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20 YEARS

Initiating Coverage
REC Ltd.

05-Janauary-2021

RETAIL RESEARCH

REC Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
NBFC	Rs.137	Buy at LTP and add on dips to Rs.119-121 band	Rs.156	Rs.169	2 quarters

HDFC Scrip Code	RECLTDEQNR
BSE Code	532955
NSE Code	RECLTD
Bloomberg	RECLTD
CMP JAN 05, 2020	137
Equity Capital (RsCr)	1,974.9
Face Value (Rs)	10
Equity Share O/S (Cr)	197.5
Market Cap (Rs Cr)	27,115
Book Value (Rs)	178
Avg. 52 Wk Volumes	7604635
52 Week High	157.25
52 Week Low	79

Share holding Pattern % (Sep, 2020)	
Promoters	52.63
Institutions	38.49
Non Institutions	8.87
Total	100.0

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Our Take:

REC is engaged in financing and promoting rural electrification projects in India. Over the last decade, the company has diversified into urban areas. REC is not a mere financial intermediary but plays a strategic role in the GoI's initiatives for the development of the power sector in India (including improvement of the T&D infrastructure in India). It is associated with various flagship programs of the Ministry of Power, Government of India, which are contributing immensely towards development of power sector in the country.

There are several growth opportunities for the sector lying ahead that will affect the business of the company significantly in the positive manner i.e. proposed amendments Electricity Act & National Tariff Policy and Rs.25trn capex pipeline for National Infrastructure in the period of FY20-25. Renewable segment provides new growth opportunities for the company. Keeping in view the Government thrust in clean energy sources, REC is also focusing more and more on finance to clean/renewable energy projects.

Valuations & Recommendation:

Despite a difficult environment mainly on account of mounting AT&C losses due to operational inefficiencies of discoms and reducing collections due to Covid-19, the company has delivered decent growth in H1FY21. There might be near term volatility in the performance of the company due to uncertainty prevailing in the industry. However Rs.90,000 Cr liquidity package by Government under the Aatmanirbhar Bharat was a big boost for the power sector. REC and PFC shall be the only lenders to provide the financial support.

We have envisaged 18% CAGR for NII and 37% CAGR for Adjusted Net Profit over FY20-22E. With incremental unlocking of the economy, the demand for power (and hence power capex) will improve from FY22E. We have estimated 13% CAGR for loan book over FY20-22E. Asset quality trends and recovery from NCLT accounts will be the key things to watch out.

We feel that investors can buy REC at the LTP and add on dips to Rs.119-121 band. We expect the Base case fair value of Rs.156 (0.87x FY22E ABV) and the Bull case fair value of Rs.169 (0.94x FY22E ABV) over the next 2 quarters.

Financial Summary

Particulars (RsCr)	Q2FY21	Q2FY20	YoY-%	Q1FY21	QoQ-%	FY19	FY20	FY21E	FY22E
NII	3,425.9	2,690.0	27.4	2,910	17.7	9329.5	10667.7	13343.0	14867.7
PPOP	3,568.9	2,142.5	66.6	2678.05	33.3	8340.8	7872.9	12770.8	13838.3
PAT	2,190.2	1,306.8	67.6	1839.01	19.1	5763.7	4886.2	7216.1	9119.0
EPS (Rs)						29.2	24.7	36.5	46.2
ABV (Rs)						119.8	123.4	151.0	179.6
P/E (x)						4.7	5.5	3.7	3.0
P/ABV (x)						1.1	1.1	0.9	0.8
RoAA (%)						2.1	1.5	1.9	2.2

(Source: Company, HDFC sec)

Recent Developments

Q2FY21 highlights:

Net Interest Income (NII) moved up 17% to Rs 3367.42 crore, driven by improvement in Net Interest Margin (51 bps QoQ and 33 bps YoY to 4.19%). The company reported all time high net profit of Rs. 2,190 crore (up 66% YoY). Outstanding loan portfolio continues rise at a strong pace of 16% to Rs 348951 crore at end September 2020. Disbursements surged 60% yoy to Rs 28826 crore in Q2FY2021, as disbursements in the T&D jumped 86% to Rs 20452 crore, while generation segment disbursements also surged 80% at Rs 6721 crore. However, short-term loans disbursements dipped 84% to Rs 115 crore in Q2FY21. Asset quality registered improvement in the quarter with GNPA falling from 6.1% to 5.2% and NNPA down from 2.9% to 2% from Q1FY21. The company has significantly increased Provision Coverage Ratio (PCR) 61% from 53% in Q1FY21. Resolutions and haircuts will be the key thing to watch out in coming quarters.

