85% of PFC's loans). Our interaction with management and industry sources indicates that progress on projects under construction remains on-track, but sanctions have slowed due to risk-averseness of developers and financiers. While lack of availability of coal raised concerns, hike in coal allocation to power sector from ~320mt (delivered ~300mt) in FY11 to ~345mt in FY12 is a positive step by government. We are however, cautiously lowering our loan growth estimates for FY12-13 from 24% Cagr to 20% in FY12 & 17% in FY13.

Policy support key to asset quality

PFC's high exposure to government-owned companies (most making losses), pressure on profitability of some private generators and high concentration of loans has raised risks on asset quality, especially as PFC remains a near zero NPA company. Slippages in government-owned projects can have serious implications across the sector and hence government support may continue. While private sector exposure (7% of loans) remains healthy, a 15% slippage in this portfolio would push-up NPA to 1% of loans and impact net worth by 6-7%. While there are risks, it is interesting to note (1) ~70% of PFC's loans are to operating entities- implying that most projects are being actively assessed on quality and (2) merchant power projects form just 2% of total loans where generally 15% of capacity is on merchant basis.

Fairly valued at 1.4x adjusted FY12 PB; lower reco to O-PF

We cut earning estimates for FY12-13 by 7-14% to build lower loan growth and higher provisioning. At current price, it trades at 1.4x FY12 (pre-money) adj PB which seems to adequately factor risks to a secular investment story. At FPO price band of Rs193-203, post money FY12 adj PB is at 1.4x for 16% ROE. While we see limited near-term triggers, downside also seems limited.

Financials

Year to 31 Mar	09A	10A	11A	12CL	13CL
Operating income (Rsm)	24,061	30,909	37,511	44,003	50,378
Net profit (Rsm)	19,699	23,571	26,188	29,357	33,076
NP forecast change (%)	-	-	*(0.9)*	*(7.4)*	*(14.0)*
EPS (Rs)	17.2	20.5	22.8	25.6	28.8
CL/consensus (0) (EPS%)	-	-	-	94	90
EPS growth (% YoY)	63.9	19.7	11.1	12.1	12.7
ROA (%)	3.2	3.1	2.7	2.5	2.4
ROE (%)	18.9	19.0	18.3	17.8	17.7
PE (x)	12.3	10.3	9.2	8.2	7.3
Adjusted PB (x)	2.1	1.8	1.6	1.4	1.3
Dividend yield (%)	1.9	2.1	2.7	3.0	3.4

Adjusted for 100% NPL coverage. Source: CLSA Asia-Pacific Markets

PFC plans to raise US$750m through issue

Government will also divest 5% stake

FPO priced at 1.4-1.5x trailing book

PFC's follow-on public offering (FPO) involving fresh share issue of 15% of the capital and 5% divestment by government will help to mobilise ~US$750. The price band of Rs193-203 (5-10% discount to price on date of announcement) is inline with pricing of earlier FPOs. Price band implies valuation at 1.4-1.5x FY11 adjusted book (pre-money).

Post capital raising government holding will dilute to 74%

Price band is at discount to price on date of announcement, in line with past issues

PFC will mobilise ~US$750m through the issue

Tier I ratio would improve from 16% to 19%

Figure 1

Summary of FPO plans

Current shares (m)	1,148
Shares to be issued (m)	230
Fresh issue (m)	172
Sale by government (m)	57
New outstanding shares (m)	1,320
Dilution (based on fresh issue)	15%
Issue price	
Lower band (Rs)	193
Upper band (Rs)	203
5% discount to retail investors	
New funds to be raised	
Lower band (Rsm)	33,228
Upper band (Rsm)	34,949
Shareholders' funds Mar-11 (Rsm)	154,118
Tier I ratio (%)	16%
Addition to capital	
Lower band (%)	22%
Upper band (%)	23%
Revised Tier I ratio	
Lower band (%)	19%
Upper band (%)	19%

