Re-Initiating Coverage

REC Ltd.

13-August-2021

RETAIL RESEARCH

REC Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
NBFC-Power Finance	Rs.149	Buy at LTP and add more at Rs.132.5	Rs.167	Rs.186	2 quarters

HDFC Scrip Code	RECLTDEQNR
BSE Code	532955
NSE Code	RECLTD
Bloomberg	RECLTD
CMP Aug 13, 2021	149
Equity Capital (Rs Cr)	1,974.9
Face Value (Rs)	10
Equity Share O/S (Cr)	197.5
Market Cap (Rs Cr)	29,465.8
Adj. Book Value (Rs)	198
Avg. 52 Wk Volumes	6594219
52 Week High	167.8
52 Week Low	91.9

Share holding Pattern % (Jun, 2021)	
Promoters	52.63
Institutions	38.66
Non Institutions	8.71
Total	100.0

Retail Research Risk Rating:

Blue*		

*** Refer at the end for explanation on Risk Ratings**

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Our take

Rural Electrification Corporation (REC), like its parent PFC, plays a major role in various power sector schemes of the Government of India. It is the second-largest lender to the sector and has been nominated as the sole nodal agency for various schemes and programs of national importance. It is a Navratna PSU company which is into infrastructure financing and financing projects across the value chain in power sector. This includes generation, transmission, and distribution companies. REC provides funds to state governments, state electricity boards, central/state power utilities, independent power producers, rural electric cooperatives, and private sector utilities through its 22 offices across India. The power sector outlook for the long term seems bright (~12% rise in power demand in FY22). The large liquidity support, several proposed reforms and Government's aggressive capex plan will keep the sector on strong growth track. As a part of future growth strategy, the management has decided that the focus would be towards renewable energy segment and they are now planning to enter into new areas of business like extending assistance for activities having a forward or backward linkage with energy related projects.

Prolong economic slowdown poses risk to the pace of collections and business growth. Resolutions and haircuts especially from the private sector will be the key thing to watch out for in coming quarters. The high client concentration and relatively high un-hedged borrowings are among the key risk factors for the company.

We had issued Initiating Report on REC Ltd on 05th January, 2021 and recommended Buy at LTP and add on dips to Rs.119-121 band, for base case target of Rs.156 and bull case target of Rs.169 over the next two quarters. Below is the link for the report:
https://www.hdfcsec.com/hsl.research.pdf/REC%20Ltd.-%20Initiating%20Coverage-%2005012021.pdf

Valuation and recommendation:

Even during the weak economic scenario, the company has reported decent numbers in Q1FY22. We have envisaged 11% CAGR growth for top line and 10% for bottom line, while loan book is estimated to grow at 12.5% CAGR over FY21-23E. Improving power demand and capex plans in the sector will keep helping REC in strengthening and growing its business operations. On the asset quality front, we feel that it should be hover around current level. Further, it is holding sufficient provisions. RoAA is estimated at 2.1% for FY23. In the medium term, credit cost normalisation and cost control remains the key drivers for stable RoA and RoE.

The company has strong capital adequacy ratio with a well-diversified resource profile. REC is a consistently high dividend paying company, the yield at the current price stands at ~8.5% which makes it one of the highest dividend paying companies in the listed space. For the last five years the average of dividend payout as a percentage of equity share capital stood at 107%. REC's dividend attractive ness seems sustainable as it has lent to relatively risk-free public sector entities and its capability to distribute dividends remains good even in case a good portion of its private sector lending goes bad. The stock is trading at only 0.6x FY23E P/ABV. We feel that such high dividend yield and low valuations provide a margin of safety for investment in the company at the current level.

In the past few quarters the company has been able to deliver constant and strong growth numbers while maintaining asset quality. Also the emerging trend in the power sector gives us confidence in the company's ability to grow at faster growth rate. Likely haircuts from resolutions and incremental provisioning will be the key monitorables. We believe that investors can buy REC Ltd at LTP (0.6xFY23E ABV) and add more at Rs.132.5 (0.5xFY23E ABV) for the base case fair value of Rs.167 (0.63xFY23E ABV) and for the bull case fair value of Rs.186 (0.7xFY23E ABV) over the next two quarters.