COVID-19 pandemic worsened the woes of power players across the country, especially the distribution companies. The situation aggravated during the lockdown as power demand from commercial and industrial segment weakened, resulting in lower revenue realization for distribution companies, as these big consumers either remained shut or only operated partially, thereby leading to lower realizations. The near-term challenges for the borrowers are likely to arise from extended working capital cycles and deferment of capex plans. To mitigate the burden of debt servicing brought about by disruptions of business activities, the company had allowed moratorium as allowed by RBI on payment of all amounts falling due between 1st March, 2020 and 31st August, 2020 to the eligible borrowers.

Accordingly, the repayment of ~ 13,602 crores falling due till 31" August 2020 (including the amount pertaining to the first moratorium period) was deferred for the moratorium period. Apart from this, in order to ease out stress on cash flows, Government of India had announced reforms linked allocation of ~Rs.90,000 crore for cash-strapped distribution companies under the Aatmanirbhar Bharat Abhiyan. This financial package has been welcome news for power producers and has given a significant boost to power sector reforms. REC and PFC shall be the only lenders to provide the financial support under the Aatmanirbhar Bharat liquidity package.

Capital Adequacy Ratio as at September 30, 2020 stands at 18.35% (Tier – I: 14.86% & Tier – II: 3.49%). Being a PSU entity, capitalization is expected to remain adequate over the medium term as raising capital is relatively easy. Credit rating agencies are showing confidence in the rating as it has a highest long term rating of AAA; this also helps the company in raising money at a lower cost. Despite the moratorium allowed to the borrowers, the Company has not experienced any significant impact on its liquidity position due to the access to diversified sources of borrowings. Additionally, the Company has available limits of more than ~Rs. 3,000 crores towards long-term loans and ~Rs. 9,800 crores towards Working Capital! Short Term Loans from various banks. Asset Liability Maturity (ALM) profile of REC shows that liquidity position is superior. Also the company has a Borrowings profile with 55.8% from Corporate Bonds, 18% from Foreign Currency Borrowings, 15% from banks and rest from other source of funds. Average annualized Cost of Funds as of Q2FY21 is 7.33%.

Long term Triggers

Government’s continued push and reformist agenda to provide support

Power sector is one of the most important drivers for economic growth and socio-economic development of a nation. Therefore, GoI is actively committed to ensuring electricity access to each household. In this direction, the Government has been taking plethora of initiatives. With an aim to provide electricity distribution infrastructure in the rural areas, GOI launched the “Deendayal Upadhyaya Gram Jyoti Yojana (DDUGJY). Further, supplementing the DDUGJY scheme, the Government introduced the scheme named Pradhan Mantri Sahaj Bijli Har Ghar Yojana (Saubhagya) to provide energy access to all by last mile connectivity by providing electricity connections to all remaining un-electrified households in rural as well as urban area. As on date, around 99% of the households have been electrified. The Saubhagya scheme is expected to create an additional power demand of about 28,000 MW.

The concentrated efforts of the Government towards ensuring continuous, uninterrupted and reliable supply of electricity are expected to boost demand for funds for capex and that would ultimately help in growth in the business of the company as it is one of the leaders in the country in this segment. As on FY20, sector-wise disbursement break-up stood at 41% for T&D projects followed by 36% for

Generation companies, 8% for renewables and remaining 16% equally divided into short/medium term loans and counter-party funding under government schemes.

