Rural Electrification Corp. Ltd.

VENTURA

Kyon ki bhaiya, sabse bada rupaiya.

BUY

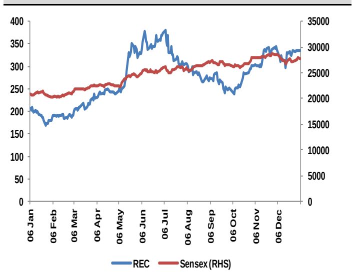
Target Price ₹ 683	CMP ₹ 315	FY17E Adj. P/BV 1.8x

Index Details	
Sensex	27,458
Nifty	8,285
BSE 100	8,371
Industry	NBFC

Scrip Details	
Mkt Cap (₹ cr)	31,124
BVPS (₹)	210.6
O/s Shares (cr)	98.8
Av Vol (Lacs)	1.4
52 Week H/L	383/167
Div Yield (%)	2.8
FVPS (₹)	10.0

Shareholding Pattern	
Shareholders	%
Promoters	65.6
DIIs	8.1
FIIs	19.9
Public	6.4
Total	100.0

REC vs. Sensex



The government is considering to divest 5% (of its 65.64% stake) by means of a follow on public offer (FPO). The recent softening of the market price of Rural Electrification Corporation Limited (REC) provides an attractive opportunity to not only buy the stock from the secondary market but also to participate in the FPO which is scheduled for the third week of January.

We initiate coverage with a BUY recommendation on Rural Electrification Corporation Limited with a target price of ₹683 (Adj. P/BV of 1.8x) on the FY17E Book value. Our target price implies an upside of 116% from the CMP over a period of 18 – 21 months. At the CMP of ₹315, it is trading at 1.3x FY15, 1.1x FY16 and 0.9x FY17 of its Adj. P/BV.

There is low market awareness of the fact that REC is among the top 25 leading financial institutions and compared to many of its peers has far superior fundamentals, strong balance sheet, leading position in the power sector with strong domain expertise and compelling valuations.

Compared to all the top 25 listed lending institutions REC

- **Ranks among the top in terms of ROE (baring HDFC Bank)**
- **Ranks No. 1 in terms of ROA**
- **Having enviably low NPLs**
- **Compelling valuations (being available at FY17 0.9x Adj. P/BV)**

Even in the mayhem of the financial meltdown the stress case 1 year forward Adj. P/BV was around 1.5x (with a mean Adj. P/BV of 2.5x since listing). Considering this, the current valuation of ~1.0x FY17 Adj. P/BV makes the stock a very attractive pick in the domain.

Rural Electrification Corporation Limited, India's leading NBFC which finances and promotes rural electrification projects, has demonstrated strong bottom line growth in the recent quarters supported by significant growth in the lending business. Given REC's excellent track record, stringent and well managed loan approval process coupled with a positive outlook for the power sector, we expect REC's growth momentum to accelerate over the coming years.

Key Financials (₹ in Cr)

Y/E Mar	Net Interest Income	Non Interest Income	PAT	EPS (₹)	Adj.BV (₹)	P/E (x)	P/Adj. BV (x)	ROA (%)	ROE (%)
2014	7178.0	216.3	4683.7	47.4	208.3	6.7	1.5	3.3	24.6
2015E	8093.9	280.0	5503.7	55.7	256.1	5.7	1.3	3.2	23.9
2016E	9889.2	345.0	6949.9	70.8	309.7	5.1	1.1	3.3	24.7
2017E	12708.2	410.0	8731.4	88.4	379.7	4.6	0.9	3.3	25.4

STOCK POINTER

Friday 9th January, 2015

The following factors drive our optimism on the company's prospects:

- **Loans are expected to grow at a robust three year CAGR of 23.3% to ₹2,54,729 crore in FY17E, on the back of significant reforms taking shape in the power sector. Further, the share of the high margin generation segment is expected to increase by 450 bps to 48.5% in FY17E, which should help bolster profitability further. We expect the asset quality to continue to remain best in class, however, as a prudent measure we have conservatively built in a 50-60 bps deterioration in NPLs for the period FY15–17E.**

- **Borrowings are expected to grow at a steady 17.7% CAGR to ₹2,05,694 crore in FY17E coupled with no significant rise in the cost of funds, given the favorable risk perception of its business among institutional investors and ability to borrow at lower costs than other marquee players, viz., PFC. Additionally, management is not averse to international borrowing to keep its cost low.**

- **On the back of the increasing share of the high margin private generation subdivision and strong funding requirements of the power sector (Rs.14 lac crore) at large, we expect a 3 year CAGR of 21% in NII to ₹12,708 crore by FY17E. NIMs are expected to remain comfortably above 5.2% over FY15E-17E from 5.1% in Q2FY15.**

- **As per Planning Commission data, the power sector will require funding of ₹14 lac crore during the XIIth Five Year Plan (2013-2017) and ₹10 lac crore during the XIIIth Five Year Plan (2018-2022). With a stable and pro reform oriented government at the centre the beleaguered fortunes of the power sector have started looking up.**

❖ Company Background

Rural Electrification Corporation Limited (REC), a NAVRATNA Central Public Sector Undertaking, was incorporated in 1969 and had an asset base of ₹1,52,853 crore as on 31.03.14. Its main objective is to finance and promote rural electrification projects all over the country. It provides financial assistance to State Electricity Boards, State Government Departments and Rural Electric Cooperatives.

Category of schemes financed by Rural Electrification Corporation Limited

Category	Objectives
Project Intensive Electrification	To cover intensive load development for providing connections to rural consumers in already electrified areas
Project Pumpsets	Aims at energisation of pumpsets
Project system Improvement	To strengthen and improve the transmission, sub transmission and distribution system in the designated area & also lines for power evacuation
Meters, Transformers, Conductors, Capacitors etc (Bulk loan)	For procurement and installation of meters, transformers and capacitors,etc
Short Term Loan	To provide finance to the Power Utilities and State Governments to meet their working capital requirement for different purposes, such as purchase of fuel for power plant, purchase of power, purchase of material and minor equipment, system and network maintenance including transformer repairs, etc
Debt Refinancing	The Scheme aims to facilitate reduction of the cost of borrowings of State Power Utilities/highly rated private power utilities by repaying their high cost term loans raised from other Banks/Financial Institutions for eligible projects/schemes
Financing Equipment Manufacturers	To provide Short term Loan/Medium term loan to the manufacturers of Power/Electrical material for power project
RE Cooperatives	Development of rural electric cooperative societies
Generation	To provide term loan to State/ Central Sector/ Private Sector Companies for Generation projects covering all types of schemes/categories irrespective of nature, size and source of generation

Source: REC, Ventura Research

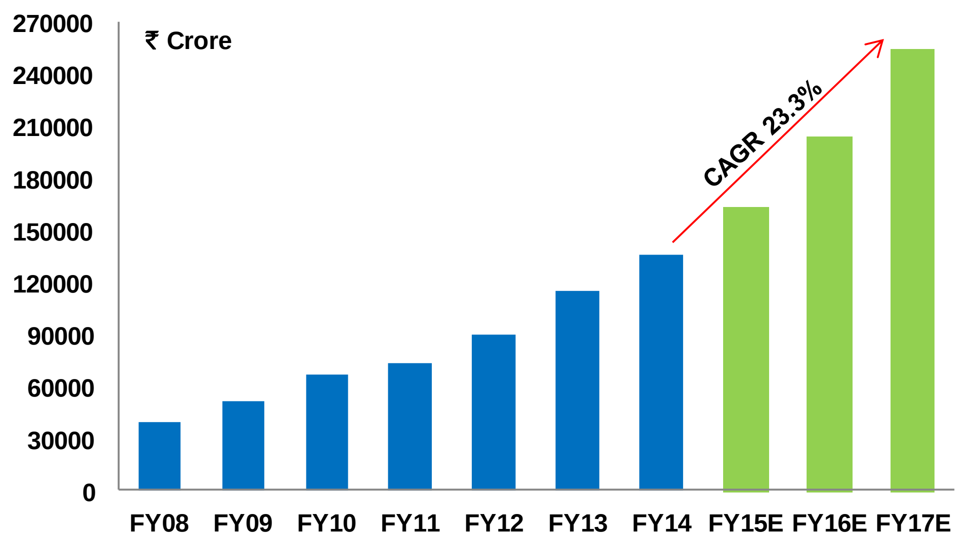
➢ Key Investment Highlights

❖ Strong demand potential will lead to robust growth in Advances

As per Planning Commission data, the power sector will require funding of ₹14 lac crore during the XIIth Five Year Plan (2013-2017) and ₹10 lac crore during the XIIIth Five Year Plan (2018-2022). With a stable and pro reform oriented government at the centre the beleaguered fortunes of the power sector have started looking up. The Government aims to improve the entire power supply chain of Generation – Transmission – Distribution. This will require substantial infrastructure development to meet the burgeoning demand of the power strapped country.

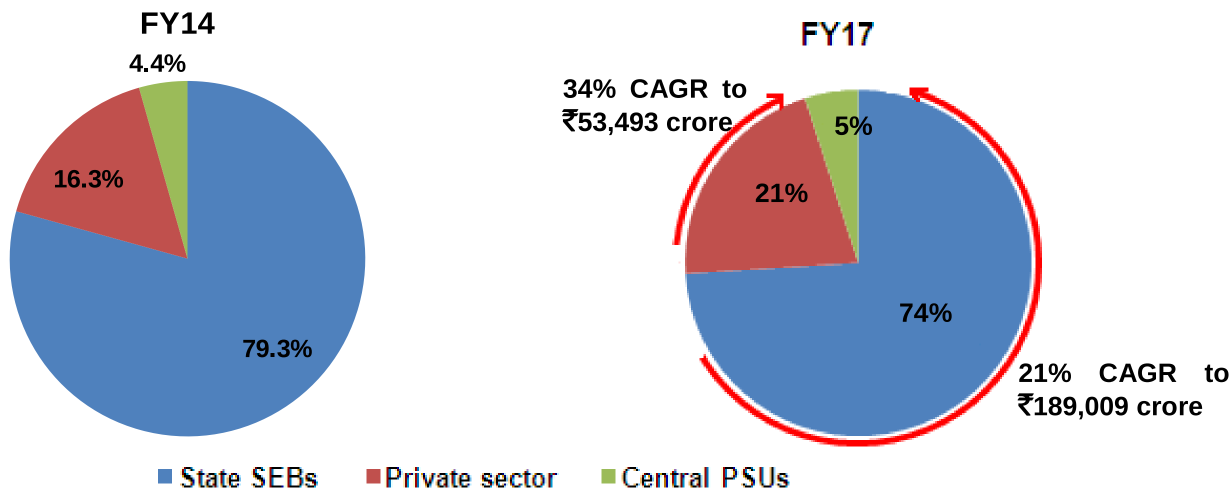
REC being a leading player in this space and with its meager asset size of a mere ₹1.5 lac crore (in FY14) is best placed to benefit from this gargantuan opportunity. We believe that the lending business in this sector will grow at a CAGR of 23.3% till FY17E to ₹2,54,729 crore (₹1,35,855 crore in FY14, grew at 19.5% CAGR between FY10-14).