Source: CLSA Asia-Pacific Markets

We are lowering loan growth estimates and raising provisioning

Lower earning estimates, ROE still healthy

Building in potential risks to loan growth, we are pruning growth estimates to 18% Cagr over FY11-13; FY13 loan growth of 17% would be among the lowest in PFC's track-record. We continue to be conservative on spreads (+30bps compression over FY11-13) and are also raising NPL provisioning. As a result, we are cutting earning estimates by 7-14%; 12% Cagr in profit over FY11-13. However, the ROE still remains healthy at ~18% and in that context valuation at 1.4x FY12 adjusted PB appear reasonable.

At 1.3x post money FY13 adjusted PB for 16% ROE target price would be Rs218

Cetris paribus, capital raising would lead to 4-7% upside to our profit estimates, but EPS would fall by 7-10% and ROE would moderate from ~18% to ~16%. Change in PB would be limited as issue is at lower premium to the book value and discount to the market price. At 1.3x FY13 post money adjusted PB for 16% ROE (current target price is based on 1.4x for 18% ROE) target price would be Rs218.

Figure 2

We cautiously lower loan growth over FY12-13...

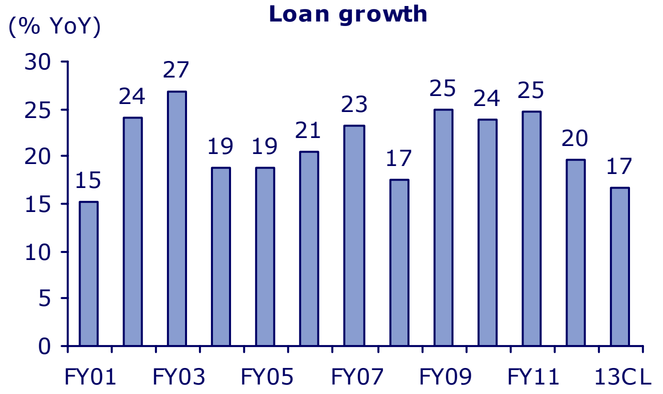
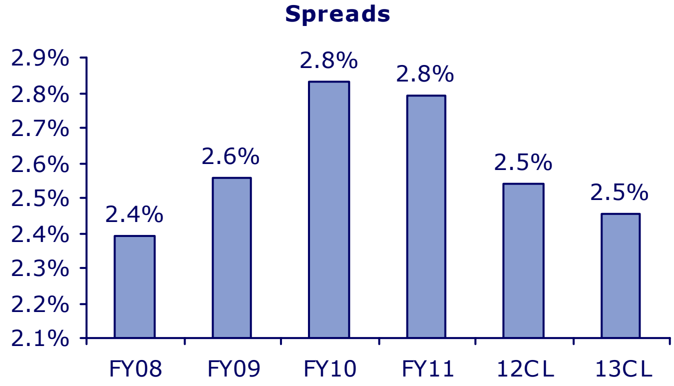


Figure 3

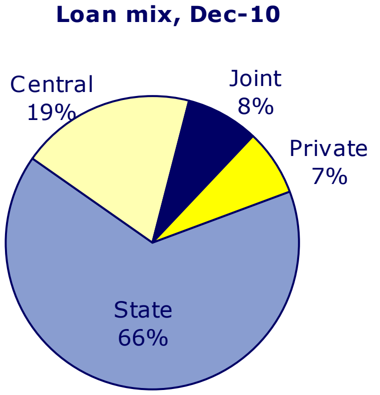
... and remain conservative on spreads

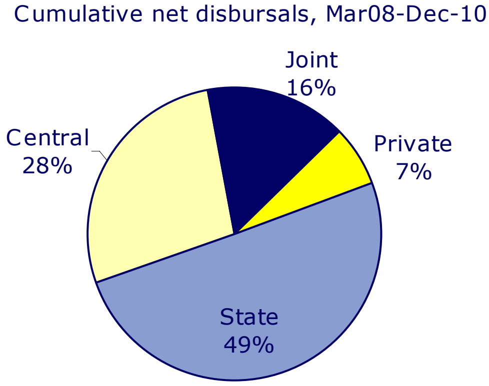


Source: Company, CLSA Asia-Pacific Markets

Figure 4 Figure 5

Loan mix and incremental disbursals are dominated by government entities, we see some risks in private sector





Source: Company, CLSA Asia-Pacific Markets

Figure 6

We are building in rise in gross NPA...