Financial Summary

Particulars (Rs.Cr)	Q1FY22	Q1FY21	YoY-%	Q4FY21	QoQ-%	FY20	FY21	FY22E	FY23E
NII	3,803.4	2,794.0	36.1	3,307.9	15.0	10667.7	13195.0	14603.4	16143.6
PPOP	3,539.0	2,676.0	32.2	3,394.0	4.3	7874.1	13176.0	14152.3	15690.2
PAT	2,246.6	1,839.4	22.1	2,070.4	8.5	4887.4	8362.0	9049.3	10201.4
EPS (Rs)						24.7	42.3	45.8	51.7
ABV (Rs)						123.4	198.2	228.4	265.0
P/E (x)						6.0	3.5	3.3	2.9
P/ABV (x)						1.2	0.8	0.7	0.6
RoAA (%)						1.5	2.2	2.1	2.1

(Source: Company, HDFC sec)

Recent Developments

Q1FY22 Result Update

Even during the quarter when the economy was hit hard with COVID second wave the company has managed to grow the loan book at 15% YoY to Rs.3.79 lakh cr. REC managed to increase its interest income sharply by 16.5% at Rs9439cr. The fees and commission income for the quarter was sharply up to Rs151cr v/s negligible number in Q1FY21.The high contributors to growth were transmission & distribution and short-term loans segments. Total Disbursements during Q1FY22 was at Rs. 15,095 cr. Net Interest Income (NII) came in at Rs. 3,804 cr, up 36% YoY. NIM, during the quarter, improved to 4.22% from 3.79% QoQ due to rise in yields. The finance costs were higher but the growth therein was much lower than than that in interest income. In addition, the exchange and translation losses were lower by 33% on yoy basis. Net Profit soared 22.16% to Rs 2,246.60 cr. The Company has also declared an interim dividend of Rs. 2/- per equity share of Rs. 10/- each for the FY22 and 17th August, 2021 has been fixed as Record Date for payment.

Management has informed that the strong credit profile, access to diversified sources of borrowings and contingency buffers placed by the Company will ensure that there is no significant impact on its liquidity position.

Asset Quality

The asset quality during the quarter improved further. Gross NPA now stood at 4.80% vs 4.84% QoQ and 6.11% YoY. Provision Coverage Ratio against Credit impaired assets stands at 66.48% as compared to 64.6% in the last quarter due to which the credit cost remained elevated. Net Credit-impaired Assets was at 1.61% vs 1.71% QoQ and 2.88% YoY. Resolutions and haircuts especially from the private sector will be the key thing to watch out in coming quarters. Gross stage-3 is broadly steady QoQ at 4.8% which is a positive development amid current circumstances.

Sector tailwinds

1) **Constant Government Push for power sector**

GoI is actively committed to give uninterrupted and reliable supply of electricity access to each household. It has continued giving push to the power sector and built reformist agenda to provide support to the sector. Several schemes have been launched in past many years and REC & PFC have actively taken part in many of them.

As a part of its Covid-19 relief package, the GoI had announced liquidity injection into the State Discoms in the form of State Govt. guaranteed loans through REC and PFC to clear the outstanding dues of Power Generation and Transmission Companies. As on 30th July 2021, the Company has already sanctioned and disbursed Rs.67,838 cr and Rs.41,177 cr respectively to the discoms as part of this liquidity package. This has helped the company in past few quarters in fetching higher loan growth.

In June-21, the government has approved a package of more than Rs. 3 lakh Cr to recharge distribution reform, solarise farm feeders and smarten up networks with intelligent control system in the cities with more than 2.75 lakh population to accommodate rising renewable energy and improve the reliability of services. The scheme aims to bring down average aggregate technical and commercial loss from 21% to 12-15%, and gradually narrow the deficit between the cost of electricity and the price at which it is supplied to 'zero' by 2024-25. REC and PFC will act as the nodal agencies and fund the reforms.

