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FPO Note | Banking

May 10, 2011

Power Finance Corporation

High-powered growth

Strong growth outlook: The surge in power sector projects in the past few years, especially from the private sector, has led to a sharp increase in funding requirements, visible in PFC's huge outstanding loan sanctions of ₹1.7lakh crore. This alone provides high loan growth visibility in the next few years (we have factored in a 25% CAGR in loan growth over FY2012–13E). Moreover, with banks having seen a 47% CAGR in power sector lending in the past two years, their exposures in most cases have reached close to board-mandated limits, creating even more space for specialised lenders such as PFC to grow. This will be further aided by the company's expanded net worth post the FPO and higher concentration limits pursuant to an infrastructure finance company (IFC) status.

Healthy profitability: Structurally, as is the case with several other niche NBFCs, regulatory arbitrage vis-à-vis banks allows PFC to earn healthy NIMs, further aided by its close-to-sovereign credit rating. Moreover, reduction in risk weightage from 100% to 20% due to the IFC status makes funding from banks ~100bp cheaper. Cyclically, we have conservatively factored in a 50bp NIM compression over FY2012–13E due to rising funding costs. That said, the recent underperformance of the stock, in our view, over discounted the ~75bp sequential NIM compression in 4QFY2011 (calculated), which was partly on account of large bond and ECB issuances (issue costs accounted upfront) as well as large disbursements towards the quarter-end.

With 87% of loans to public sector utilities so far, asset quality has not been an issue irrespective of the financial health of utilities. In our view, the scenario pertaining to PSU borrowers is likely to remain unchanged, further aided by the likely benign approach towards any required restructuring and NPA recognition pertaining to such loans, given quasi-sovereign status as well as systemic issues of the alternative. The increasing proportion of private sector loan sanctions, in our view, does increase the risk profile. Though, in any case, this is unlikely to manifest in the next few years, when most loans relate to projects under implementation, the substantial valuation discount to PFC's historical valuation range provides further margin of safety.

Attractive valuations: At the CMP, the stock is trading at 1.1x FY2013 P/ABV. Historically, the stock has traded at 1.2-2.2x one-year forward ABV with a median of 1.75x. Considering asset-quality issues that could creep up as exposure to private sector increases, we have assigned an FY2013E P/ABV multiple of 1.4x, 20% lower than PFC's median P/ABV multiple since listing. The resultant target price of ₹254 implies an upside of 25% from the upper end of the price band. **Hence, we recommend Subscribe to the issue.**

Key financials

Y/E March (₹ cr)	FY2010	FY2011E	FY2012E	FY2013E
NII	2,874	3,466	4,056	4,733
% chg	44.1	20.6	17.0	16.7
Net profit	2,357	2,619	3,073	3,601
% chg	19.7	11.1	17.4	17.2
NIM (%)	3.9	3.8	3.6	3.3
EPS (₹)	20.5	22.8	23.3	27.3
P/E (x)	9.9	8.9	8.7	7.4
P/ABV (x)	1.7	1.5	1.3	1.1
RoA (%)	3.1	2.7	2.6	2.4
RoE (%)	18.3	18.1	16.6	15.8

Source: RHP, Angel Research. Note: Valuations at the upper price band

SUBSCRIBE

Issue Open: May10, 2011
Issue Close: May 13, 2011

Issue Details
Face Value: ₹10
Present Eq. Paid-up Capital: ₹1147.8cr
Offer Size: 22.96cr Shares
Fresh Issue: 17.22cr Shares
Offer for sale:5.74cr Shares
Post Eq. Paid-up Capital: ₹ 1,320cr
Issue size (amount):** ₹4,353-4,573cr
Fresh Issue: **₹3,265-3,434cr
Offer for sale: ** ₹1,088-1,143cr
Price Band: ₹193-203#
Post-issue implied mkt cap**: ₹ 25,474cr-26,795cr
Promoters holding Pre-Issue: 89.8%
Promoters holding Post-Issue: 73.7%

*Note: **At the lower and upper price band, respectively, # 5% discount to retail investors*

Book Building	
QIBs	Up to 50%
Non-Institutional	At least 15%
Retail	At least 35%

Post Issue Shareholding Pattern	
Promoters Group	73.7
MF/Banks/Indian FIs/FIIs/Public & Others	26.3

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Company background

Power Finance Corporation Ltd. (PFC) is a leading power sector public financial institution and a non-banking financial company, providing fund and non-fund based support for development of the Indian power sector. The company plays a major role in channelising investment into the power sector and acts as a vehicle for development of this sector. PFC enjoys the highest credit rating in the Indian market; while in international markets, the company is rated at par with the Indian Sovereign rating. The company is registered as a non-banking financial company (NBFC) by the RBI and was conferred with the status of Nav-Ratna PSU by the Government of India on June 22, 2007. The company was conferred with the status of NBFCND-IFC (Non Banking Finance Company-Non Deposit Taking-Infrastructure Finance Company) on July 28, 2010.