Advances to grow at CAGR of 23.3%



Source: REC, Ventura Research

Private Sector contribution to improve over the coming years

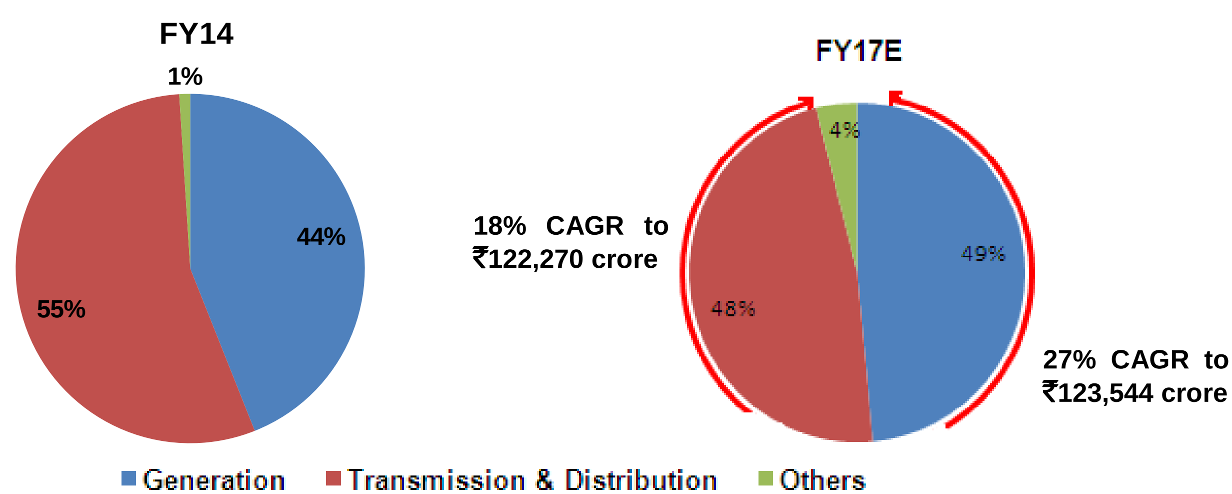


Source: REC, Ventura Research

Portfolio well balanced between Power generation and T&D Assets

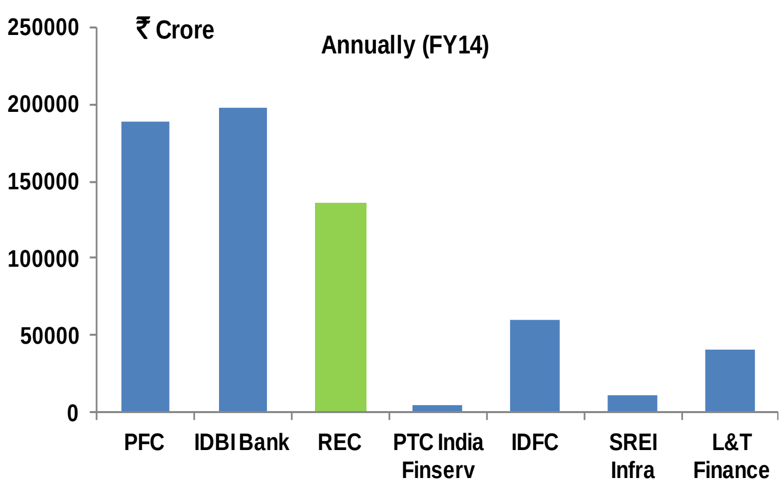
REC has a balanced portfolio properly divided among Generation, T&D and Short Term Loans where as PFC is more focused on the Generation segment. REC provides funding for projects for significantly longer periods (up to 12 years) unlike banks (only up to 7 years) and hence this provides REC with an edge banks when it comes to attracting business. Further the recent RBI approval for lending upto 25 years stands the company in good stead.

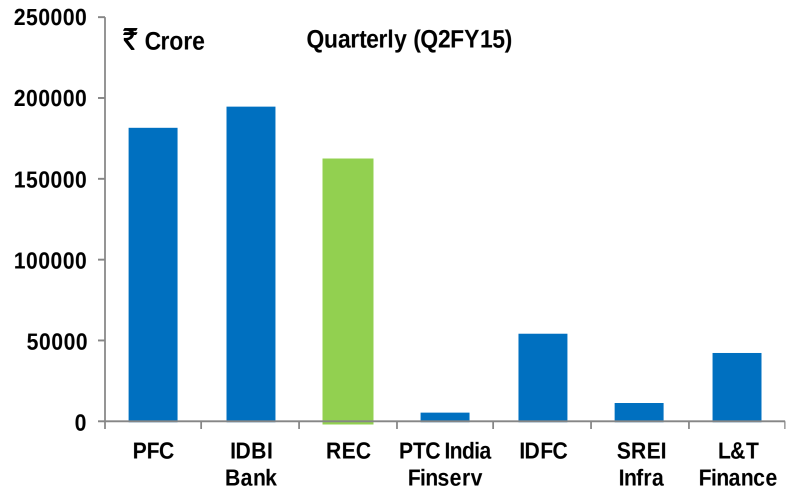
Portfolio well balanced between Power Generation and T&D Assets



Source: REC, Ventura Research

REC is a leading player among infra financing companies





Source: REC, Ventura Research

❖ Positive outlook for power sector to aid REC's growth

A slew of reforms undertaken by the government are expected to improve the beleaguered outlook of the power sector. We are optimistic of the positive impact of below mentioned recent reforms. REC by virtue of its domain expertise and leading position in the power sector is best placed to benefit from them.

Snapshot of power sector reforms

Description	Comments
Power sector to be the biggest beneficary of the impending Coal block auction	The aggregate reserve of 63 blocks earmaked for power sector is slated to be around 4.4bn tonnes and 126.8MT pa of EC capacity is good enough to meet the needs of power plants of up to ~32GW
Financial restructuring of Discoms to improve the outlook on their financial viability	We believe this restructuring scheme will improve state DISCOMS ability to secure long- term & short-term funding and kick start capacity addition plans for future industrial growth.
Feeder separation scheme to help boost operational efficiencies and check revenue leakages	We believe this will lead to increase in SEB's revenues, put a check on power theft & increase appropriate utilization of power.
Major Focus on Reduction in AT&C Losses	AT&C losses to be contented through use of GIS and smart grids which will lead to growth in distribution leg of G-T-D cycle.
Significant expansion of transmission systems on the cards	The MOP is expected to add 130,000 circuit km in the 13th FYP which would involve installation of high-voltage 765 kV transmission system and the use of advanced technology products.

Source: REC, Ventura Research

- **Power sector to be the biggest beneficiary of the impending Coal block auction:**
  The Coal ministry has earmarked 101 mines for bidding/allocations v/s 74 mines earlier specified in the coal ordinance. Of the 101 mines earmarked, 63 are for power sector (35 allocated to government companies and 28 will auctioned to the private sector). Cumulatively the aggregate reserve of these 63 blocks is slated to be around 4.4bn tonnes and 126.8MT per annum of EC capacity is good enough to meet the needs of power plants of up to ~32GW.

State wise mapping of coal blocks for allocation and auctions

State	Allocation			Auction				Grand Total
	Power	Steel	Total	Regulated Sector	Power	Steel	Total	
Arunachal Pradesh	-	-	**-**	1	-	-	**1**	**1**
Jharkhand	6	1	**7**	7	7	3	**17**	**24**
Madhya Pradesh	-	-	**-**	7	3	-	**10**	**10**
Maharashtra	6	-	**6**	8	0	-	**8**	**14**
West Bengal	7	-	**7**	2	3	-	**5**	**12**
Chhattisgarh	6	-	**6**	8	7	-	**15**	**21**
Telangana	1	-	**1**	-	-	-	**-**	**1**
Odisha	9	-	**9**	1	8	-	**9**	**18**
Grand Total	**35**	**1**	**36**	**34**	**28**	**3**	**65**	**101**

Source: Ministry of Coal, Ventura Research

- **Financial restructuring of Discoms to improve the outlook on their financial viability**

  Over the years, lack of fiscal and operational discipline, coupled with poor policy implementation has resulted in Power Discoms suffering massive losses (accumulated loss till FY 13 was ₹2,40,000 crore). This has stymied the ability of SEBs to raise debt (both long- term as well as short-term) and destabilized their power capacity addition plans. The result of this has been crippling power cuts in several states impacting industrial output.

  To resolve this issue, the Cabinet Committee of Economic Affairs (CCEA) recently approved a scheme to restructure the accumulated losses of SEB Discoms. The salient features are enumerated below.

  1. 50% of the outstanding short-term liabilities up to 31 Mar’12 would be taken over by state governments and then converted into bonds to be issued by Discoms, duly backed by state government guarantees.
  2. This liability will be gradually taken over by the respective state governments from Discoms over the next 2-5 years by way of special securities.
  3. The balance 50% of short-term liabilities will be restructured by rescheduling loans and provide a moratorium of 3 years on the principal.