2) <u>Power Companies strong outlook</u>

COVID impact: The power sector in the country witnessed limited disruption due to COVID-19, as power comes under essential services category. However, demand for power fell steeply on account of drop in the commercial and industrial activity. Power distribution was impacted the most, with fall in revenue collections affecting the financial and liquidity position of players. As the lockdown eased out, power demand started to recover. Further, the Government announced liquidity infusion into the power sector, granting relief from the sudden cash crunch. We expect power demand to post a 12% rise in FY22, led by improved economic activity in the country.

The Government's focus on attaining '24x7 Power For All' has accelerated the capacity addition in the country. The Central government's liquidity package under the Atmanirbhar scheme has significantly improved liquidity for discoms (power-distribution companies). Furthermore, with CCEA (Cabinet Committee on Economic Affairs) approving the Rs 3.03 lakh cr reform-linked package, we can expect improved infrastructure capital expenditure by discoms over the next 3-4 years. This would, in our view, promote private participation in the discom space. Funds under the scheme would be released in proportion to the discoms' achievements against mutually agreed targets in the action plan. These reforms could turn the sector around if executed successfully and enable sub-sectors like gencos (power-generation companies), transcos (power-transmission companies) and discoms to improve their operational efficiencies and become self-sufficient.

It is also expected that the proposed reforms like the Draft Electricity Amendment Bill could act as the silver lining and can lead to the revival of the power sector in the country. However, the key would be the successful implementation of these reforms.

In the wake of the economic repercussions of the COVID-19 pandemic, many companies across the world are now considering diversifying their supply chain and relocate to India. Persistent economic and agricultural growth is also likely to drive the electricity demand further in the coming years. Power sector could witness a paradigm shift due to these changes. To meet these challenges and harness emerging opportunities, REC is well placed in the short-term as well as long-term.

National Infrastructure pipeline has outlined Rs.25trn capex for the period FY20-25 for power sector. This is a 41% jump from the Rs17.7trn capex done in the sector between FY13-FY19. All these represents the kind of opportunity power sector in India has. This in turn provides the long term loan growth visibility for REC.

3) <u>Renewable segment could provide next leg of growth</u>

The Indian renewable energy sector is the fourth most attractive renewable energy market in the world. With the increased support of the Government and improved economics, the sector has become attractive from investors’ perspective.

REC is a major player in Renewable Energy segment and in creation of India’s Green Energy Corridor. Still the renewable energy segment is only 4% of total loans outstanding because the overall renewable share in the energy generation mix is low. However, since last many quarters the share is rising consistently. The GoI has set ambitious targets for renewable energy for the short to medium term. By year 2022, the country aims to have 175 gigawatts (GW) of installed renewable energy capacity. The National Electricity Plan 2018 further raises the ambition to achieve 275 GW of renewables by year 2027, which would increase the share of renewable energy to 44% of the installed capacity and 24% in electricity generation. There is tremendous opportunity for PFC, REC companies to take advantage of this push for renewable energy.

<u>REC’s dominant market position</u>

REC, like its parent PFC, plays a major role in various power sector schemes of the Government such as Deendayal Upadhyaya Gram Jyoti Yojana (DDUGJY) and SAUBHAGYA. It is the second-largest lender to the sector. Furthermore, the company has been nominated as the sole nodal agency to operate the National Electricity Fund Scheme—an interest subsidy scheme introduced by GoI—to promote capital investment in the power distribution sector. It is likely to retain a dominant position in power sector financing being strategically important vehicles for the implementation of the GoI's various power sector schemes.