Details of the issue

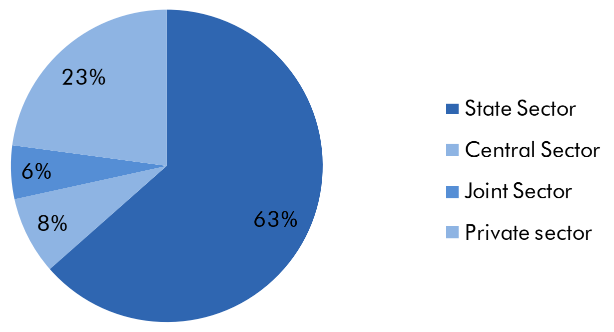
The IPO comprises an issue of 22.95cr equity shares of face value of ₹10 each in the price band of ₹193–203 per share. The issue comprises a fresh issue of 17.22cr equity shares and an offer for sale of 5.74cr equity shares by the Government of India. The company expects to raise between ₹3,092cr and ₹3,262cr at the lower and upper price band, respectively. The primary issue of shares would result in a dilution of the promoter's holding by 16.1% to 73.7%. The issue proceeds are planned to be utilised for augmenting the capital base to ensure compliance with requisite capital adequacy norms and to meet future capital requirements arising out of growth in the business and for general corporate purposes.

Investment arguments

Strong growth outlook

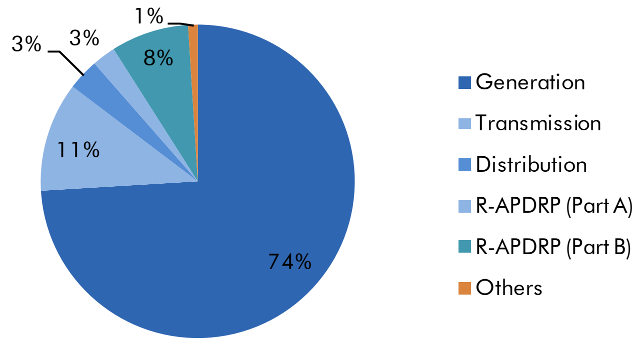
The surge in power sector projects in the past few years, especially from the private sector, has led to a sharp increase in funding requirements, visible in PFC's huge outstanding loan sanctions of ₹1.7lakh crore. This alone provides high loan growth visibility in the next few years (we have factored in a 25% CAGR in loan growth over FY2012–13E). Moreover, with banks having seen a 47% CAGR in power sector lending in the past two years, their exposure in most cases has reached close to board-mandated limits, creating even more space for specialised lenders such as PFC to grow. This will be further aided by the company's expanded net worth post the FPO and higher concentration limits pursuant to its IFC status.

Exhibit 1: Outstanding sanction mix* – Sector wise



*Source: RHP, Angel Research; Note: *As of December 31, 2010*

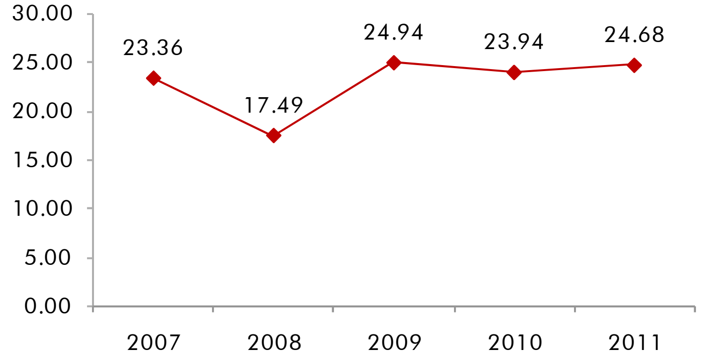
Exhibit 2: Outstanding sanction mix* – Project wise