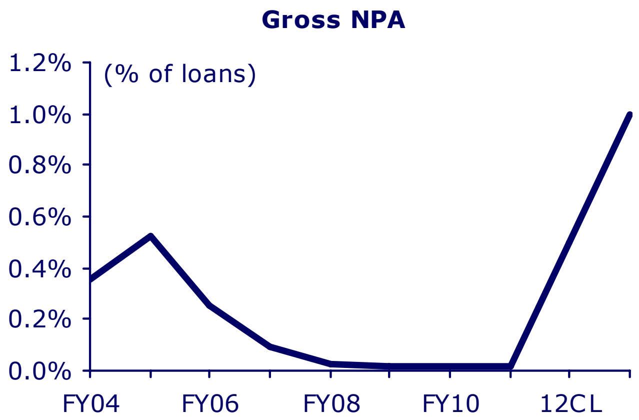
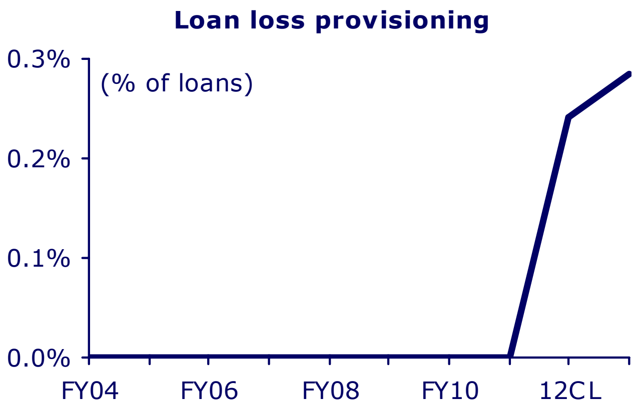


Figure 7

... and increased loan loss provisioning



Source: Company, CLSA Asia-Pacific Markets

Figure 8

While earnings growth would moderate…

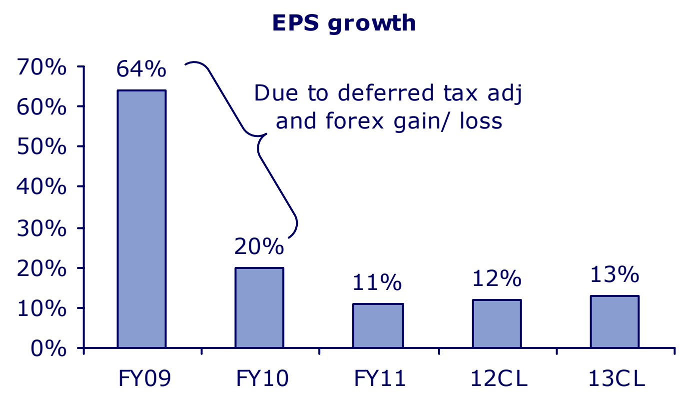
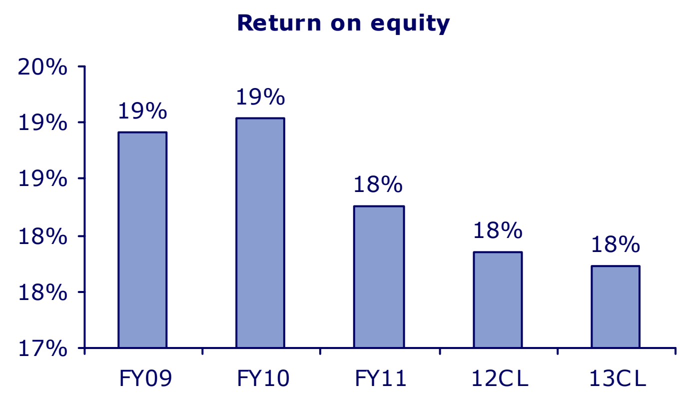