Growth opportunity is significant

There are several growth opportunities for the sector lying ahead that will affect the business of the company significantly in the positive manner. The proposed amendment in the Electricity Act is aimed at addressing issues that are adversely impacting the financial viability and therefore the investments in the sector. Establishment of Electricity Contract Enforcement Authority to enforce the performance of contracts like PPAs/ FSAs/ TSAs related to generation and transmission of power could help in addressing the issue of renegotiation of PPAs by DISCOMs, which is leading to lot of uncertainties in the sector. Proposed amendments in the National Tariff Policy such as capping of losses at 15% for determination of tariff, higher penalties for non-compliance to RPOs, restrictions on creation of new regulatory assets etc. will also help in making the sector more efficient. 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.

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 is going to 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.

Plays a strategic role in Government's flagship programs

REC is not a mere financial intermediary but plays a strategic role in the GoI's initiatives for the development of the power sector in India. It is associated with various flagship programs of the Ministry of Power, Government of India, which are contributing immensely towards development of power sector in the country. At present REC is the Nodal Agency for Rajiv Gandhi Grameen Vidyutikaran Yojanan (RGGVY), Deendayal Upadhyaya Gram Jyoti Yojana i.e., DDUGJY and SAUBHAGYA scheme, i.e., Pradhan Mantri Sahaj Bijli Har Ghar Yojana. REC is also supporting the Ministry of Power for implementation of Ujwal DISCOM Assurance Yojana i.e., UDAY.

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 hydromechanical 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.

Renewable segment - A new growth opportunity

The renewable segment has also seen its share of positive news where the tariffs have stabilized and this provide huge opportunities to invest in clean sources of energy. This also gives strong tailwinds to India's ambitious green energy target. Government is also pursuing innovative models in distributed solar power generation in line with its goal of transitioning towards clean fuels.

Government is making efforts to find specific solutions to incentivize every state for improving performance. It is also focusing on indigenous production in various sectors and it is critical that share of power sector equipment manufactured in India should increase going forward. We believe that various Government initiatives like 'Make In India' & 'Digital India' will go a long way towards building an ecosystem for manufacturing wafers, ingots, cells and modules within the country. This will help the Indian Power Sector being self-reliant and self-sustainable.

Keeping in view the Government thrust in clean energy sources, REC is also focusing more and more on finance to clean/renewable energy projects. Being a leading lender in the country in the segment, the Company is well positioned to get benefit out of it.

What could go wrong?

- The borrowers here 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.

- To implement and execute any reform measures is difficult for this sector as broad-based political consensus is necessary. Even the much needed tariff increases to ensure sustained improvement in the performance might also take a lot of time to approve.

REC Ltd.

- 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.

- Any delay in the recovery, higher than expected haircuts or sharp rise in the slippage could impact the profitability and business growth prospects.

- 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 provision high and return ratio compressed for a longer time.

- Recent Pandemic led economic recession has created a considerable amount of stress in the fiscal situation. So government in the current scenario might not be in the position to keep infusing capital in the value chain at the same rate.

- The company has high customer concentration risk. Advances to top ten borrowers constitute about 39.3% of total gross loans outstanding.

- REC's ability to borrow from banks may be restricted with the limit on banks' exposure to infrastructure finance companies at 10% of their capital funds.

- Potential merger of PFC & REC and the likely structure remains over hang. However give the cold reaction of debt markets to such a proposal, following exposure limits by lenders and concentration norms in a single borrower by the combined entity, the merger seems less likely in the near future.

- About 18% of the borrowings are in foreign currency out of which ~66% has been hedged as of Sept 2020. In case of depreciation in the value of Rupee, REC may have to provide for the difference on the balance exposure.

- REC being quasi sovereign finds it cheap to borrow over various time buckets due to its high credit rating. Any indication by the GoI that it is not willing to back the company could result in higher costs of borrowing for the company.

- Currently receivables from the Discoms/SEBs are directly or indirectly guaranteed by the respective state Govts. In case the State Govts show unwillingness or are unable to fund the losses of these entities, then REC could see a rise in NPAs even from the PSU sector. In Oct'20, the pending dues of power distribution companies (discoms) to power generation companies (gencos) rose 1% mom to Rs1.26tn but was up 35% yoy. Discoms in key states – Rajasthan, Tamil Nadu, Uttar Pradesh, Karnataka, Maharashtra, J&K and Telangana – account for 79% of the total overdue to gencos.