*Source: RHP, Angel Research; Note: *As of December 31, 2010*

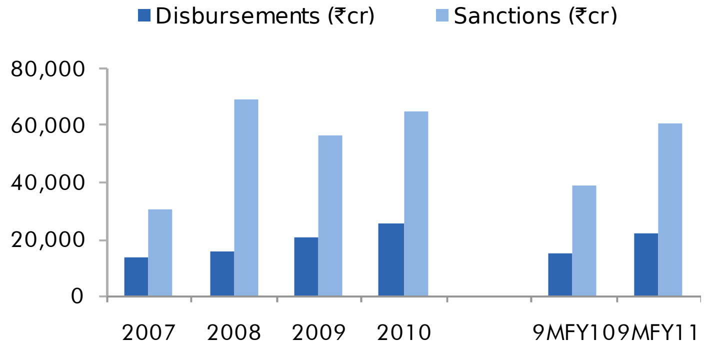
Outstanding sanctions as of December 31, 2010, stood at 1.7lakh crore, with higher concentration towards public sector (~77% of total outstanding sanctions) and generation projects (~74% of total outstanding sanctions).

Exhibit 3: Healthy yoy loan growth



Source: RHP, Angel Research

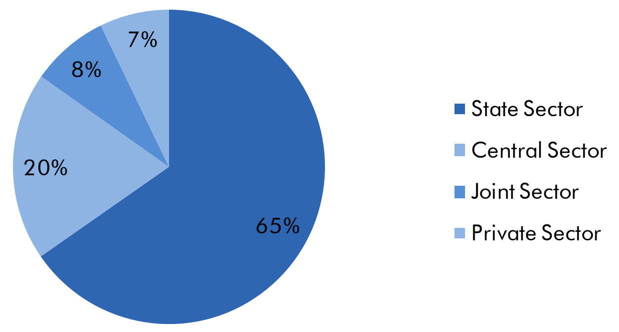
Exhibit 4: Disbursements and sanctions



Source: RHP, Angel Research

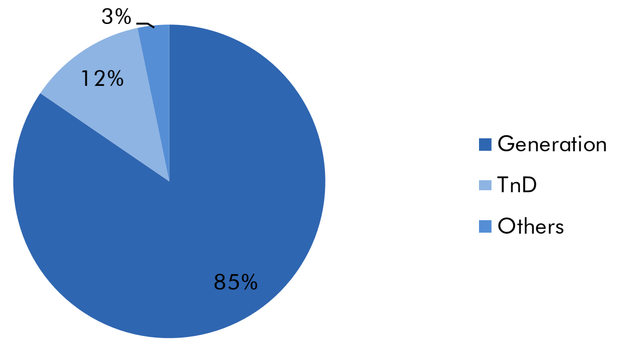
Loan growth has been healthy on a yearly basis, and seeing the large demand supply gap in power requirements and increasing needs for power financing, we expect loan growth to sustain at 25% levels for FY2013. The disbursement and sanctions over FY2007–9MFY2011 have also been healthy (₹22,270cr worth disbursements and ₹61,077 worth sanctions done in 9MFY2011).

Exhibit 5: Outstanding loan mix* – Sector wise



*Source: Company, Angel Research; Note: *As of December 31, 2010*

Exhibit 6: Outstanding loan mix* – Project wise



*Source: Company, Angel Research; Note: *As of December 31, 2010*

Outstanding loans as of December 31, 2010, stood at ₹92,040cr, with higher concentration to public sector units (~93% of total loans outstanding) and to generation projects (85% of total loans outstanding).

Exhibit 7: Borrowing profile (%)

Borrowing Profile (%)	4QFY2009	1QFY2010	2QFY2010	3QFY2010	4QFY2010	1QFY2011	2QFY2011	3QFY2011
Bonds	70.7	71.4	73.7	73.0	69.5	74.1	73.7	73.6
Term Loans	26.6	26.4	24.5	25.2	27.1	25.4	25.9	25.1
Short-term Loans	2.7	2.1	1.8	1.7	3.5	0.5	0.3	1.3
Total	100	100	100	100	100	100	100	100
Rupee Denominated	95.0	95.4	97.3	97.5	95.9	96.1	94.8	95.0
Foreign Currency Loans	5.0	4.6	2.7	2.5	4.1	3.9	5.2	5.0
Total	100	100	100	100	100	100	100	100