Figure 9

… ROE would still be healthy at ~18%



Source: CLSA Asia-Pacific Markets

Assuming capital infusion with same loan growth…

We see 4-7% upside to net profit in FY12-13

… but EPS would be lower by 7-10%

BVPS would rise by 3-5%

While ROE will expand, ROE would contract

Valuations at 1.4x FY12 adjusted PB are reasonable

Figure 10

Summary comparison of pre-money post money earnings and valuations

	FY12CL	FY13CL
Net profit		
Pre-money	29,357	33,076
Post-money	30,481	35,357
% change	4%	7%
EPS		
Pre-money	26	29
Post-money	23	27
% change	-10%	-7%
BVPS		
Pre-money	152	173
Post-money	160	179
% change	5%	3%
Adjusted BVPS		
Pre-money	147	161
Post-money	155	168
% change	5%	5%
ROA		
Pre-money	2.5%	2.4%
Post-money	2.6%	2.6%
ROE		
Pre-money	18%	18%
Post-money	15%	16%
PE at Rs203		
Pre-money	8.2	7.3
Post-money	9.1	7.9
Adjusted PB		
Pre-money	1.4	1.3
Post-money	1.4	1.3

Source: CLSA Asia-Pacific Markets

We expect NII to grow at 14% Cagr over FY11-13

Rise in NPL provisioning will cap profit growth to 12%

We are building slowdown in loan growth to 18% Cagr over FY12-13

Figure 11

Summary P&L

Income Statement (Rs mn)	FY09	FY10	FY11A/CL	FY12CL	FY13CL
Interest income	64,781	79,700	100,585	123,779	146,028
Interest expense	41,774	49,859	64,095	82,147	98,477
Net interest income	**23,007**	**29,841**	**36,490**	**41,631**	**47,551**
Other income	1,055	1,068	1,021	2,372	2,827
- Fee income	*742*	*716*	*1,437*	*2,122*	*2,569*
Total income	**24,061**	**30,909**	**37,511**	**44,003**	**50,378**
Operating expenses	4,120	797	2,078	2,117	2,456
Pre-provision Profit	19,941	30,112	35,433	41,886	47,922
Total Provision	**37**	**(21)**	**0**	**2,873**	**3,967**
-Provision for NPL	*0*	*0*	*0*	*2,873*	*3,967*
- Provision for Investments	*15*	*(15)*	*0*	*0*	*0*
- Generic Provisions	*22*	*-6*	*0*	*0*	*0*
PBT	19,905	30,133	35,433	39,013	43,955
Provision for Tax	205	6,562	9,245	9,656	10,879
PAT	**19,699**	**23,571**	**26,188**	**29,357**	**33,076**

Source: CLSA Asia-Pacific Markets

Figure 12

Summary balance sheet

Balance Sheet (Rs mn)	FY09	FY10	FY11A/CL	FY12CL	FY13CL
Cash balances	3,928	13,943	23,503	24,669	29,703
Advances	644,290	798,558	995,707	1,190,990	1,388,922
Investments	359	314	539	314	314
Fixed assets	752	745	767	844	928
Current assets	32,763	34,212	47,643	54,790	63,008
Total Assets	**682,092**	**847,772**	**1,068,159**	**1,271,606**	**1,482,876**
Equity Capital	11,478	11,478	11,478	11,478	11,478
Reserves & Surplus	103,601	121,130	142,640	163,411	186,813
Shareholders' funds	115,078	132,608	154,118	174,889	198,290
Borrowings	521,602	671,084	855,986	1,031,434	1,210,786
Interest subsidy from GoI	9,089	6,635	4,519	3,841	3,265
Current liabilities	36,322	37,445	53,537	61,443	70,535
Total Liabilities	**682,092**	**847,772**	**1,068,159**	**1,271,606**	**1,482,876**

