FPO NOTE

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Power Finance Corporation Ltd

Issue Opens	Issue Closes
10th May'11	13th May'11

An Overview

PFC was set up on 16th July 1986 as a Financial Institution (FI) with an objective to provide funding to the power and associated sectors, to help its borrowers in financial, technical and managerial areas to ensure optimum utilization of available resources and to mobilize various resources from domestic and international sources at competitive rates. As the Co also plays a strategic role in Govt of India initiation, it is also involved in various GoI programs for the power sector. It has 89.78% ownership by the Government of India. Post FPO this will fall to 73.72% and PFC will likely become the country's fourth largest lender in terms of net worth.

Soon after it went public in 2007, it received a Nav-Ratna status from Govt and recently in July 2010 has been accorded IFC status. As an IFC PFC can raise funds on a cost-competitive basis (including infrastructure bonds) and increase its lending exposures to individual entities and groups.

PFC provides various fund based financial assistance, like project finance, short- term loans, buyer's line of credit etc as well as non-fund based assistance like guarantees and letters of comfort. It also provides various fee-based technical advisory and consultancy services for power sector projects (from project conceptualization to the post-commissioning stage).

Its primary sources of funds include equity capital, internal resources and domestic and foreign borrowings. It has done active management of interest rate, foreign currency and liquidity risks. It currently enjoys the highest credit ratings of "AAA" and "LAAA" for our long-term domestic borrowings and "P1+" and "A1+" for our short-term borrowings from CRISIL.

Around 84% of the outstanding loan is towards generation and borrower-wise ~65% of it is to State sector. The company's outstanding loan sanctions stood at R1,70,000 crore as on December 31, 2010. This creates a good demand visibility for the Co. Going forward the existing shortage and persistent demand will keep the demand robust. Envisaged capacity addition for 12th plan is 100,000 MW with an expected investment of over Rs 11 trillion.

PFC is also contemplating banking license.

The retail investors are entitled for a 5% discount on issue price.

Recommendation

Invest ★★★★★

Issue Summary

Price Band (Rs)*	193	203
Bid Lot	28 shares	
Face Value	Rs.10	
Total no of shares to be raised	~22.93 crs	

Pre-issue share capital	Rs 1147.77crs	
Post-issue share capital	Rs 1319.93crs	
Issue Size	Rs 4425 crs	Rs 4645 crs
Post Issue Market Cap	Rs 2,54,747 crs	Rs 2,64,946 crs
P/E on FY11	9.7	10.2

Allotment Pattern

Net Issue	No. of Shares	%
QIB's	<= 114.6 crs	50%
Non Institutional	>=34.44 crs	15%
Retail	>= 80.25 crs	35%
Employees	n.a	n.a
Total	229.3 crs	100%

Objects of the Issue

As the Indian economy continues to grow, the country's power requirements are expected to grow substantially as well which will require significant investment and hence financing.

The primary reason for raising funds is to augment capital base to ensure compliance with requisite capital adequacy norms and to meet future capital requirements arising out of growth in business.

Book Running Lead Managers

- **DSP Merrill Lynch Limited**
- **Goldman Sachs (India) Securities Private Limited**
- **ICICI Securities Limited**
- **JM Financial Consultants Private Limited**

Investment Positives

- **Range of financial products and services** – PFC provides comprehensive range of financial products and related advisory services covering entire power related clients from generation, transmission and distribution projects as well as for related renovation and modernization projects. Power being one of the most important resources has resulted in cropping up of a number of initiatives like UMPP, APDRP etc in recent times which has increased the scope for PFC as well.

Developments towards streamlining of energy sector in India has not only benefitted the asset quality but also opened new avenues for PFC

- **Strategic role in GoI initiatives and established relationships** - PFC is involved in the development and implementation of various policies and reforms for the power sector in India which allows it to carry out strategic functions like acting as the nodal agency for the UMPP and the R-APDRP and as a bid process coordinator for the ITP scheme. This improves the expertise of the Co in the related field and helps project assessment.

Strategic involvement of PFC in power sector of the country keeps it updated and improves expertise. As such PFC has a very experienced Management.

- **Opportunities as an IFC** – An IFC status is meant to benefit the NBFC's like PFC which are in the business of financing long term infrastructure projects. For example, an IFC has ability to raise funds on a cost-competitive basis (ECB's and retail Infra bonds) and take higher debt exposure on individual and group level.
  As an NBFC, PFC is less regulated than banks and as an Govt-owned NBFC it has further relaxations till March 2012 after which PFC will have to submit a roadmap 2012, setting out the manner in which it intends to comply with prudential regulations of RBI.

- **Strong Financials** –
  i) PFC has grown its Net interest income at a CAGR of 27.1% over FY06-10 with profit growing at CAGR 22.6%.
  ii) The Co has been one the most efficient PSU's with a lean employee base of ~344 employees.
  iii) The defaults of the Co has been near zero percent despite the fact that around 22% of its loans are unsecured in nature, it has concentration with respect to borrowers and sector and has significant exposure to SEB's.
  iv) The return ratios have been strong with RoE of ~19%and RoA of ~3%.
  v) The net interest margin has been robust at ~4%.
  vi) The outstanding loan sanctions of Rs 1,70,000 crore as on December 31, 2010 creates a good demand visibility for the Co.