Source: Company, Angel Research

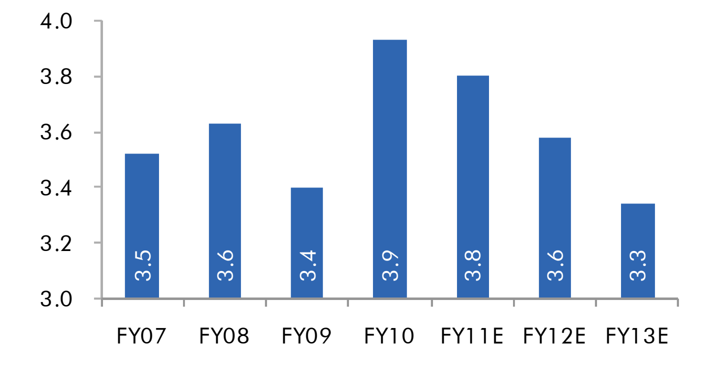
Healthy profitability

Structurally, as is the case with several other niche NBFCs, regulatory arbitrage vis-à-vis banks allows PFC to earn healthy NIMs, further aided by its close-to-sovereign credit rating. Moreover, reduction in risk weightage from 100% to 20% due to the IFC status makes funding from banks ~100bp cheaper. Cyclically, we have conservatively factored in a 50bp NIM compression over FY2012–13E due to rising funding costs. That said, the recent underperformance of the stock, in our view, over discounted the ~75bp sequential NIM compression in 4QFY2011 (calculated), which was partly on account of large bond and ECB issuances (issue costs accounted upfront) as well as large disbursements towards the quarter-end.

With 87% of loans to public sector utilities so far, asset quality has not been an issue irrespective of the financial health of the utilities. In our view, the scenario pertaining to PSU borrowers is likely to remain unchanged, further aided by the likely benign approach towards any required restructuring and NPA recognition pertaining to such loans, given quasi-sovereign status as well as systemic issues of the alternative. The increasing proportion of private sector loan sanctions, in our view, does increase the risk profile. Though, in any case, this is unlikely to manifest in the next few years, when most loans relate to projects under implementation, the substantial valuation discount to PFC's historical valuation range provides further margin of safety.

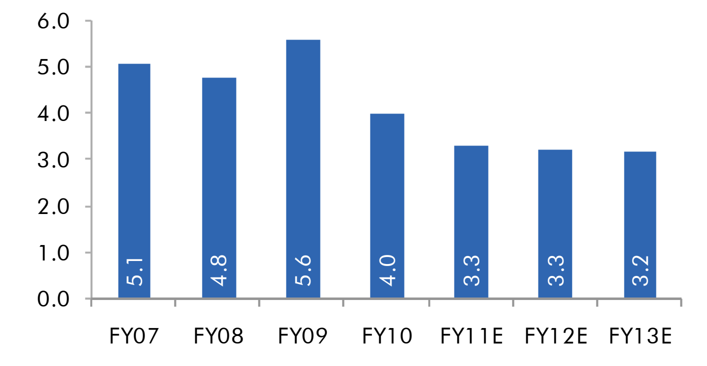
Overall, driven by 25% loan growth and NIM of 3.3% by FY2013E, we estimate PAT CAGR of 17.3% (EPS CAGR 0f 9.4%) over FY2011–13. PFC has delivered healthy ROAs and ROEs over FY2007–10. Going forward, we expect ROAs and ROEs to sustain at 2.4% and 15.8%, respectively.

Exhibit 8: Healthy NIMs and...



Source: Company, Angel Research

Exhibit 9: ...low C-I* ratio leading to higher profitability



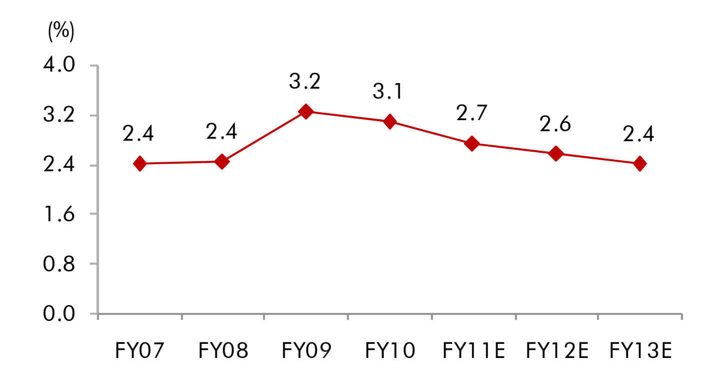
*Source: Company, Angel Research, Note * Cost-to-income ratio*