We believe this restructuring scheme will improve state DISCOMS ability to secure long-term & short-term funding and kick start capacity addition plans for future industrial growth.

4. The financial restructuring of liabilities is to be accompanied by concrete action by the Discoms and state authorities in the form of adequate tariff hikes, reduction in T&D losses and pass-through of fuel costs, thereby contributing to gradual improvement in the financial health of SEBs.

5. This turnaround plan will be monitored by two committees at the state and central levels, respectively.

6. The central government will provide incentives by way of grants equivalent to the additional energy saved by way of accelerated AT&C loss reduction beyond the loss trajectory specified under RAPDRP.

7. The central government will also provide capital reimbursement support of 25% of principal repayment by the state governments on the liability taken over by them under the scheme.

- **Feeder separation scheme to help boost operational efficiencies and check revenue leakages**

  The Government of India has allocated ₹43,000 crore for the **Deendayal Upadhyaya Gram Jyoti Yojana (DUGJY)** for feeder separation. The national feeder separation scheme will separate the agricultural load from the non-agricultural load in rural areas through dedicated feeders for agricultural consumers and non-agricultural consumers. Several states offer agricultural consumers power at subsidized tariffs, which is misused by non-agricultural users, leading to lower revenues for the State Electricity Boards (SEBs). In addition, this scheme will enable the SEB to flatten the load curve by shifting the agricultural load to off-peak hours. Thus, the scheme will reduce the technical and commercial losses and reduce unbilled revenues.

  REC being the nodal agency for implementation will be compensated at 0.5% of total cost of works and hence should earn fee based income of ₹211 crore by over the life span of the projects.

We believe this will lead to an increase in SEB's revenues, put a check on power theft & increase appropriate utilization of power.

Target set by the Government under the DUGJY scheme

Scheme addition details	Target	Investments ₹ Crore
Number of feeders to be separated / laid	16500 nos	24750
New Sub-stations	1620 nos	4050
Augmentation of existing sub-stations	1615 nos	
33 or 66 KV lines	21900 kms	1520
Installation of Distribution Transformers	2 lakhs	5350
Installation of meters at consumer end /distribution transformers / feeders	11910800	6450
	Total	**42120**
Other Cost (NOFN & PMC)		491
Creation of Rural Electrification Data Hub at REC		**10**
Fee of Nodal Agency - REC Fees 0.50% of TCW		**211**
Provision for MoP for enabling activities - 0.50% of TCW		211
	Grand Total	**43043**

Source: Ministry of Power, Ventura Research

AT&C losses to be contented through use of GIS and smart grids which will lead to growth in the distribution leg of the G-T-D cycle.

- **Major Focus on Reduction in AT&C Losses:** The key focus area of the government is to reduce AT&C losses, which accounts for 98% of the power industry loss. As a result, the investments are expected to increase in higher technology products such as gas-insulated sub-stations (GIS) and smart grids to be the key drivers of growth in distribution.

  We believe funding for smart grids would not be a constraint, as these projects are mostly sponsored by Central schemes such as **R-APDRP.** The total investment outlay for smart grids in the 13th Five-year Plan is ₹9,500 crore.

- **Significant expansion of transmission systems on the cards**

  The Ministry of Power (MoP) is expected to add 130,000 circuit km in the 13th Five-year Plan for which the estimated outlay is ~ ₹2,00,000 crore. This would involve installation of high-voltage 765 kV transmission system and the use of advanced technology products such as gas insulated substations and smart grids. (The approximate cost of a 765kV transmission system/km is ₹1.5- 2 crore v/s ₹1.1 crore for a 400kV transmission system).

Expected Transmission Capital Expenditure during 12th & 13th Five Year Plan

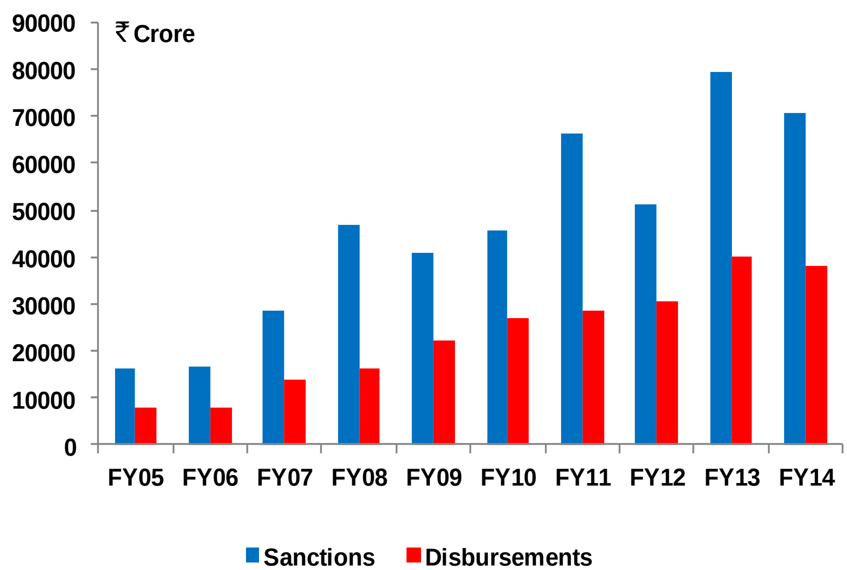
Description	11th Plan FY07 - 12	12th Plan FY12 - 17E	13th Plan FY17 - 23E
Planned power capacity addition (GW)	53	88	119
Renewable Energy addition (GW)	25	28	31
Transmission line addition (circuit km)	60184	107440	130000
Ending transmission line (circuit km)	257481	364921	494921
Fund requirement ₹ crore)	1400	2000	2400

Source: Ministry of Power, Ventura Research

❖ Project approvals & sanctions expected to pick up

The amount of sanctions has growth at very steady pace, clocking at a CAGR of 11.7% over FY10-14 (25.7% over FY05-09) mainly due to structural problems in the power sector. However, disbursement as a percentage of sanctions has been, on an average, within the range of 48% to 52%. The company has, on an average, sanctioned 863 projects each year since FY05.

Barring for last couple of years, S&D has grown at a steady rate



Source: REC, Ventura Research

Proactive and dynamic disbursement policies have helped check fiscal profligacy

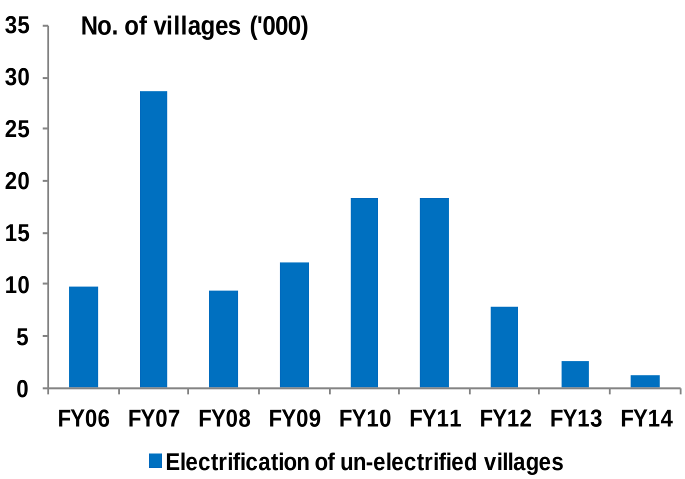
The company has implemented a standard set of rules for disbursement processes which is indeed quite strict and policy driven. They follow more of a reimbursement process than of disbursement where in they monitor the client progress closely and then reimburse their expenses based on actual. It has in place a strong process of scheme formulation, implementation, monitoring and supervision.

REC has been able to meet targets while serving as Nodal Agency

The Rajiv Gandhi Grameen Vidyutikaran Yojana (RGGVY) which was launched by the Government of India in April 2005 aimed to establish

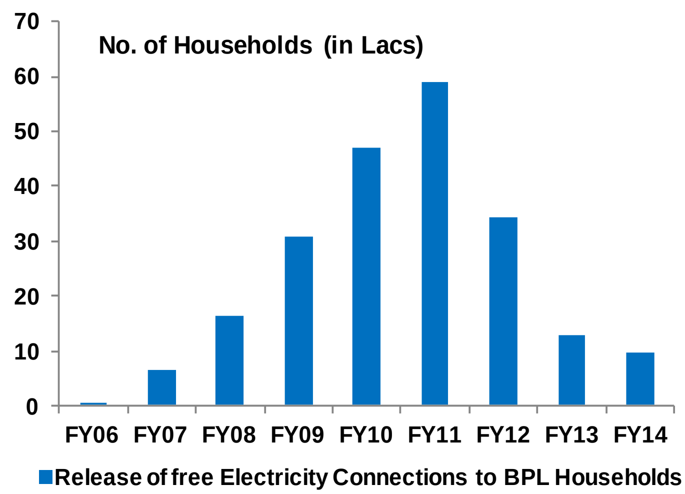
- Rural Electricity Distribution Backbone (REDB) with at least a 33/11 KV sub-station in the blocks where it does not exist;
- Village Electrification Infrastructure (VEI) with at least one Distribution transformer in a village or hamlet; and
- Stand alone grids with generation where grid supply is not feasible. Subsidy towards capital expenditure to the tune of 90% is canalized through REC, which is a nodal agency for implementation of the scheme. Electrification of un-electrified Below Poverty Line (BPL) households is financed with 100% capital subsidy.

No. of villages electrified under RGGVY



Source: REC, Research

No. of households covered over the years



Source: REC, Ventura Research

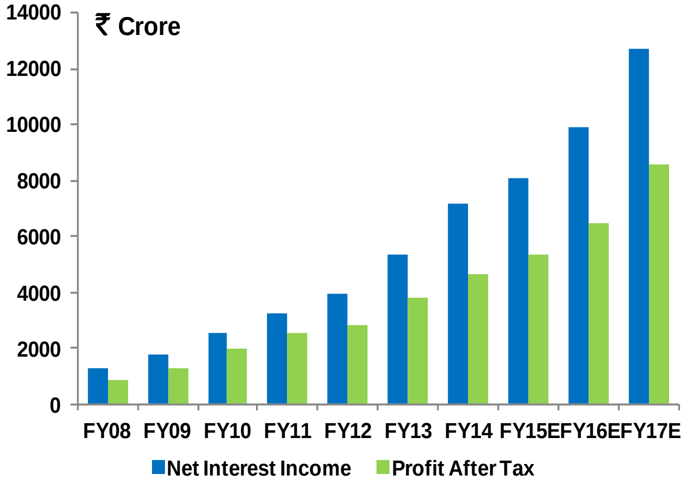
However, moving forward the management believes that the number of villages covered will come down as almost all the villages are covered and those which are left are located at un-reachable places.