Loan Book Composition

	FY19	FY20	FY21	Q1FY22
State	81	81	84	84
Joint	7	7	6	6
Private	12	12	10	10
Total	**100**	**100**	**100**	**100**
Generation	43	43	41	41
Renewable Energy	5	5	5	4
Transmission	*19*	*19*	*16*	*16*
Distribution	*32*	*33*	*38*	*38*
Total T&D	51	52	54	54
Short Term Loans	1	-	-	1
Total	**100**	**100**	**100**	**100**

(Source: Company, HDFC sec Research)

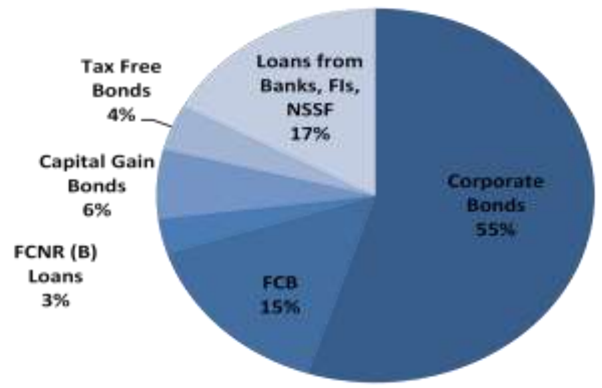
Capital Positioning and resource profile

As of Q1FY22, the Capital Adequacy Ratio (CAR) stood at 20.21% with Tier – I capital ratio at 17.01%. Even after the stake sale by Government to PFC, we believe the company will keep on getting adequate funds at a reasonable rate as GOI has 56% stake in PFC. Credit rating agencies are showing confidence in the rating as it has a highest long term rating of AAA- domestic, International Ratings of "Baa3" & "BBB- " from Moody's and Fitch respectively.

Recently in the Q1FY22 meeting, the board has also approved raising of funds through issue of unsecured/ secured non-convertible bonds/ debentures through private placement, up to an amount of Rs 85,000 cr in one or more tranches, subject to approval of shareholders. The funds will be raised, from time to time, during a period of one year from the date of passing of resolution.

REC has a well-diversified resource profile with 65% money raised from bonds, 17% via loans from various entities and 18% via foreign currency loans. Further, ~70% of the foreign currency exposure with 5 years residual maturity is hedged.

Borrowing Profile



(Source: Company, HDFC sec Research)

Future Strategy

With a strong foothold in its existing area of operations, REC is poised to enter into new areas of business. This will include extending assistance for activities having a forward or backward linkage with energy related projects, financing electro-mechanical and hydro-mechanical components and associated civil works in large lift irrigation projects, pollution control equipment in thermal power plants and other emerging technologies. Renewable Energy would continue to be a key focus area for REC over the next few years, in keeping with the Government of India's strong policy support to develop this segment. E-Vehicles, agriculture pumpsets, energy efficient equipment, smart transmission and distribution systems, TBCB projects etc. would continue to create new business opportunities.

Risks and concerns

Deterioration in asset quality

A higher-than-expected deterioration in the asset quality could result in the erosion of the Tier I capital. Fresh formation of bad loans could keep provisioning high and return ratios compressed for a longer time.

Further, any delay in the recovery, higher than expected haircuts or sharp rise in the slippage could impact the profitability and business growth prospects. This could also impact its ability to payout large dividends.

Hedging risk

About 15% of the borrowings are in foreign currency out of which ~70% has been hedged as of June 2021. In case of depreciation in the value of Rupee, REC may have to provide for the difference on the balance exposure.

Banks' exposure to infrastructure finance companies is fixed at 10% of their capital funds. This may restrict REC's ability to borrow from Banks in future.

Capital Gains tax benefits under Section 54EC are being cut and hence this could impact REC's abilities to raise money from these bonds.

Inherently risky borrowers' nature and high customer concentration

The borrowers are from power sector and the credit risk profile of them is weak because of their poor financials. PSUs, especially discoms, are an inherently weak asset class and even the private sector power players have increasingly become more vulnerable to asset quality risks owing to issues such as lack of fuel availability, inability to pass on fuel price increases, and absence of long-term power purchase agreements for assured power offtake.