Exhibit 10: Near negligible NPAs for PFC

Gross NPA as on	2006	2007	2008	2009	2010	9MFY11
Public sector (₹cr)	31.7	25.9	4.2	4.2	4.2	4.2
Private sector (₹cr)	59.3	16.4	8.9	8.9	8.9	8.9
Total	909.9	423.1	131.6	131.6	131.6	131.6
GNPA ratio (Public, %)	0.01%	0.01%	0.00%	0.00%	0.00%	0.00%
GNPA ratio (Private, %)	0.21%	0.05%	0.02%	0.02%	0.02%	0.01%
GNPA Total (%)	0.26%	0.10%	0.03%	0.02%	0.02%	0.01%

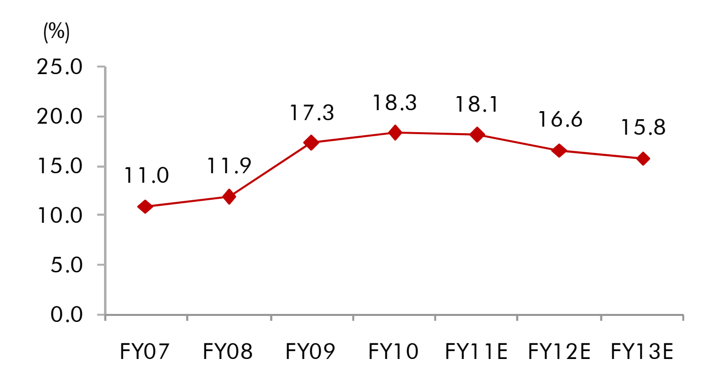
Source: RHP, Angel Research

Exhibit 11: Healthy ROAs...



Source: Company, Angel Research

Exhibit 12: ...and healthy ROEs



Source: Company, Angel Research

IFC status to aid in capitalising on available financing opportunities in the power sector

PFC before being categorised as an IFC was categorized as a loan company (a category of NBFCs). Thus, loans given to PFC (despite it having AAA rating accorded by CRISIL and CARE) were assigned a 100% risk weightage, as a bank's claims on all categories of NBFCs except AFCs and IFCs are uniformly risk weighted at 100%.

However, bank claims on corporates, asset finance companies (AFCs) IFCs (NBFC-IFC) are risk weighted as per the ratings assigned by rating agencies registered with the SEBI and accredited by the RBI. Hence, post conferral of IFC status to PFC (July 28, 2010), the risk weightage assigned to loans given to PFC by banks stands at 20%, allowing banks to keep aside lower capital (1/5th of the previous amount required) to meet capital adequacy norms and, hence, employ higher leverage to increase their ROAs. These gains, which accrue to banks in terms of higher returns, will enable PFC relatively easier and cheaper access to funds than what it had when it was classified as a loan company. In our view, the benefit to PFC in the form of lower cost of funds from banks works out to ~100bp.

The IFC status also makes PFC eligible to raise, under the automatic route, ECBs up to US$500mn each fiscal, subject to the aggregate outstanding ECBs not exceeding 50.0% of the net worth. With foreign currency loans coming at a cheaper cost than domestic borrowings, we expect PFC to maximise this advantage by raising more foreign currency borrowings in future. As of December 31, 2010, foreign currency borrowings stood at ₹3,813cr (4.0% of total borrowings). The company recently availed (February 2011) of a JPY, denominated foreign currency loan equivalent to US$260mn

Exhibit 13: Concentration of credit / investment

NBFC Type	Loan company	IFC
Lending ceilings		
Lending to any single borrower	15% (+ 5*)	25%
Lending to any single group of borrowers	25% (+ 10*)	40%
Investing ceilings		
Investing in shares of a company	15% (+ 5*)	15% (+ 5*)
Investing in shares of a single group of companies	25% (+ 10*)	25% (+ 10*)
Loans and investment taken together		
Lending and investing to single party	25% (+ 5*)	30%
Lending and investing to single group of parties	40% (+ 10*)	50%

*Source: RHP, Angel Research Note: * Additional exposure applicable in case of infrastructure loans*

Classification of PFC as an IFC will permit banks to take an exposure of up to 20% (15% for NBCFs engaged in infra lending) of their capital funds to PFC. Also, as a government-owned NBFC, loans made to central and state entities in the power sector (92.9% of total loan portfolio as of December 31, 2010) are currently exempt from the RBI's prudential lending norm (0.4% provisioning for standard assets) that are applicable to other non-government owned NBFCs (hit of ~₹340cr to P&L if this exemption is withdrawn).