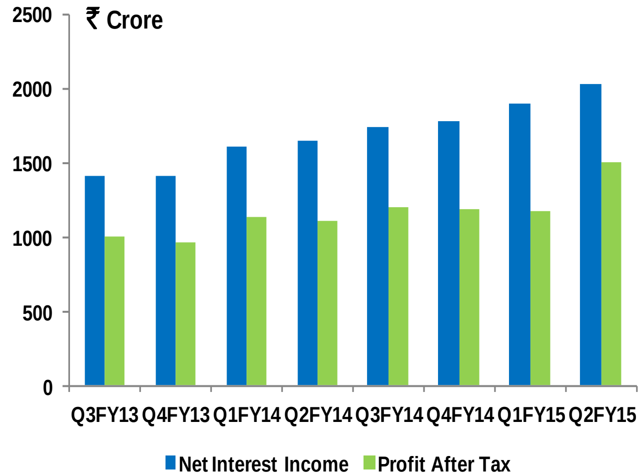
❖ Inherent strengths to power robust growth in profitability

REC enjoys competitive advantages over its peers due to flexibility to lend and borrow for longer tenure along with access to low cost tax exempt bonds (@ 6%). Its AAA-rating enables it to raise funds at extremely competitive rates, in both domestic and international markets. This has helped REC to maintain healthy spreads (300-400 bps).

All the above attributes helped its NII grow at a CAGR of 23% to ₹7,178 crore in FY14 (₹2,535 crore in FY10) and we expect the growth rate to be maintained, albeit at a slightly lower pace (CAGR of 21%). We forecast NII to grow to ₹12,708 crore by FY17E against the backdrop of its strong market position and increasing share of the high margin private sector generation subdivision.

NII expected to grow at a CAGR of 21% over FY15E – 17E





Source: REC, Ventura Research

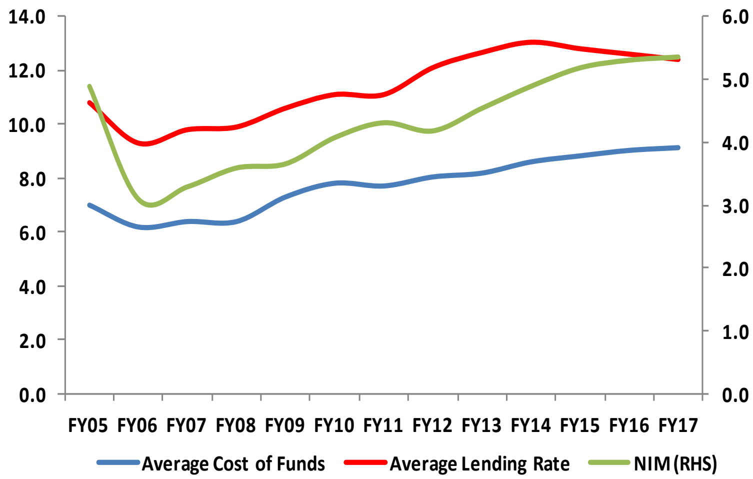
Cost to income ratio to increase marginally

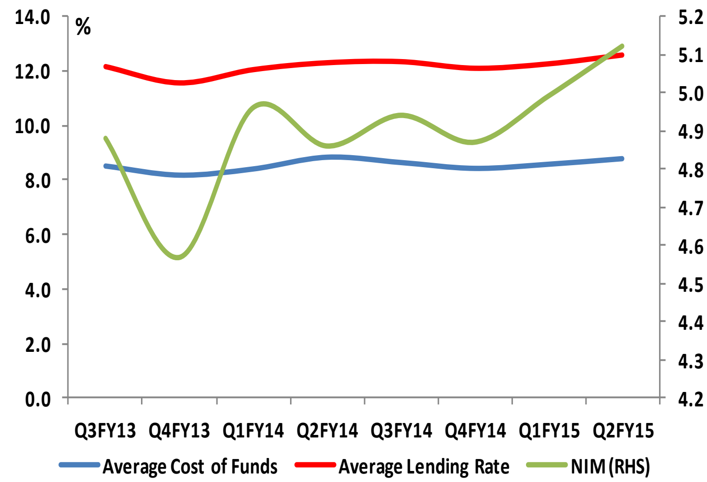
We expect the cost to income ratio to grow from 2.7% in FY14 to 4.9% by FY17E as the business expands and the price to acquire things rises. Factoring in a once in three year increase in the salary component of employee costs; we believe the ratio will move up to 4.9% by FY17E.

NIM to sustain well above 5%

REC has steadily expanded its NIM to 4.9% in FY14 from 4.1% clocked in FY10 supported by efficient management of the cost of funds (8-9% over the past five years) and healthy spreads (+ 300 - 400 bps). Moving forward we expect the NIM expansion to continue and to reach 5.4% by FY17E as the contribution from the high margin private sector lending business expands and it continue to have access to low cost funds.

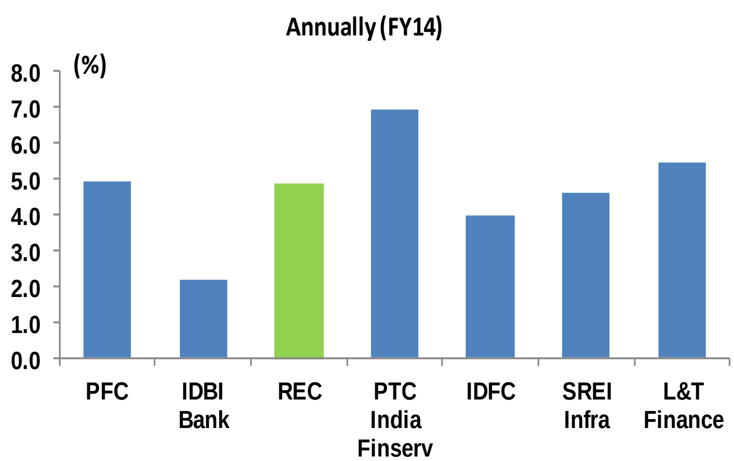
Yield enhancement to fuel NIM expansion

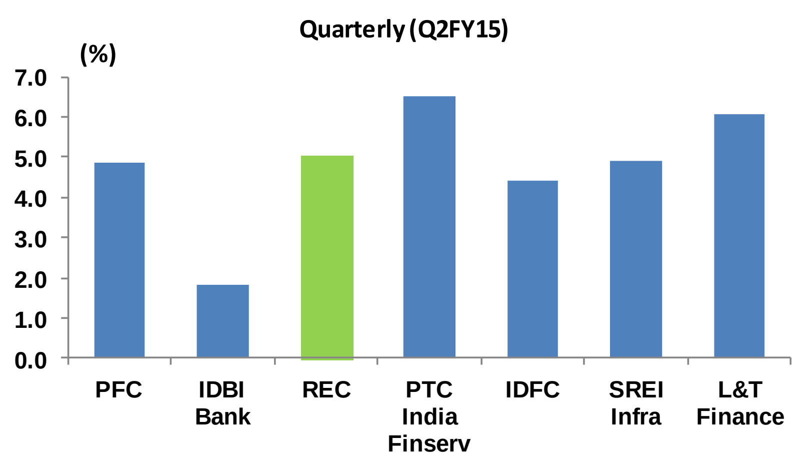




Source: REC, Ventura Research

REC NIM is well above the industry average





Source: REC, Ventura Research

❖ Superior Asset Quality is the mainstay of its business model

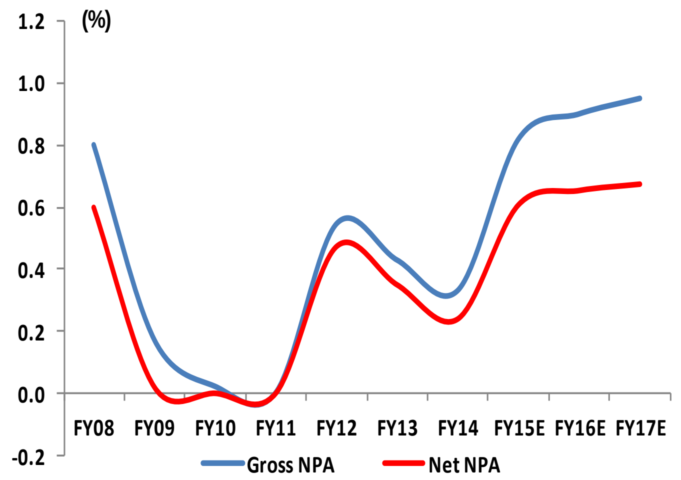
Despite the challenging scenario, over the years REC has been able to maintain a superior asset quality backed by tight internal control policies and constant monitoring of individual companies even after disbursement of loans. As of FY14 its GNPL ad NNPL levels were maintained at an abysmal 0.36% and 0.26% levels respectively.

However in H1FY15 there was a slight deterioration in asset quality as two new NPLs were booked (both belonging to the private sector). Its pertinent to note that all of its 4 NPL accounts are from the private sector only and the public sector portfolio continues to remain spotless.

Given the fact that the contribution from the private sector and generation projects is expected to increase we have modeled slightly higher GNPL (0.82% to 0.95%) and NNPL (0.61% to 0.68%) levels.

