

BSE Code: 532955
NSE Code: RECLTD
Reuters Code: RURL.NS
Bloomberg Code: RECL:IN
Power play with attractive dividend yield....

Rural Electrification Corporation Ltd. (REC) is one of the leading public Infrastructure Finance Company in India with a network of 18 project offices including 5 Zonal and 3 sub offices along with 1 Training centre. REC's business model spans across the value chain of power infrastructure financing along with consultancy and advisory for power distribution and transmission projects catering to large and marquee state run power generation and transmission-distribution companies.

Investment Rationale

🔗 **Business growth momentum to sustain on the back of generation and renewable segments:** REC has grown its loan book at a healthy pace of 15% CAGR over FY12-17. Segmental mix has broadly remained unchanged over the years with transmission & distribution segment contribution remaining at 50.8% as of FY17 (49.2% in FY12). Based on borrower profile, exposure to private sector generation has grown at a rapid pace of 25.4% CAGR over FY12-17 growing to 16.5% of total exposure in FY17 as compared to 10.5% in FY12. Going forward, we expect RECL's loan book to grow at a healthy CAGR of 12% over FY17-20E mainly led by higher growth in generation and renewable sectors.

🔗 **Net interest margin (NIM) to stabilize from hereon:** REC steadily maintained its NIM above 4.5% over the last five years on the back of access of low cost of funds along with healthy spreads supported by low competition from banks. However, NIM remain suppressed and declined to 3.8% in 9MFY18 owing to higher interest reversals along with repayments of high yield SEB loans. However, we expect NIM has bottomed out and to stabilize from hereon and hover around current levels over FY17-20E.

🔗 **Return ratios to decline but remain competitive:** REC used to enjoy ~20%+ RoE and ~3%+ RoA over FY12-17 on account of healthy loan growth, higher operating efficiency and lower credit cost. However, with compression in NIM along with increase in credit cost, REC's RoE declined to 14.5% and RoA declined to 2.3% in 9MFY18. Going forward, we expect RoE and RoA to remain around 15% and 2.3%, respectively over FY17-20E which is competitive as compared to industry average of Banks and NBFCs.

🔗 **Adequately capitalized for future growth:** REC would not be required to raise equity capital to deliver the aforesaid asset growth given the company's high capital adequacy ratio (CAR) of 21.2% (Tier-1 ratio at 18.6%) currently along with RoE much higher than asset growth.

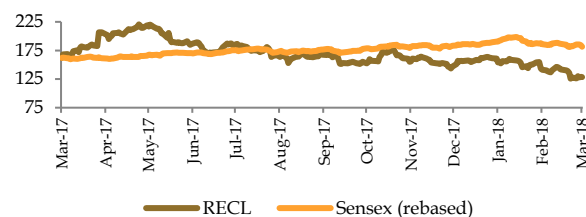
Valuation: REC's profitability will continue to remain under pressure over FY17-20E as provisions are likely to remain high given the increasing stress in power sector and high level of private restructured loan book (~5.6% of loans). However, the attractive dividend yield of ~7.5% will restrict any further fall in the stock price. Notably, REC consistently rewards its shareholders with healthy dividend, showing that the company is investor friendly. Further, REC is diversifying its portfolio toward renewable projects. Hence, we recommend BUY rating on the stock with a target price (TP) of Rs146 (P/ABV of 0.8x for FY20E).

Market Data

Rating	BUY
CMP (Rs.)	128
Target (Rs.)	146
Potential Upside	14%
Duration	Long Term
Face Value (Rs.)	10
52 week H/L (Rs.)	224/123
Adj. all time High (Rs.)	224
Decline from 52WH (%)	42.6
Rise from 52WL (%)	4.2
Beta	1.0
Mkt. Cap (Rs.Cr)	25,388

Fiscal Year Ended

Y/E	FY17A	FY18E	FY19E	FY20E
Interest Income (Rs.Cr)	22,936	22,169	24,839	28,139
Interest Expense (Rs.Cr)	13,775	13,856	15,551	17,646
Net Interest Income (Rs. Cr)	9,160	8,313	9,287	10,493
Pre Pro Profit (Rs. Cr)	9,969	8,729	9,780	11,084
EPS	31.6	26.1	29.0	32.7
P/E (x)	4.1	4.9	4.4	3.9
P/BV (x)	0.8	0.7	0.6	0.6
P/ABV (x)	0.8	0.8	0.8	0.7
ROE (%)	20.2	14.8	15.2	15.5
ROA (%)	3.0	2.3	2.3	2.3

One year Price Chart


Shareholding Pattern	Dec-17	Sep-17	Chg.
Promoters (%)	58.3	58.9	(0.6)
Public (%)	41.7	41.1	0.6

Rural Electrification Corporation Ltd. (REC) is one of the leading public Infrastructure Finance Company in India.