Healthy margins, decent return ratios and NPA of near zero % - Indicating healthy financial performance

Demand and business visibility is strong for PFC given the power and related investment requirement and ability of PFC to lend long term

Concerns

Though PFC as a Co is strong, the sector it lends to suffers from a number of inherent concerns, which in turn leads to concern for PFC as well. Some of the general concerns are like delays in the implementation of GoI policies and initiatives, delays in obtaining environmental clearances or land etc. Other major specific concerns are-

Power sector suffers from a number of inherent concerns like coal shortage, bulging accumulated losses of state electricity boards, delays in implementation etc

- **Coal shortage may hit power generation Cos** – With about 54% of power generated from coal-fired power plants in India, shortage of coal is one big threat. Based on projected shortages, 42000 MW of new capacity could be stranded due to this. Blending high-calorific imported coal has its own technical limitation while it is also costlier. At the same time allocation and linkages of coal blocks have been mired by controversies. All these may threat the loan repayment capacity of PFC's borrowers.
- **Weak financial position of public sector utilities -** Historically, public sector utilities have had a relatively weak financial position and have in the past defaulted on their indebtedness. As per reports, accumulated losses of state-owned distribution companies are approaching Rs2.5 trillion and is expanding by nearly Rs1 trillion a year, of which Rs40,000 crore was due to transmission and distribution (T&D) losses, and the rest because of tariff being lower than the cost of generation.
  As of December 31, 2010, state sector borrowers accounted for 65.3% of PFC's total outstanding loans.
  Apart form APRDRP and R-APDRP, Govt is contemplating a number of initiatives to revive the distribution sector like subsidy scheme, common rating mechanism, ensuring fixing of tariff by regulators, smart credit etc. The talks on privatising distribution Cos are however inhibited by concerns.
  On generation front also steps have been initiated for better fuel and equipment supply.
- **Concentration of Borrowers and loans –** 54% of the total outstanding loans as at end of December 2010 came from top 10 borrowers. Around 84% of the outstanding loan is towards generation sector and borrower-wise ~65% of it is to State sector.

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- **Interest Rate Risk –** Given the high interest rate scenario, on one hand the cost pressure will increase and on the other hand the increased interest burden on already reeling borrowers can have adverse implication.

Peers Comparison

9M11 (Rs in Cr)	PFC	REC
Loan Book	92,118	76,455
NIM %	4.09	4.52
RoE %	18.81	21.1
RoA %*	2.75	3.29
GNPA %	0.01	0.03
EPS (TTM)	22.75	25.22
Book Value	124.78	127.06
CMP	214	224
PBV x	1.71	1.76
PE x	9.4	8.8

* Based on 9M annualized profits

As REC has yet not come out with its results, to keep it comparable we have used 9 months results for comparison.

Financials

Profit and Loss Account (Rs in cr)

Particulars	FY07	FY08	FY09	FY10	FY11 (unaudited)
Interest Earned	3,818	5,012	6,551	8,061	10,128
Interest charges	2,335	3,144	4,433	4,912	6,492
NII	1,483	1,868	2,119	3,149	3,636
Other Income	21	22	22	21	32
Operating income	1,504	1,890	2,141	3,169	3,668
Expenditure	71	103	144	138	125
PBT	**1,433**	**1,787**	**1,997**	**3,031**	3,543
Provision for Tax	291	475	537	802	924
PAT	**1,142**	**1,312**	**1,460**	**2,229**	**2,619**
EPS (Pre Issue)	10.96	11.43	12.72	19.42	22.82
EPS (Post Issue)					19.84

Our View

PFC is a strong organisation with strong balance sheet. It has had a good and consistent financial performance with a very healthy asset quality. Though there are concerns that the Co may suffer from weakness of its borrowers, all being under Govt, gives us the comfort of likely support in any crisis. The power requirement in country is huge and the company has a good visible demand going forward. PFC is tapping opportunities at all levels in energy sector including renewable energy financing and equity participation in projects. The Co is nodal agency for many initiatives of Govt. All this apart from valuation makes us believe that it would a medium risk proposition to invest in PFC.

At price of Rs 203, the stock would be available at a P/BV of ~1.6 times the FY11P and 1.2 times FY12E. We believe that the issue would dilute the return on equity, but looking at the prospects it may take only little more than a year for the Co to regain the same.

An efficiently run Govt organisation, PFC is a good bet despite the concerns in the sector. Since all involved are from Government owned entities, we feel that there are little chances of major shocks.

We recommend a Subscribe with medium risk.

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Mutual Funds and all securities investments are subject to market risks and there is no assurance or guarantee that the Fund's objectives will be achieved. As with any investment in securities, the NAVs of the units issued under the schemes can go up or down depending upon the factors and forces affecting the securities market. Past performance of the sponsor/Mutual Fund does not guarantee the future performance of the schemes of the Mutual Fund. The names of the schemes do not in any manner indicate either the quality of the schemes, its future prospects or its returns. The NAV of the schemes may be affected by settlement periods and transfer procedures. Trading volumes may restrict the liquidity of the scheme's investments. Before investing, please read the Offer Document for details and risk factors.

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