PFC, now being classified as an IFC, is also allowed to issue infrastructure bonds that offer tax benefits to investors (currently these bonds can only be issued by IFCI, LIC, IDFC and IFCs). The company recently raised ₹235cr via issue of these infrastructure bonds (March 31, 2011).

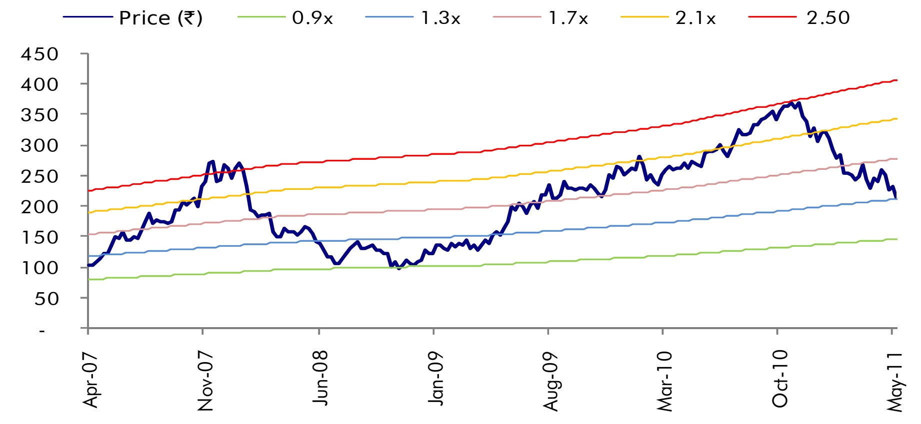
Investment risks

Historically, PFC has witnessed superior asset quality, which is reflected in the near zero NPAs that the company has maintained on its loan portfolio. Although, state electricity boards, to which PFC has the highest exposure, have been in poor health for a while now, there default seems unlikely given their quasi-sovereign status; however, the risk of restructuring cannot be ruled out. As of December 31, 2010, the top 10 borrowers accounted for 54.1% of the loan portfolio, indicating high borrower concentration. A single default or restructure on these accounts could send the NPAs soaring and stem asset-quality concerns, which the company has successfully managed to evade until now.

Outlook and valuation

At the CMP, the stock is trading at 1.1x FY2013 P/ABV. Historically, the stock has traded in at 1.2-2.2x one-year forward ABV with a median of 1.75x. Considering asset-quality issues that could creep up as exposure to private sector increases, we have assigned an FY2013E P/ABV multiple of 1.4x, 20% lower than PFC's median P/ABV multiple since listing. The resultant target price of ₹254 implies an upside of 25% from the upper end of the price band. **Hence, we recommend Subscribe to the issue.**

Exhibit 14: P/ABV band



Source: Company, Angel Research

Exhibit 15: Reco summary

Comp	Reco.	CMP (₹)	Tgt. Price (₹)	*Upside (%)*	FY2013E P/ABV (x)	FY2013E Tgt. P/ABV (x)	FY2013E P/E (x)	FY11E-13E EPS CAGR (%)	FY2013E RoA (%)	FY2013E RoE (%)
PFC	Buy	203$	254	25.2	1.1	1.4	7.4	9.4	2.4	15.8
REC*	NA	222	NA	NA	1.3	NA	6.4	16.3	3.0	21.4

*Source: Company, Angel Research; Note * Bloomberg estimates for REC, $ At the upper end of the issue*