Source: CLSA Asia-Pacific Markets

ROE are healthy at ~18%

Valuations at 1.4x FY12 adjusted PB are reasonable

Figure 13

Key ratios

	FY09	FY10	FY11A/CL	FY12CL	FY13CL
EPS	17.2	20.5	22.8	25.6	28.8
Earnings growth	64%	20%	11%	12%	13%
PPP / Share	17.4	26.2	30.9	36.5	41.8
BV/share	100	116	134	152	173
Adjusted BV / Share	100	115	134	147	161
ROAA	3.2%	3.1%	2.7%	2.5%	2.4%
ROAE	18.9%	19.0%	18.3%	17.8%	17.7%
NIM	3.9%	4.1%	4.0%	3.7%	3.6%
Gross NPLs	0.02%	0.02%	0.02%	0.50%	1.00%
Net NPLs (ex floating prov)	0.01%	0.01%	0.01%	0.25%	0.50%
Coverage (incl float prov)	53.8%	53.8%	33.7%	49.4%	49.8%
Capital Adequacy Ratio	17.6%	18.3%	17.0%	15.8%	14.8%
- Tier I CAR	16.5%	17.1%	15.9%	14.7%	13.8%
Fee growth	94.8%	-3.6%	100.7%	47.7%	21.0%
Cost-Income ratio (Excl Treasury)	6.6%	5.9%	4.8%	4.8%	4.9%
Fee income/ Total Inc (Excl Treasury)	3.1%	2.3%	3.8%	4.8%	5.1%
Cost Asset Ratio	0.6%	0.1%	0.2%	0.2%	0.2%
Loan Growth	25%	24%	25%	20%	17%
Equity / Assets	16.9%	15.6%	14.4%	13.8%	13.4%
Equity / Loans	17.9%	16.6%	15.5%	14.7%	14.3%
Provision/ Loans	0.0%	0.0%	0.0%	0.2%	0.3%
Tax Rates	1.0%	21.8%	26.1%	24.8%	24.8%
Yield on Advances	11.2%	11.0%	11.2%	11.3%	11.3%
Yield on Assets	10.2%	11.1%	10.9%	11.0%	11.1%
Cost of Funds	8.8%	8.3%	8.3%	8.7%	8.8%
P/E	11.8	9.9	8.9	7.9	7.0
P/PPP	11.7	7.7	6.6	5.6	4.9
P/BV	2.0	1.8	1.5	1.3	1.2
P/ABV	2.0	1.8	1.5	1.4	1.3
Dividend per Share	4.0	4.5	5.7	6.4	7.2
Dividend Payout	23%	22%	25%	25%	25%
Dividend Yield	2%	2%	3%	3%	4%

Source: CLSA Asia-Pacific Markets

Target price is based on 1.4-1.3x FY13 adjusted PB

Figure 14

Target price computation

	Pre-money	Post money
RoE	18%	16%
Growth	5%	6%
Cost of equity	14%	14%
Theoretical PB	1.4	1.3
Assumptions for cost of capital		
Risk free rate	8%	8%
Risk premium	6%	6%
Beta	1.0	1.0
Cost of equity	14%	14%
Adjusted FY13 BVPS	161	168
Target price	225	218

Source: CLSA Asia-Pacific Markets

Recommendation history - Power Finance Corp POWF IB

Date	Rec level	Closing price	Target
10 May 2011	O-PF	211.00	225.00
18 January 2011	BUY	272.45	350.00
04 January 2011	BUY	306.90	400.00
10 October 2010	BUY	363.45	440.00

Source: CLSA Asia-Pacific Markets

Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).