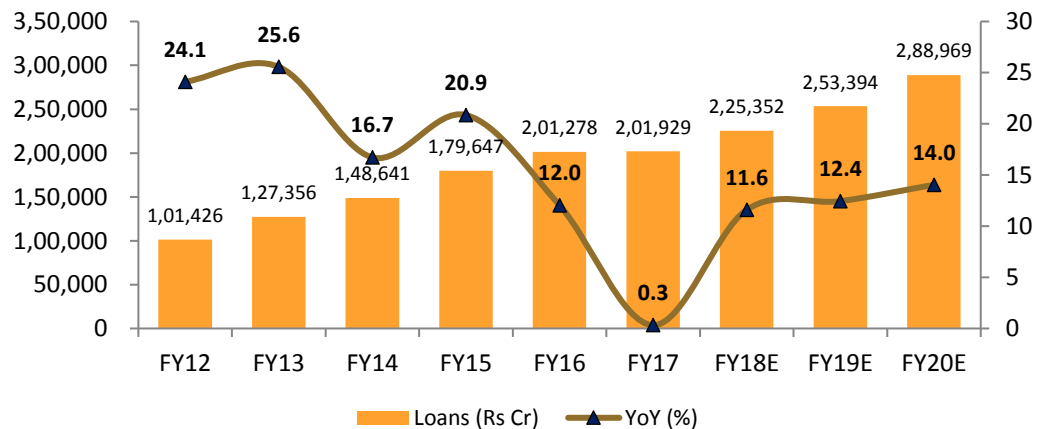
Rural Electrification Corporation Limited (REC) - Company Overview

Rural Electrification Corporation Ltd. (REC) is one of the leading public Infrastructure Finance Company in India with a network of 18 project offices including 5 Zonal and 3 sub offices along with 1 Training centre. REC's business model spans across the value chain of power infrastructure financing along with consultancy and advisory for power distribution and transmission projects catering to large and marquee state run power generation and transmission-distribution companies.

Business growth momentum to sustain on the back of generation and renewable segments

REC has grown its loan book at a healthy pace of 15% CAGR over FY12-17. Segmental mix has broadly remained unchanged over the years with transmission & distribution segment contribution remaining at 50.8% as of FY17 (49.2% in FY12). Based on borrower profile, exposure to private sector generation has grown at a rapid pace of 25.4% CAGR over FY12-17 growing to 16.5% of total exposure in FY17 as compared to 10.5% in FY12. State PSUs form 75.3% of outstanding loans as of FY17 while joint contributes remaining 8.3%.

Loan book to grow at a CAGR of 12% over FY17-20E



Source: Company, In-house research

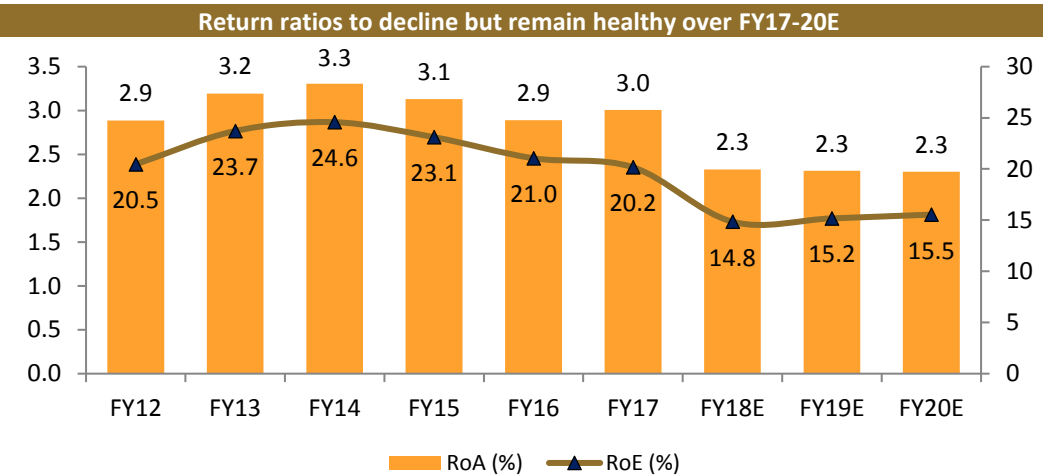
In Q3FY18, loan book grew at 11% YoY led by power generation sector (46% of total loans) which grew at a similar pace in Q3FY18. While loans to Joint sector (9% of total loans) and state sector (77% of total loans) grew by 22% YoY and 12% YoY, respectively, loans to private sector grew at a meagre pace of 1% YoY as the company continues to remain cautious given the higher stress in the sector. Sanctions and disbursements increased by a robust pace of 124% YoY and 25% YoY on the back of 340% YoY and 32% YoY growth in the generation sector, respectively. However, T&D sector's sanctions and disbursements declined by 5% YoY and 28% YoY, respectively. Going forward, we expect RECL's loan book to grow at a healthy CAGR of 12% over FY17-20E mainly led by higher growth in generation and renewable sectors.