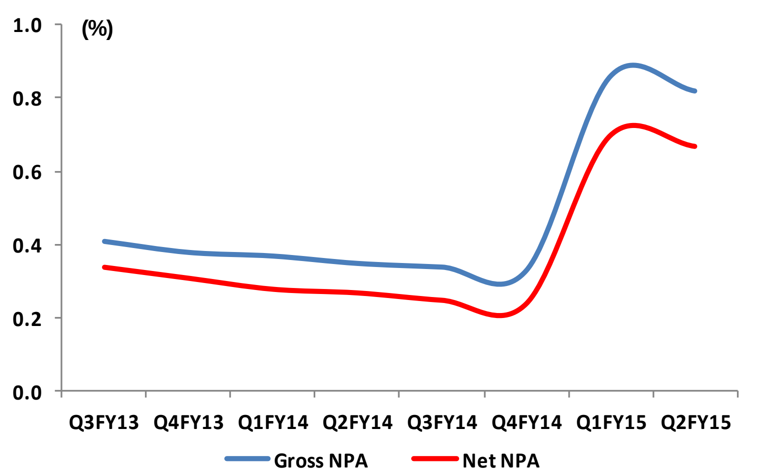
Restructured loan book currently stands at ~ 5K-6k which requires a provision of 180 crore, considering the size of the loan book it is very minimal. By virtue of relaxed asset classification and provisioning norms compared with banks (GNPA recognition at 180 days past due), REC has low credit costs. Based on RBI's announcements on specific provisions Order No. **RBI/2010-11/370**, REC has been making standard asset provisions at 0.25% on incremental loans and 0.083%/year on the outstanding stock as of FY12 since 3QFY14.

Conservatively built in 50-60 bps over FY15E-17E



Source: REC, Ventura Research

Two new NPAs identified in recent quarters



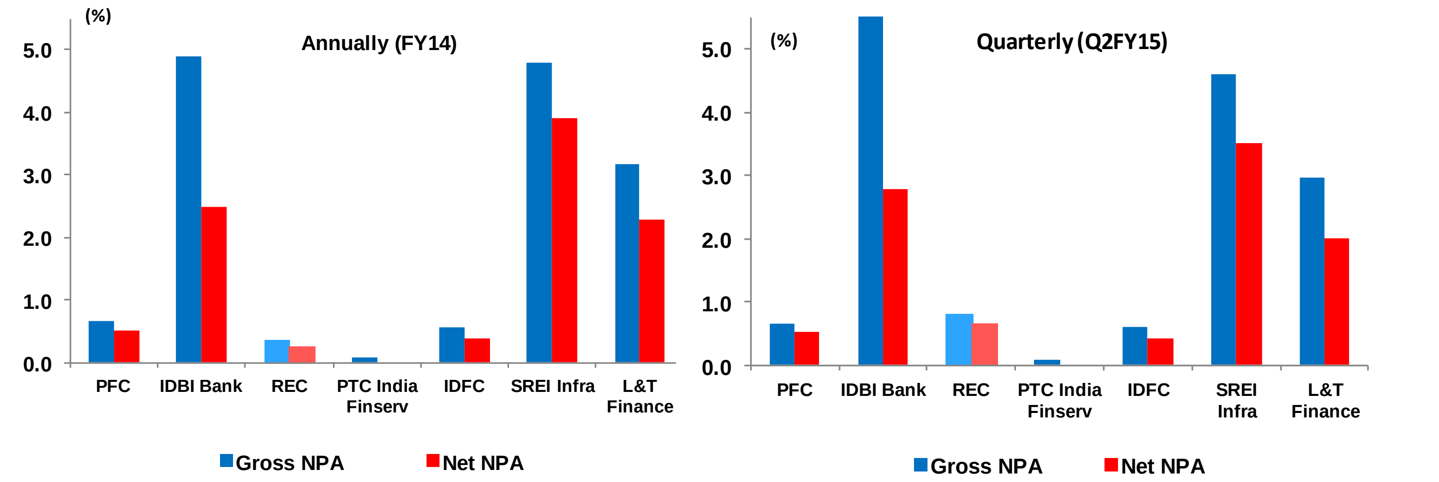
Source: REC, Ventura Research

List of NPAs in Private Sector

Company	Amount of Gross NPA	Cummulative Provision each year			
		FY12	FY13	FY14	Q2FY15
Shree Maheshwar Hydel Power Corporation Limited & Konaseema Gas Power Limited	470	46	71	119	140
Corporate Power Ltd	812				82
Jas Infrastructure Capital Pvt	33				3
Old NPAs	20	18	18	18	18
Total	**1335**				**243**

Source: REC, Ventura Research

Superior asset quality among peers



Source: REC, Ventura Research

❖ Well diversified borrowings to support pace of loan growth

With continuous access to low cost tax exempt bonds and favorable foreign currency borrowing available at its disposal, we expect the borrowings to grow at a CAGR of 18% over FY15E-17E to ₹2,05,694 crore (₹1,26,242 crore in FY14). In the past, the share of term loans from banks (-12%) and funding from financial institutions (-8%) has gone down between FY08 to FY14 in favour of foreign currency borrowings (+11%) and bonds & debentures (+11%). Moving forward we expect this trend to continue as there is ample liquidity in cheaper foreign funds and a good appetite for longer duration borrowing.

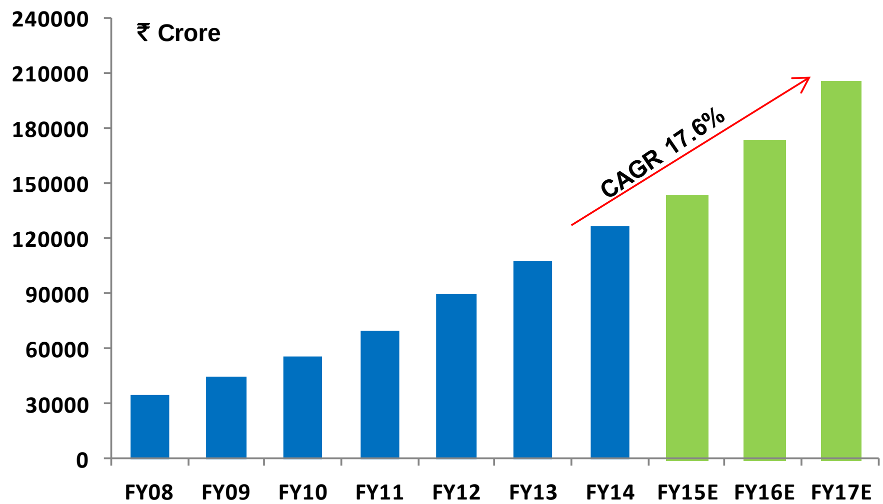
Prudent currency risk management has helped REC buck FX losses

REC hedges ~85% of its foreign currency borrowings and the balance is left uncovered in order to gain from market movements. Hence, it does not carry a high exchange rate risk. Further, its earnings received a boost from the recent AS-11 guidelines that allow REC to amortize mark-to-market losses on unhedged foreign currency exposures over the residual maturity of the exposure.

REC is bettered placed than banks to fund the power sector; as

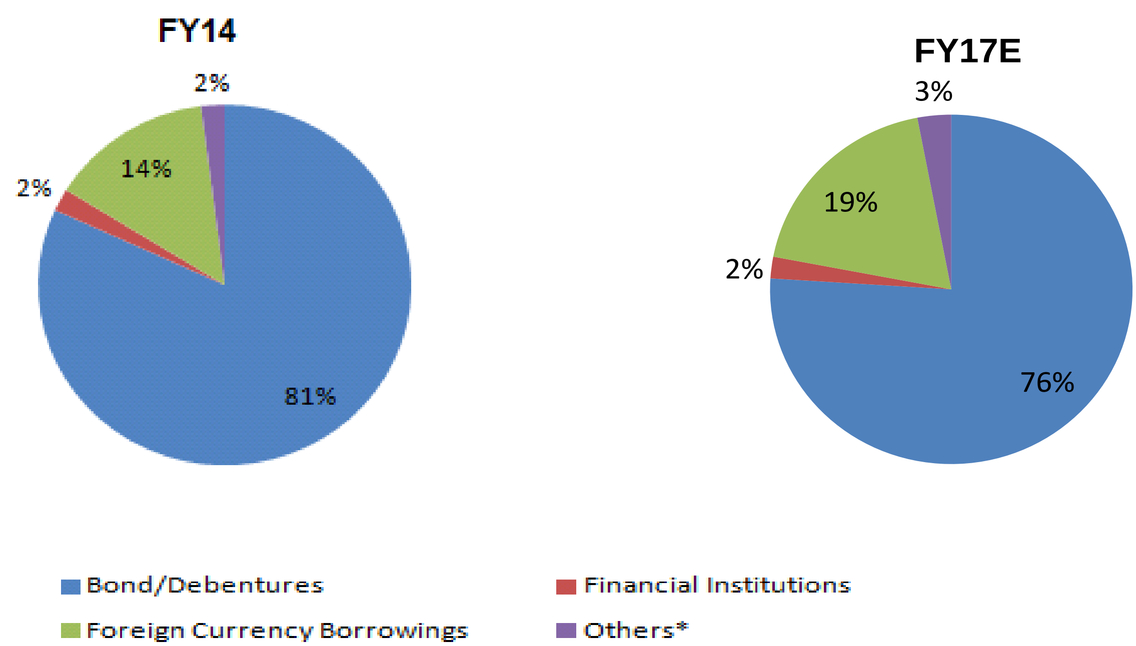
(i) It can lend for longer duration (for 12-14 years vis a vis 7-8 years), which is the requirement of the power sector,
(ii) relaxed RBI provisioning norms &
(iii) better ALM.