- In a follow up announcement post the recent MPC meet, the RBI has announced guidelines regarding the distribution of dividends by NBFCs from FY21 onward. The regulations are placed mainly on three parameters; capital adequacy, net NPA ratio (for deposit-taking NBFCs and systematically important non deposit-taking NBFCs) and leverage ratio (for non-systemically important, non-deposit taking NBFCs). Both REC and PFC have a historic dividend payout of ~45%. As per new norms, they will be eligible for a ~25% dividend payout. A cut in the dividend payout would lead to a fall in dividend yield and remove one key attraction to buy these PSUs

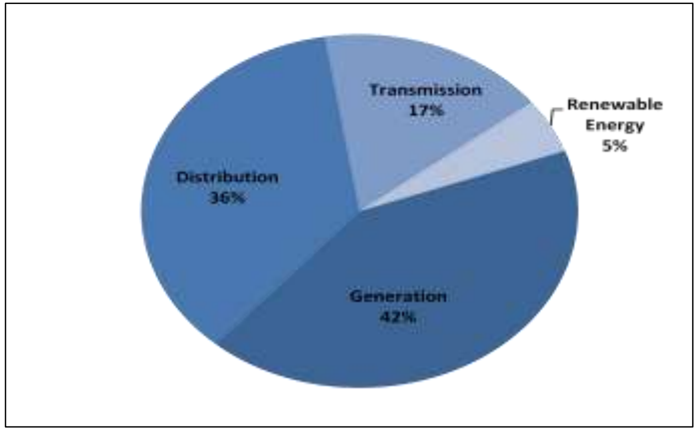
Company Profile:

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).

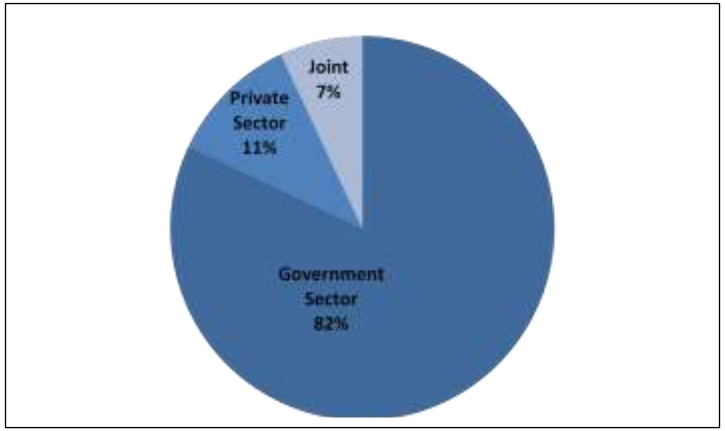
It was established by GoI for the purpose of developing the infrastructure in rural India. Over the last decade, the company has diversified into urban areas and plays a strategic role in GoI's plan to improve the T&D infrastructure in India. REC's clients mainly include state power utilities, private power sector utilities, joint sector power utilities and power equipment manufacturers. Loans to T&D projects constituted ~45% of the total loan book. PFC now holds 52.63% stake in the company as a promoter entity.

REC Ltd.

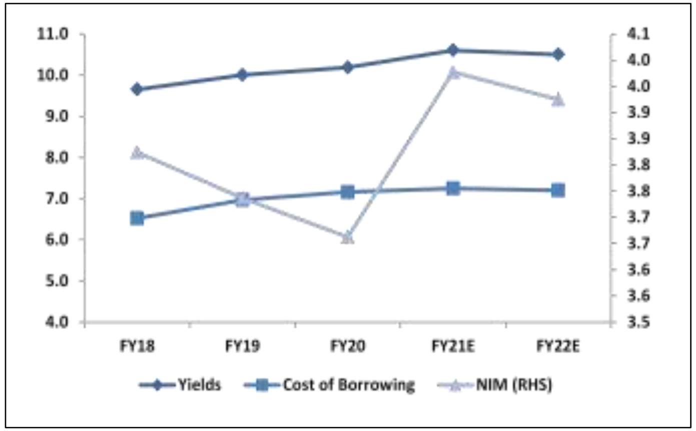
Loan Assets Scheme Wise (%)