Due to the lockdown, there has been a general fall in the demand for electricity in the country and the revenue realization of the distribution utilities has been adversely impacted. As a result, the credit worthiness of the borrowers has deteriorated. This might lead to fresh slippages in the future.

The company has high customer concentration risk. Advances to top ten borrowers constitute about 41.64% of total gross loans outstanding.

REC Ltd.

Major Borrowers

Sr. No.	Top Ten Borrowers	% of Total Loan Assets
1	Tamil Nadu Generation and Distribution Corporation Ltd	7.51%
2	Maharashtra State Electricity Distribution Company Ltd	6.10%
3	Uttar Pradesh Power Corporation Ltd	5.32%
4	Telangana State Power Generation Corporation Ltd	3.88%
5	Maharashtra State Power Generation Company Ltd	3.72%
6	Rajasthan Rajya Vidyut Utpadan Nigam Ltd	3.55%
7	Tamil Nadu Transmission Corporation Ltd	3.19%
8	Telangana State Water Resources Infrastructure Development Corporation Ltd	2.94%
9	Andhra Pradesh Power Generation Corporation Ltd	2.92%
10	UP RAJYA VIDYUT UTPADAN NIGAM Ltd	2.51%
	Total	**41.64%**

(Source: Company, HDFC sec Research)

Company Background:

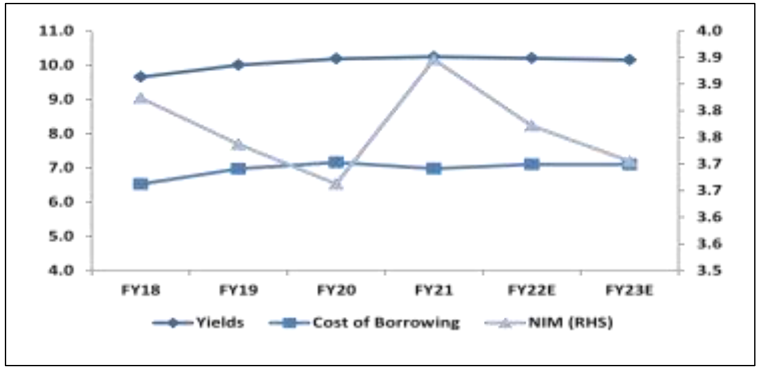
Rural Electrification Corporation (REC), incorporated in 1969 by Government of India, to finance and promote rural electrification projects in India. It is engaged in financing projects or schemes of power generation (both conventional and renewable energy), transmission, distribution, rural electrification and activities having forward/backward linkage with power projects, in both public and private sectors. Its key products include Long Term, Medium Term and Short Terms Loans etc. for the entire power sector value chain. In addition to that, REC also acts as nodal agency for various schemes and programs of national importance of the Ministry of Power, Government of India (GoI).

It was established by GoI for the purpose of developing the infrastructure in rural India. Over the last decade, the company has diversified into urban areas and plays a strategic role in GoI's plan to improve the T&D infrastructure in India. REC's clients mainly include state power utilities, private power sector utilities, joint sector power utilities and power equipment manufacturers. PFC now holds 52.63% stake in the company as a promoter entity having bought the stake from the Govt of India in March 2019 @Rs.139.50 per share.

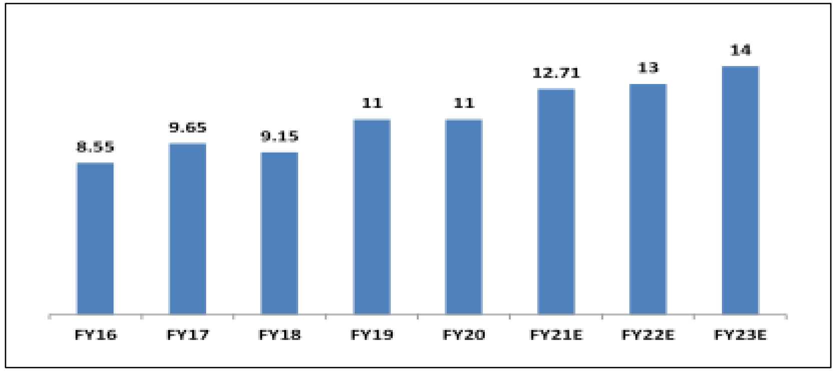
REC Ltd.