Borrowings to support robust loan growth



Source: REC, Ventura Research

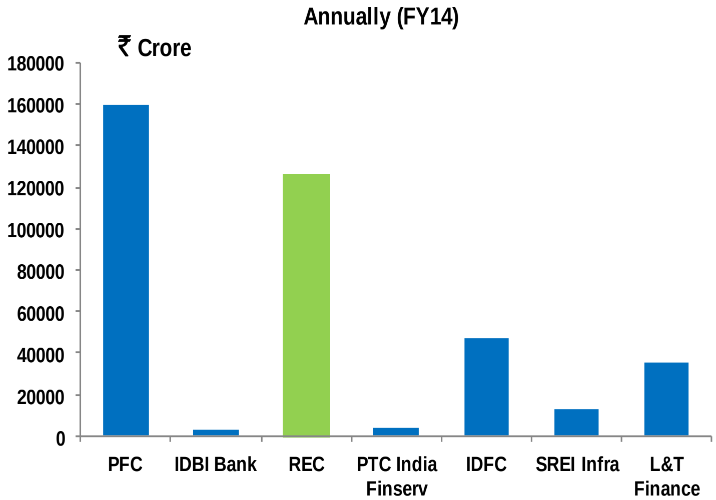
Funding mix – REC can borrow at the most competitive rates across tenors and funding sources

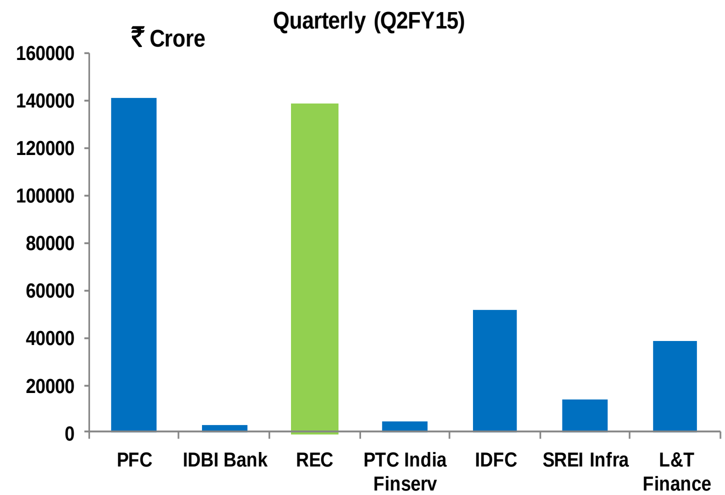


* It includes term loans from bank, commercial paper, short term loans, borrowings from GOI, etc.

Source: REC, Ventura Research

High borrowings among peers to sustain business growth



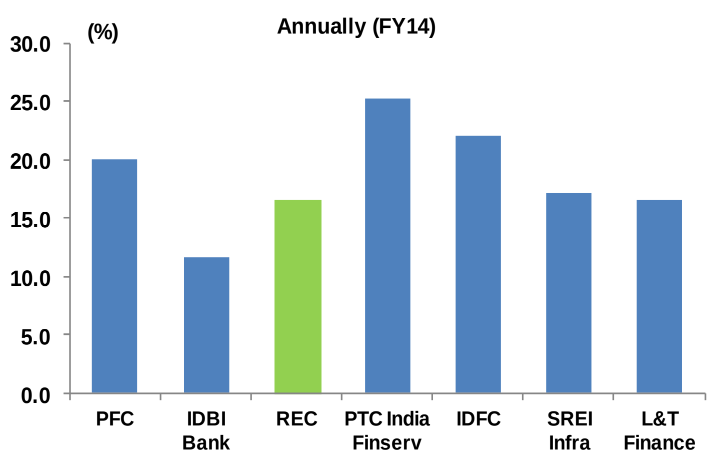


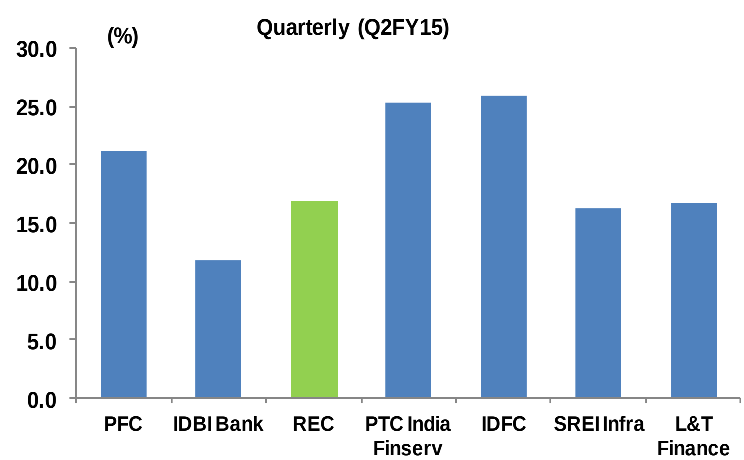
Source: REC, Ventura Research

❖ Superior ratios to persist; ROA to sustain at the level of 3.3%

Though capital adequacy norms are relaxed for NBFCs (vis a vis banks), the CAR is healthy and superior to its peers. We believe current level of CAR is comfortable for robust business growth. Return on average equity is expected to improve slightly by 90 bps to 25.5% by FY17E as the PAT is expected to register a CAGR growth of 22.4% over FY15E-17E as power sector reforms kick in. In terms of ROE, we expect it to sustain the levels of 3.3% over FY15E-17E with proportionate increase in asset base and returns.

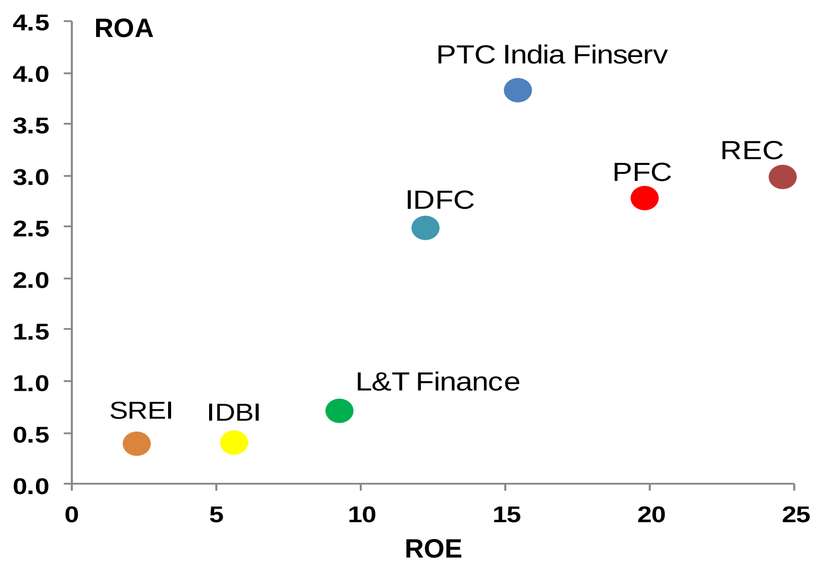
CAR in line with the industry average





Source: REC, Ventura Research

ROE v/s ROA



Source: REC, Ventura Research

❖ Financial Performance

- **Modest loan growth, disbursements pick up:** In 2QFY15, the REC loan book grew 17.3% YoY (4.6% QoQ) to ₹1,62,400 crore, driven by the transmission (up by 20.3%) and generation (up by 18.5%) segments. The share of short-term credit declined to less than 1% of the overall credit portfolio, against 2.7% last year. Lending to private sector continues to increase (+410bps YoY to 17.4%). Disbursements during the quarter moved up 21% YoY, the fastest in the last five quarters. During the quarter, REC borrowed funds worth ₹6,850 crore at an average annualized cost of 7.9%. Foreign borrowings stood at ₹1,500 crore; borrowings through bonds were ₹2,800 crore. Outstanding borrowings stood at ₹1,30,700 crore. Foreign borrowing at ₹19100 crore form 14.6% of total borrowings. Outstanding bond borrowings stood at ₹103,700 crore and bank borrowings stood at ₹3,870 crore.

- **Higher NIM drives strong NII growth:** The reported NIM, at 5.1%, increased 26bps YoY (+12bps QoQ), the yield on assets increased 28bps YoY. A dynamic borrowing mix could help sustain the NIM at above 5% of NIM over FY15E-17E. The NII grew 7.2% QoQ (23.3% YoY) to ₹2.032 crore mainly driven by interest income growth. (+7.27% QoQ, +19.65% YoY).

- **Asset quality stable, credit costs to be higher than in the past:** No further delinquencies were seen in the quarter. REC's restructured book stands at ~1.9% of advances. While the outlook for the power sector has improved, we have built in a greater provision of 30bps over FY15E-17E to factor in the higher private-sector exposure.

Quarterly Financial Performance

Particulars	Q2FY15	Q2FY14	FY14	FY13
NII (Net Interest Income)	**2,032**	**1,648**	**7,178**	**5,382**
Non Interest Income	80	57	216	211
Total Income	**2,112**	**1,705**	**7,394**	**5,592**
Total Operating Expenses	76	85	205	201
Pre Provision Opt. Profit	**2,036**	**1,620**	**7,189**	**5,392**
Provisions	160	164	658	228
Profit Before Tax	**1,876**	**1,455**	**6,531**	**5,164**
Tax	535	509	1,847	1,346
Profit After Tax	**1,341**	**946**	**4,684**	**3,818**
Business Parameters				
Advances	1,49,177	1,26,363	1,35,855	1,14,529
Borrowings	1,29,056	1,08,791	1,12,702	93,440
Sanction	11,950	18,320	70,740	79,528
Disbursement	9,996	8,264	35,546	39,275
S/D Ratio (%)	83.65	45.11	50.25	49.39
Profit & Loss Ratio				
NIM (%)	5.12	4.86	4.90	4.55
Yield on Loans (%)	12.56	12.28	12.18	11.62
Cost of Funds (%)	8.76	8.81	8.58	8.17
RoNW (%)	26.36	24.00	24.57	23.85
RoAA (%)	2.70	3.10	3.00	3.20
Asset Quality				
Gross NPA (%)	0.82	0.35	0.33	0.38
Net NPA (%)	0.67	0.27	0.24	0.31
GNPA/Networth (%)	0.01	0.01	0.01	0.01