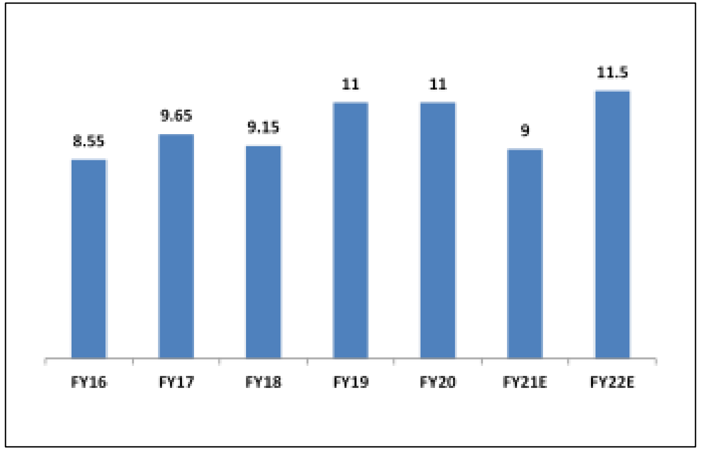
Loan Assets Sector Wise (%)



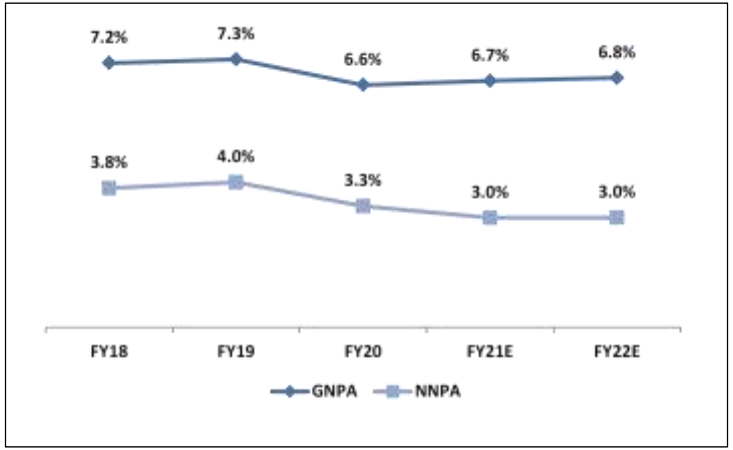
NIM Trend



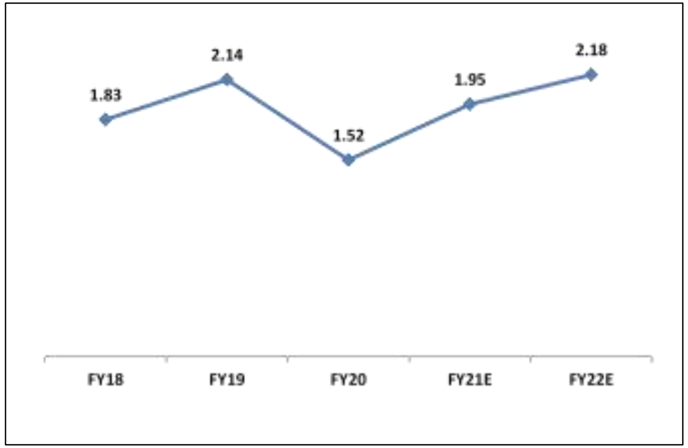
Dividend Per Share



NPA Trend



Return Ratio



(Source: Company, HDFC sec)

RETAIL RESEARCH

REC Ltd.