REC has two wholly-owned subsidiary companies, namely REC Power Distribution Company Limited (RECPDCL) and REC Transmission Projects Company Limited (RECTPCL), which provide project consultancy and implementation services in the areas concerned with the power sector.

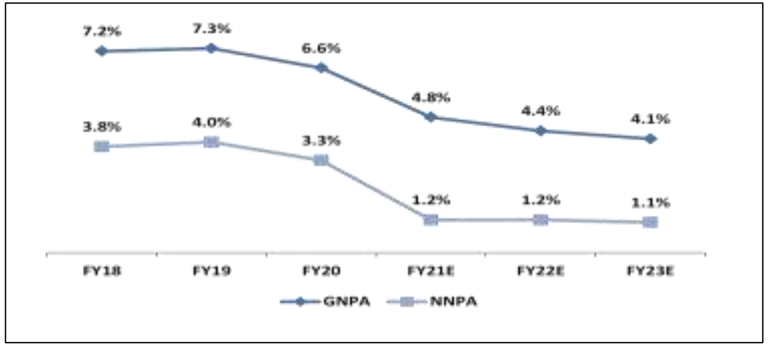
NIM (%)



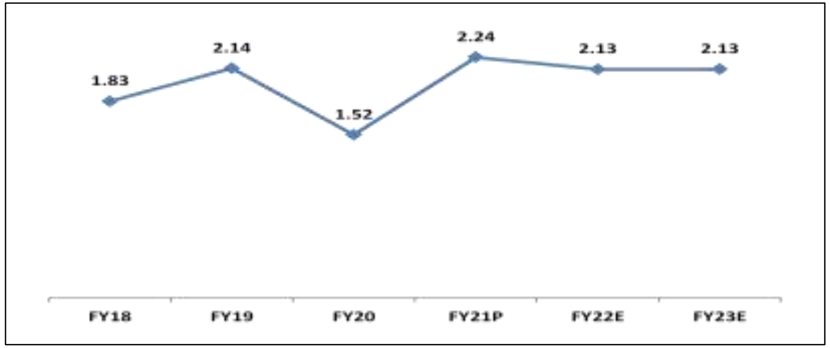
Dividend Per Share (Rs.)



Asset Quality Trend (%)



RoAA%



(Source: Company, HDFC sec Research)

RETAIL RESEARCH

REC Ltd.

Financials

Income Statement

(Rs cr)	FY19	FY20	FY21	FY22E	FY23E
Interest Income	24971	29665	34684	39492	44222
Interest Expenses	15642	18997	21489	24889	28078
Net Interest Income	**9329**	**10668**	**13195**	**14603**	**16144**
Non-interest income	370	166	727	387	479
Operating Income	**9700**	**10834**	**13922**	**14991**	**16623**
Operating Expenses	1359	2960	746	838	933
PPP	8341	7874	13176	14152	15690
Prov & Cont	240	890	2420	2323	2178
Profit Before Tax	8101	6985	10756	11829	13512
Tax	2337	2097	2394	2780	3310
PAT	**5764**	**4887**	**8362**	**9049**	**10201**