Source: REC, Ventura Research

❖ Financial Outlook

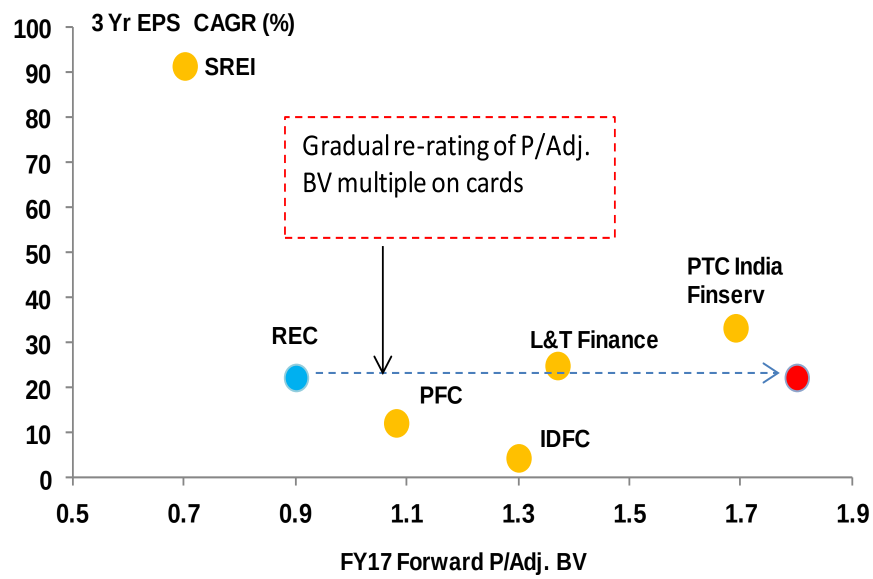
We expect NII to grow at a CAGR of ~21% over FY15E-17E to ₹12,708 crore with NIM improving to 5.4% (+50bps by FY17E). The PAT is expected to grow at ~20.6% CAGR over FY15E-17E to ₹8,210 crore. On the balance sheet front, loans are expected to grow at a CAGR of 23.3% to ₹2,54,729 crore by FY17E, while borrowings are likely to grow at a CAGR of 17.7% to ₹2,05,694 crore over the same period.

❖ Valuation

We initiate coverage with BUY recommendation on Rural Electrification Corporation Limited with a target price of ₹683 (Adj. P/BV of 1.8x) on the FY17E Book value. Our target price implies an upside of 116% from the CMP over 18 – 21 months. At the CMP of ₹315, it is trading at 1.3x FY15, 1.1x FY16 and 0.9x FY17 of its Adj. P/BV.

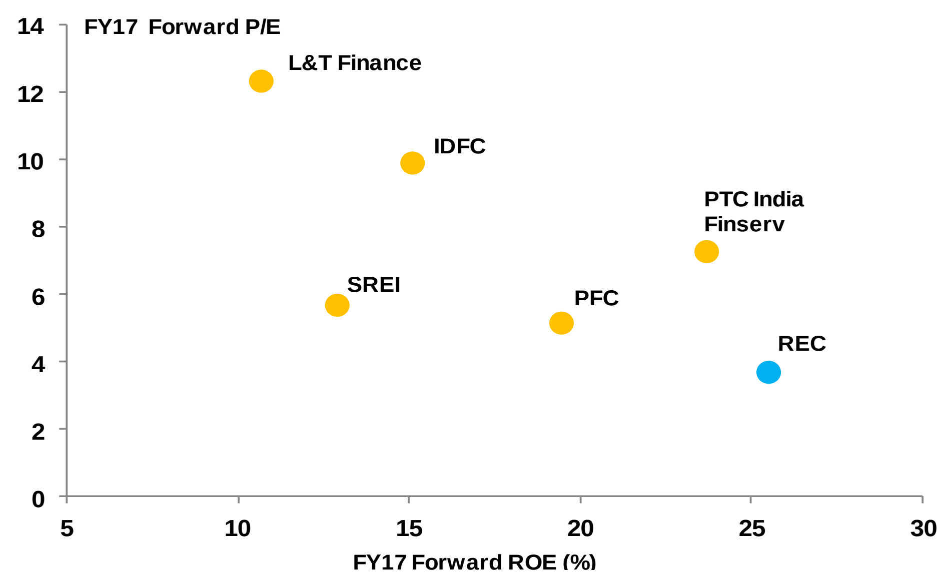
On the valuation parameters, REC is a far more compelling investment opportunity than its peers. Its P/Adj. BV is expected to reach till 1.8x levels in three years from current level of 0.9x.

ROE v/s ROA



Source: REC, Ventura Research

ROE v/s ROA



Source: REC, Ventura Research

There is low market awareness of the fact that REC is among the top 25 leading Financial Institutions and compared to many of its peers has far superior fundamentals, strong balance sheet, leading position in the power sector with strong domain expertise and compelling valuations.

Compared to all the top 25 lending institutions REC

- Ranks among the top in terms of ROE (baring HDFC Bank)
- Ranks No. 1 in terms of ROA
- Having enviably low NPLs
- Compelling valuations (being available at FY17 0.9x Adj. P/BV)
-

Even in the mayhem of the financial meltdown the stress case 1 year forward Adj. P/BV was around 1.5x (with a mean Adj. P/BV of 2.5x since listing).

Peers Comparison (₹ Crore)

Y/E March	NII	OP	PAT	BV/ Share	RoE (%)	RoA (%)	P/E	P/ Adj. BV
PFC								
FY 2014	8750	7712	5417	207.4	19.8	2.8	7.3	1.4
FY 2015E	9658	8916	6078	239.0	20.5	2.9	6.5	1.3
FY 2016E	10753	10294	6892	277.3	20.0	2.8	5.8	1.1
IDFC								
FY 2014	2585	2431	1701	97.0	12.2	2.5	14.0	1.6
FY 2015E	2736	3003	1832	104.5	11.3	2.5	13.3	1.5
FY 2016E	2821	3059	2027	111.5	10.8	2.4	12.5	1.4
PTC India								
FY 2014	315	299	207	24.0	15.4	3.8	16.9	2.6
FY 2015E	439	413	249	26.7	17.7	3.8	13.0	2.3
FY 2016E	601	564	346	30.9	20.0	3.5	9.8	2.0
IDBI Bank								
FY 2014	6049	1743	1121	147.4	5.6	0.4	8.9	0.5
FY 2015E	5778	1553	1220	138.7	5.3	0.4	0.5	0.5
FY 2016E	6405	2130	1674	145.8	7.0	0.4	2.0	0.5
SREI Infra								
FY 2014	137	121	58	48.6	2.2	0.4	19.9	1.0
FY 2015E	354	342	118	51.0	4.4	0.7	7.1	0.9
FY 2016E	544	535	305	56.6	10.5	1.8	4.5	0.8
L&T Finance								
FY 2014	1684	756	596	33.0	9.2	0.7	19.1	2.0
FY 2015E	2343	1262	744	38.0	12.9	0.7	14.8	1.7
FY 2016E	2780	1539	925	42.0	14.0	0.9	12.2	1.6

Source: REC, Ventura Research

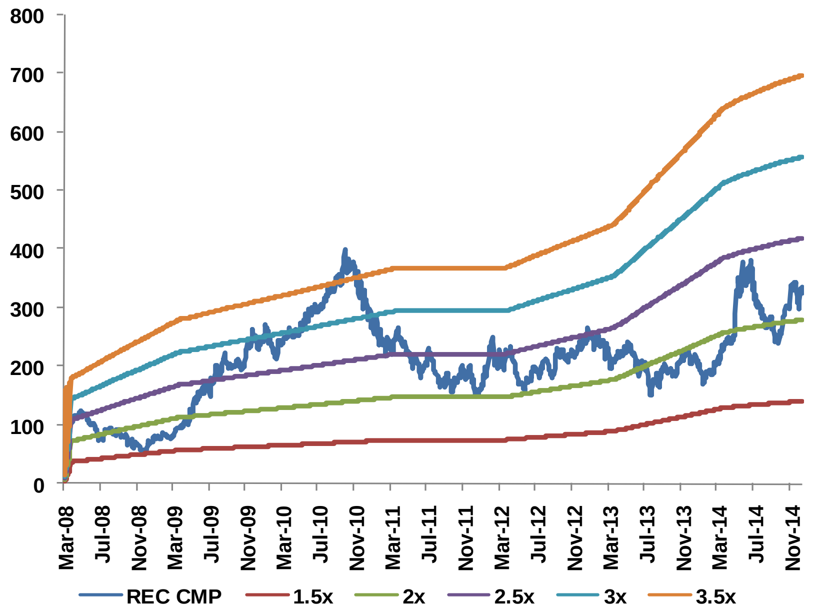
REC has compelling valuations; best in class on all parameters