Net interest margin (NIM) to stabilize from hereon

REC steadily maintained its NIM above 4.5% over the last five years on the back of access of low cost of funds along with healthy spreads supported by low competition from banks. However, NIM remain suppressed and declined to 3.8% in 9MFY18 owing to higher interest reversals along with repayments of high yield SEB loans. Besides, the rising competition from the banks also dented margin. However, we expect NIM has bottomed out and to stabilize from hereon and hover around current levels over FY17-20E.

Return ratios to decline but remain competitive

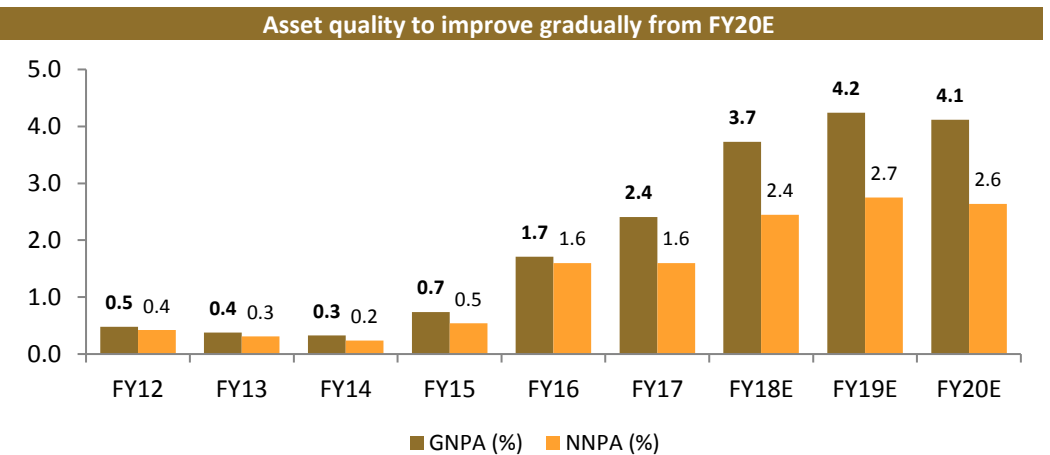
REC used to enjoy ~20%+ RoE and ~3%+ RoA over FY12-17 on account of healthy loan growth, higher operating efficiency and lower credit cost. As a result, the company reported 17.3% CAGR in net profit over FY12-17. However, with compression in NIM along with increase in credit cost, REC's RoE declined to 14.5% and RoA declined to 2.3% in 9MFY18. Going forward, we expect RoE and RoA to remain around 15% and 2.3%, respectively over FY17-20E which is competitive as compared to industry average of Banks and NBFCs.



Source: Company, In-house research

Asset quality overhang to continue

Asset quality deteriorated significantly as Gross/Net non-performing asset (NPA) ratio increased by 45/37 bps QoQ to 3.0%/2.0% in Q3FY18 mainly led by slippages of Lanco Anpara where it has exposure of ~Rs1,250cr. However, gross restructured assets declined by 9% QoQ following upgrade in public sector unit (PSU). As per management, some more PSU restructured accounts are likely to get upgraded in future. However, given stress in the power sector and the uncertainty surrounding private restructured assets (Rs12,644cr), we expect the asset quality issues to continue over near to medium term and the company's Gross/Net NPA ratios to increase significantly to 4.2%/2.7% by FY19E.