Balance Sheet

(Rs cr)	FY19	FY20	FY21	FY22E	FY23E
Share Capital	1975	1975	1975	1975	1975
Reserves & Surplus	32328	33102	41451	47933	55370
Shareholder funds	**34303**	**35077**	**43426**	**49908**	**57345**
Borrowings	244321	286340	329780	371312	419628
Other Liab & Prov.	19093	25071	27024	29186	31375
SOURCES OF FUNDS	**297717**	**346488**	**400231**	**450406**	**508348**
Fixed Assets	154	153	260	360	450
Intangible assets	10	10	7	10	10
Capital Work-in-Progress	197	288	336	180	90
Investment	2398	2313	1910	2864	3236
Cash & Bank Balance	1596	3700	3070	5172	5304
Advances	270451	312084	365262	409093	462276
Other Assets	22911	27941	29387	32727	36982
TOTAL ASSETS	**297717**	**346488**	**400231**	**450406**	**508348**

(Source: Company, HDFC sec Research)

REC Ltd.

Key Ratios (%)

	FY19	FY20	FY21	FY22E	FY23E
Return Ratios					
Calc. Yield on adv	10.0%	10.2%	10.2%	10.2%	10.2%
Calc. Cost of borr	7.0%	7.2%	7.0%	7.1%	7.1%
NIM	3.7%	3.7%	3.9%	3.8%	3.7%
RoAE	17.3%	14.1%	21.3%	19.4%	19.0%
RoAA	2.1%	1.5%	2.2%	2.1%	2.1%
Asset Quality Ratios					
GNPA	7.3%	6.6%	4.8%	4.4%	4.1%
NNPA	4.0%	3.3%	1.2%	1.2%	1.1%
PCR	48%	50%	66%	73%	73%
Growth Ratios					
Advances	18.2%	15.4%	17.0%	12.0%	13.0%
Borrowings	19.5%	17.2%	15.2%	12.6%	13.0%
NII	6.6%	14.3%	23.7%	10.7%	10.5%
PPP	2.0%	-5.6%	67.3%	7.4%	10.9%
PAT	30.4%	-15.2%	71.1%	8.2%	12.7%

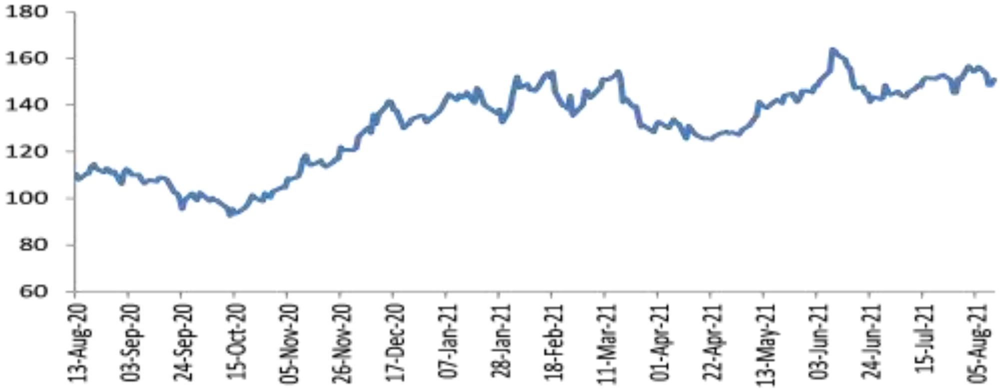
(Source: Company, HDFC sec Research)

Key Ratios

	FY19	FY20	FY21	FY22E	FY23E
Valuation Ratios					
EPS	29.2	24.7	42.3	45.8	51.7
P/E	5.1	6.0	3.5	3.3	2.9
Adj. BVPS	119.8	123.4	198.2	228.4	265.0
P/ABV	1.2	1.2	0.8	0.7	0.6
DPS	11.0	11.0	12.7	13.0	14.0
Div. Yield	7.4	7.4	8.5	8.7	9.4
Other Ratios					
Cost-Income	14.0	27.3	5.4	5.6	5.6
Leverage	7.9	8.9	8.4	8.2	8.1

REC Ltd.

One Year Price Chart



HDFC Sec Retail Research Rating description

Green rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Blue Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

Disclosure:

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