Company	Market Cap* (₹)	Business Size* FY14 (₹)	FY17 Price/Adj. BV	FY17 ROE (%)	FY17 ROA (%)	Net NPAs (%)
State Bank Of India	2267	26042	1.5	15.0	0.9	2.7
Bank Of Baroda	462	9659	0.9	16.0	0.8	1.7
Bank Of India	189	8477	0.6	13.7	0.6	2.3
Punjab National Bank	376	8007	0.8	15.0	0.9	3.3
Canara Bank	190	7218	0.6	13.2	0.6	2.3
ICICI Bank Ltd	2015	6706	2.1	16.4	1.8	1.1
HDFC Bank Ltd	2330	6703	3.1	22.5	2.0	0.3
Union Bank Of India	144	5268	0.7	13.7	0.7	2.7
Axis Bank Ltd	1184	5110	2.0	18.8	1.8	0.4
IDBI Bank Ltd	117	4335	0.5	8.7	0.5	2.8
Central Bank Of India	135	4174	NA	NA	NA	3.4
Indian Overseas Bank	74	4039	0.5	7.1	0.4	5.2
Syndicate Bank	79	3863	0.6	16.1	0.7	2.2
UCO Bank	82	3491	0.6	13.6	0.5	3.2
Oriental Bank Of Commerce	96	3326	0.6	12.3	0.7	3.3
Corporation Bank	NA	3305	NA	NA	NA	2.9
Allahabad Bank	69	3288	0.5	12.2	0.9	3.5
Power Finance Corp. Ltd	367	3150	1.0	19.6	2.7	0.8
Indian Bank	95	2845	0.7	12.3	0.7	2.6
Andhra Bank	54	2495	0.5	11.9	0.5	3.9
Rural Electrification Corp. Ltd	317	2490	1.0	21.3	3.0	0.7
Vijaya Bank	43	2058	0.6	10.3	0.4	1.9
Bank Of Maharashtra	46	2057	NA	NA	NA	3.3
Dena Bank	33	1876	0.4	11.7	0.5	3.6
United Bank of India	31	1773	NA	NA	NA	7.2
State Bank Of Travancore	32	1587	NA	NA	NA	3.2
Punjab & Sind Bank	25	1420	NA	NA	NA	3.9
State Bank Of B&J	45	1380	NA	NA	NA	2.5
Yes Bank Ltd	32	1298	2.1	20.4	1.7	0.1
The J&K Bank Ltd	72	1157	0.9	18.5	1.4	2.5
IndusInd Bank Ltd	419	1156	2.9	20.8	1.9	0.3
Kotak Mahindra Bank Ltd	1014	1121	5.0	16.2	2.0	1.0
State Bank Of Mysore	26	1110	NA	NA	NA	2.9
IDFC Ltd	250	1058	1.3	10.7	2.1	0.4
The Federal Bank Ltd	127	1032	1.3	15.5	1.3	0.7
The South Indian Bank Ltd	41	837	0.9	17.1	1.0	0.9
Karur Vysya Bank Ltd	70	777	1.3	17.8	1.1	0.6
ING Vysya Bank Ltd	18	770	1.8	13.4	1.3	0.4
The Karnataka Bank Ltd	27	689	0.7	14.9	0.9	2.4
Shriram Transport Finance Co.	240	646	2.0	18.2	3.0	0.8
M&M Financial Services Ltd	182	478	2.5	19.6	2.9	3.1
City Union Bank Ltd	58	381	1.6	17.4	1.6	1.3
Reliance Capital Ltd	116	376	NA	NA	NA	0.5
The Lakshmi Vilas Bank Ltd	16	315	NA	13.2	0.8	2.8

(* ₹ in lac crore in case of market cap & business size)

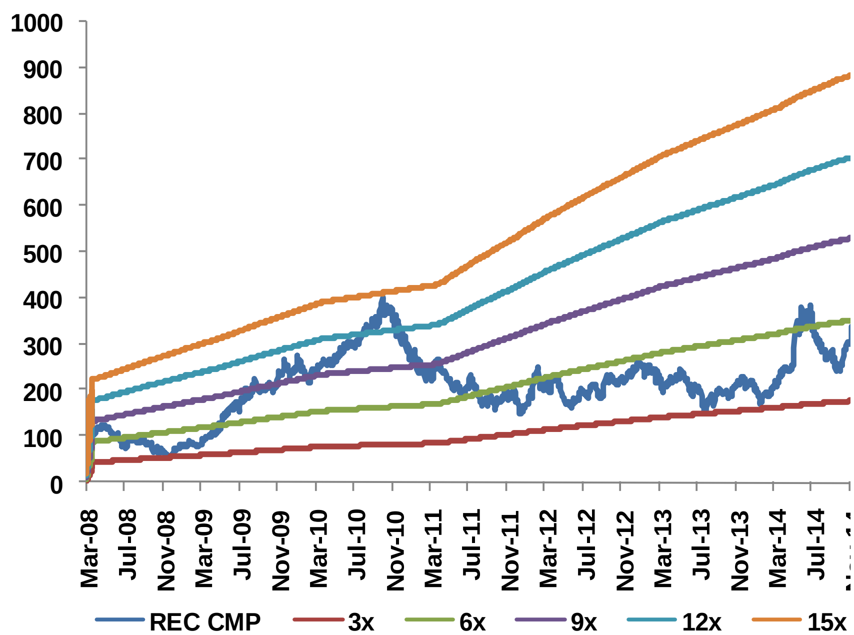
Source: REC, Ventura Research

P/BV



Source: REC, Ventura Research

P/E



Source: REC, Ventura Research

Financial and Projections

Y/E March (₹ in crore)	FY13	FY14	FY15E	FY16E	FY17E
Income Statement					
Interest Income	**13,387.8**	**16,904.5**	**20,737.4**	**25,531.7**	**31,426.4**
Interest Expense	8,006.3	9,726.4	12,643.5	15,642.5	18,718.1
Net Interest Income	**5,381.5**	**7,178.0**	**8,093.9**	**9,889.2**	**12,708.2**
YoY change (%)	*35.5%*	33.4%	12.8%	22.2%	28.5%
Non Interest Income	210.9	216.3	280.0	345.0	410.0
Total Net Income	**5,592.4**	**7,394.4**	**8,373.9**	**10,234.2**	**13,118.2**
Total Operating Expenses	**200.8**	**205.3**	**396.5**	**518.2**	**643.1**
Pre Provision profit	**5,391.7**	**7,189.1**	**7,977.4**	**9,716.0**	**12,475.1**
YoY change (%)	*37.8%*	33.3%	11.0%	21.8%	28.4%
Provisions for expenses	227.7	657.9	639.2	690.2	833.2
Profit Before Tax	**5,164.0**	**6,531.1**	**7,338.2**	**9,025.9**	**11,641.9**
YoY change (%)	*29.5%*	26.5%	12.4%	23.0%	29.0%
Taxes	1,346.3	1,847.4	1,834.6	2,075.9	2,910.5
Net profit	**3,817.6**	**4,683.7**	**5,503.7**	**6,949.9**	**8,731.4**
YoY change (%)	*35.5%*	22.7%	17.5%	26.3%	25.6%
Balance Sheet					
Advances	1,14,529	1,35,855	1,63,026	2,03,783	2,54,729
Net Block & CWIP	80	82	85	85	85
Cash and Bank	1,484	1,193	4,384	4,600	5,133
Loan and Advances	12,853	12,724	16,383	22,506	28,120
Investments	661	1,708	2,735	1,898	2,142
Other Assets	891	1,290	1,660	1,760	1,860
Total Assets	**1,30,498**	**1,52,853**	**1,88,273**	**2,34,632**	**2,92,069**
Long Term Borrowings	90,960	1,10,162	1,43,676	1,73,805	2,11,694
Short Term Borrowings	2,480	2,540	2,500	3,000	3,500
Provisions	416	700	750	750	750
Current Liabilities	19,116	18,584	15,804	26,071	38,105
Other Liabilities	71	197	150	150	150
Equity	987	987	987	987	987
Reserves	16,467	19,682	24,405	29,869	36,883
Total Liabilities	**1,30,498**	**1,52,853**	**1,88,273**	**2,34,632**	**2,92,069**
Dupont Analysis					
% of Average Assets					
Net Interest Income	4.5%	5.1%	4.7%	4.7%	4.8%
Non Interest Income	0.2%	0.2%	0.2%	0.3%	0.3%
Net Income	4.6%	5.2%	5.0%	5.0%	5.2%
Operating Expenses	0.2%	0.2%	0.3%	0.4%	0.5%
Operating Profit	4.5%	5.1%	4.6%	4.5%	4.6%
Provisions & Contingencies	0.2%	0.5%	0.5%	0.6%	0.7%
Taxes	1.1%	1.5%	1.5%	1.7%	2.4%
Avg.Assets / Avg.Equity (x)	122	143	173	214	267

Y/E March (₹ in crore)	FY13	FY14	FY15E	FY16E	FY17E
Ratio Analysis					
Efficiency Ratio (%)					
Int Expended / Int Earned	59.8%	57.5%	61.0%	61.3%	59.6%
Int Income / Total Funds	10.3%	11.1%	11.0%	10.9%	10.8%
NII / Total Income	39.6%	41.9%	38.5%	38.2%	39.9%
Other Inc. / Total Income	1.6%	1.3%	1.3%	1.3%	1.3%
Ope. Exp. / Total Income	1.5%	1.2%	1.9%	2.0%	2.0%
Net Profit / Total Funds	2.9%	3.1%	2.9%	3.0%	3.0%
Loans / Borrowings	122.6%	120.5%	111.5%	115.3%	118.4%
Investment / Total Assets	0.5%	1.1%	1.5%	0.8%	0.7%
NIM	4.6%	4.9%	5.2%	5.3%	5.3%
Solvency					
Gross NPA (Rs. Cr)	490	490	1,335	1,834	2,420
Net NPA (Rs. Cr)	401	353	992	1,334	1,720
Gross NPA	0.4%	0.4%	0.8%	0.9%	1.0%
Net NPA	0.4%	0.3%	0.6%	0.7%	0.7%
Capital Adequacy Ratio (%)	16.2%	16.5%	17.8%	17.9%	18.4%
Tier I Capital (%)	15.3%	14.8%	15.2%	15.5%	15.6%
Tier II Capital (%)	0.9%	1.8%	2.6%	2.4%	2.8%
Per Share Data (Rs.)					
EPS	38.7	47.4	55.7	70.4	88.4
Dividend Per Share	8.2	9.5	10.5	12.0	14.0
Book Value	176.7	209.3	257.1	312.4	383.4
Adjusted Book Value of Share	175.7	208.3	256.1	309.7	379.7
Valuation Ratio					
Price/Earnings (x)	8.3	6.7	5.7	4.5	3.6
Price/Book Value (x)	1.8	1.5	1.2	1.0	0.8
Price/Adj.Book Value (x)	1.8	1.5	1.2	1.0	0.8
Return Ratio					
RoAA (%)	3.2%	3.3%	3.2%	3.3%	3.3%
RoAE (%)	23.8%	24.6%	23.9%	24.7%	25.4%
Growth Ratio (%)					
Interest Income	29.3%	26.3%	22.7%	23.1%	23.1%
Interest Expenses	25.5%	21.5%	30.0%	23.7%	19.7%
Other Income	32.7%	2.6%	29.4%	23.2%	18.8%
Total Income	29.4%	25.9%	22.8%	23.1%	23.0%
Net profit	35.5%	22.7%	17.5%	26.3%	25.6%
Loans	27.3%	18.6%	20.0%	25.0%	25.0%
Borrowings	19.7%	17.1%	13.8%	21.0%	18.3%

Ventura Securities Limited

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