Financials

Income Statement

(Rs Cr)	FY19	FY20	FY21E	FY22E
Interest Income	24971	29665	35562	39776
Interest Expenses	15642	18997	22219	24908
Net Interest Income	**9329**	**10668**	**13343**	**14868**
Non interest income	370	190	738	530
Operating Income	**9700**	**10858**	**14081**	**15398**
Operating Expenses	1359	2985	1310	1560
PPP	8341	7873	12771	13838
Prov & Cont	240	890	3019	1515
Profit Before Tax	8101	6983	9751	12323
Tax	2337	2097	2535	3204
PAT	**5764**	**4886**	**7216**	**9119**

Balance Sheet

(Rs Cr)	FY19	FY20	FY21E	FY22E
Share Capital	1975	1975	1975	1975
Reserves & Surplus	32328	33102	38540	45388
Shareholder funds	**34303**	**35077**	**40515**	**47363**
Borrowings	244321	286340	326595	365289
Other Liab & Prov.	19093	25071	27578	30887
SOURCES OF FUNDS	**297717**	**346488**	**394688**	**443539**
Fixed Assets	154	153	160	180
Intangible assets	10	10	10	10
Capital Work-in-Progress	197	288	300	320
Investment	2398	2313	2153	3190
Cash & Bank Balance	1596	3700	4457	9207
Advances	270451	312084	358896	398733
Other Assets	22911	27941	28712	31899
TOTAL ASSETS	**297717**	**346488**	**394688**	**443539**

(Source: Company, HDFC sec Research)

REC Ltd.

Key Ratios:

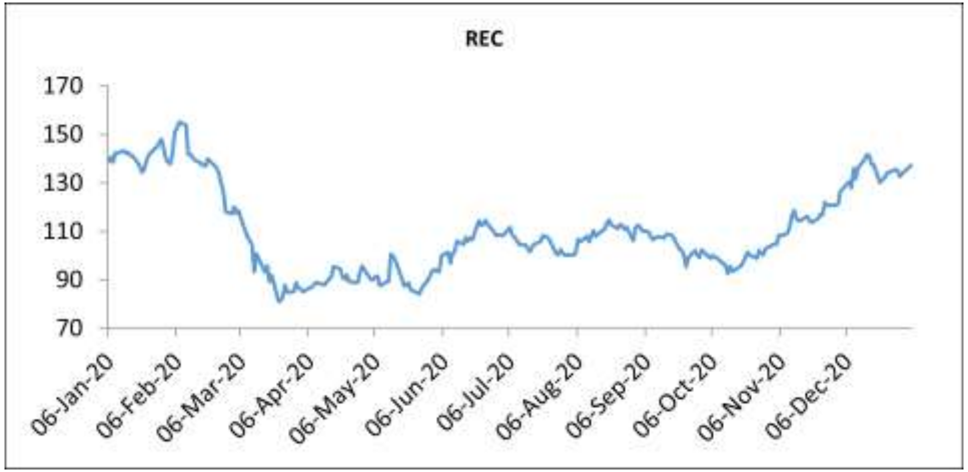
	FY19	FY20	FY21E	FY22E
Return Ratios				
Calc. Yield on adv	10.0%	10.2%	10.6%	10.5%
Calc. Cost of borr	7.0%	7.2%	7.3%	7.2%
NIM	3.7%	3.7%	4.0%	3.9%
RoAE	17.3%	14.1%	19.1%	20.8%
RoAA	2.1%	1.5%	1.9%	2.2%
Asset Quality Ratios				
GNPA	7.3%	6.6%	6.7%	6.8%
NNPA	4.0%	3.3%	3.0%	3.0%
PCR	48%	50%	56%	56%
Growth Ratios				
Advances	18.2%	15.4%	15.0%	11.1%
Borrowings	19.5%	17.2%	14.1%	11.8%
NII	6.6%	14.3%	25.1%	11.4%
PPP	2.0%	-5.6%	62.2%	8.4%
PAT	30.4%	-15.2%	47.7%	26.4%

(Source: Company, HDFC sec Research)

Key Ratios:

	FY19	FY20	FY21E	FY22E
Valuation Ratios				
EPS	29.2	24.7	36.5	46.2
P/E	4.7	5.5	3.7	3.0
Adj. BVPS	119.8	123.4	151.0	179.6
P/ABV	1.1	1.1	0.9	0.8
DPS	11.0	11.0	9.0	11.5
Div. Yield	8.0	8.0	6.6	8.4
Other Ratios				
Cost-Income	14.0	27.5	9.3	10.1
Leverage	7.9	8.9	8.9	8.4

One Year Price Chart



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