Income statement

Y/E March (₹ cr)	FY07	FY08	FY09	FY10	FY11	FY12E	FY13E
Net Interest Income	1,417	1,758	1,994	2,874	3,466	4,056	4,733
- YoY Growth (%)	16.5	24.1	13.4	44.1	20.6	17.0	16.7
Other Income	176	119	118	266	202	240	300
- YoY Growth (%)	46.2	(32.0)	(0.9)	124.5	(23.8)	18.8	25.0
Operating Income	1,593	1,878	2,113	3,140	3,668	4,296	5,033
- YoY Growth (%)	19.2	17.9	12.5	48.6	16.8	17.1	17.1
Operating Expenses	81	90	118	126	121	140	161
- YoY Growth (%)	13.5	10.9	31.6	6.4	(3.5)	15.0	15.0
Pre - Provision Profit	1,512	1,788	1,994	3,014	3,547	4,157	4,872
- YoY Growth (%)	19.5	18.3	11.6	51.1	17.7	17.2	17.2
Prov. and Cont.	0	-	4	0	3	6	8
- YoY Growth (%)	(83)	(100)	NA	(89)	670	76	44
Profit Before Tax	1,512	1,788	1,990	3,013	3,543	4,151	4,864
- YoY Growth (%)	19.5	18.3	11.3	51.4	17.6	17.1	17.2
Provision for Taxation	525	581	21	656	925	1,077	1,262
- as a % of PBT	34.8	32.5	1.0	21.8	26.1	26.0	26.0
PAT	986	1,207	1,970	2,357	2,619	3,073	3,601
- YoY Growth (%)	1.6	22.4	63.2	19.7	11.1	17.4	17.2

Balance sheet

Y/E March (₹ cr)	FY07	FY08	FY09	FY10	FY11	FY12E	FY13E
Share Capital	1,148	1,148	1,148	1,148	1,148	1,320	1,320
Reserve & Surplus	8,677	9,249	11,269	12,184	14,264	19,904	22,656
Borrowings	33,584	40,648	52,160	67,108	85,591	104,804	133,508
- Growth (%)	24.7	21.0	28.3	28.7	27.5	22.4	27.4
Other Liabilities & Provisions	2,129	2,443	3,586	4,375	5,804	7,480	9,401
Total Liabilities	**45,538**	**53,487**	**68,163**	**84,815**	**106,806**	**133,508**	**166,885**
Investments	59	66	36	31	54	67	84
Advances	43,919	51,574	64,436	79,856	99,562	124,453	155,566
- Growth (%)	23.3	17.4	24.9	23.9	24.7	25.0	25.0
Fixed Assets	81	77	75	75	77	96	120
Other Assets	1,478	1,770	3,616	4,853	7,114	8,892	11,115
Total Assets	**45,538**	**53,487**	**68,163**	**84,815**	**106,806**	**133,508**	**166,885**

Key Ratios

Year end March	FY07	FY08	FY09	FY10	FY11	FY12E	FY13E
Per Share Data (₹)							
EPS	8.6	10.5	17.2	20.5	22.8	23.3	27.3
ABVPS (75% Coverage for NPAs)	85.6	90.6	108.2	116.1	134.3	160.8	181.6
DPS	2.3	3.5	4.5	5.5	3.5	4.5	5.5
Profitability ratios (%)							
NIMs	3.5	3.6	3.4	3.9	3.8	3.6	3.3
ROA	2.4	2.4	3.2	3.1	2.7	2.6	2.4
ROE	11.0	11.9	17.3	18.3	18.1	16.6	15.8
Asset Quality (%)							
Gross NPAs	0.03	0.02	0.02	0.02	0.02	0.02	0.02
Net NPAs	0.00	0.00	0.01	0.01	0.01	0.01	0.01
Valuation Ratios $							
PER (x)	23.6	19.3	11.8	9.9	8.9	8.7	7.4
P/ABVPS (x)	2.4	2.2	1.9	1.7	1.5	1.3	1.1
Dividend Yield	1.1	1.7	2.2	2.7	1.7	2.2	2.7
DuPont Analysis (%)							
NII	3.5	3.6	3.3	3.8	3.6	3.4	3.2
(-) Prov. Exp.	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Adj NII	3.5	3.6	3.3	3.8	3.6	3.4	3.1
Other Inc.	0.4	0.2	0.2	0.3	0.2	0.2	0.2
Op. Inc.	3.9	3.8	3.5	4.1	3.8	3.6	3.3
Opex	0.2	0.2	0.2	0.2	0.1	0.1	0.1
PBT	3.7	3.6	3.3	3.9	3.7	3.5	3.2
Taxes	1.3	1.2	0.0	0.9	1.0	0.9	0.8
ROA	2.4	2.4	3.2	3.1	2.7	2.6	2.4
Leverage	4.6	4.9	5.3	5.9	6.6	6.5	6.6
ROE	11.0	11.9	17.3	18.3	18.1	16.6	15.8

Note: $ Valuations at the upper price band

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