Source: Company, In-house research

Adequately capitalized for future growth

REC would not be required to raise equity capital to deliver the aforesaid asset growth given the company's high capital adequacy ratio (CAR) of 21.2% (Tier-1 ratio at 18.6%) currently along with RoE much higher than asset growth.

Outlook and Valuation

REC's profitability will continue to remain under pressure over FY17-20E as provisions are likely to remain high given the increasing stress in power sector and high level of private restructured loan book (~5.6% of loans). However, the attractive dividend yield of ~7.5% will restrict any further fall in the stock price. Notably, REC consistently rewards its shareholders with healthy dividend, showing that the company is investor friendly. Further, REC is diversifying its portfolio toward renewable projects. We believe this enhances the company's potential to expand its loan book. With the gap between sanctions and disbursements widening, we believe that REC has substantial room to increase advances, even without fresh sanctions. Hence, we recommend BUY rating on the stock with a target price (TP) of Rs146 (P/ABV of 0.8x for FY20E).

Key Risks:

- REC's growth depends on its ability to remain effectively competitive in the power financing space and to pass the higher cost of funds to customers.
- Given the higher restructured loan book (~8.9% of total loans), any major slippage or ineffective recoveries can raise NPAs significantly, adversely affecting profitability and growth.
- REC is subject to risk arising from asset-liability mismatch as majority of its loans are long-term in nature due to wholesale financing of large power projects, whereas its borrowings are relatively for shorter term.
- REC is exposed to project-specific and general risks inherent to the power sector. Any delay in the power sector projects due to lack of fuel supplies, supply of key equipment or delay in getting environment clearances can adversely affect the profitability of power projects, increasing the company's NPAs.

Profit & Loss Account (Standalone)

Y/E (Rs. Cr)	FY17A	FY18E	FY19E	FY20E
Interest Income	22,936	22,169	24,839	28,139
Interest Expense	13,775	13,856	15,551	17,646
Net Interest Income	9,160	8,313	9,287	10,493
Non Interest Income	1,160	743	832	943
Net Income	10,320	9,055	10,119	11,436
Operating Expenses	352	326	339	352
Total Income	24,095	22,911	25,671	29,082
Total Expenditure	14,127	14,182	15,891	17,998
Pre Provisioning Profit	9,969	8,729	9,780	11,084
Provisions	1,109	1,175	1,376	1,627
Profit Before Tax	8,859	7,554	8,404	9,457
Tax	2,615	2,400	2,670	3,004
Net Profit	6,244	5,154	5,734	6,453

Balance Sheet (Standalone)

Y/E (Rs. Cr)	FY17A	FY18E	FY19E	FY20E
Liabilities				
Capital	1,975	1,975	1,975	1,975
Reserves and Surplus	31,351	34,134	37,497	41,578
Borrowings	167,517	187,268	210,570	240,133
Provisions	2,043	2,366	2,661	3,034
Other Liabilities	6,351	7,887	9,502	11,559
Total Liabilities	209,236	233,630	262,204	298,279
Assets				
Fixed Assets	181	219	264	319
Investments	2,696	2,254	2,534	2,890
Advances	200,373	224,901	252,887	288,391
Other Assets	1,496	4,056	4,561	5,201
Cash and Bank Balances	4,490	2,200	1,959	1,478
Total Assets	209,236	233,630	262,204	298,279

Key Ratios (Standalone)

Y/E	FY17A	FY18E	FY19E	FY20E
Per share data (Rs.)				
EPS	31.6	26.1	29.0	32.7
DPS	9.7	10.0	10.0	10.0
BV	168.7	182.8	199.9	220.5
ABV	152.4	154.9	164.6	182.0
Valuation (%)				
P/E	4.1	4.9	4.4	3.9
P/BV	0.8	0.7	0.6	0.6
P/ABV	0.8	0.8	0.8	0.7
Div. Yield	7.5	7.8	7.8	7.8
Capital (%)				
CAR	21.2	20.7	20.3	19.9
Tier I	18.4	18.0	17.6	17.1
Tier II	2.8	2.8	2.8	2.8
Asset (%)				
GNPA	2.4	3.7	4.2	4.1
NNPA	1.6	2.4	2.7	2.6
PCR	33.6	34.4	35.2	36.0
Management (%)				
Credit/ Deposit	5.0	5.2	5.4	5.6
Cost/ Income	3.4	3.6	3.4	3.1
Earnings (%)				
NIM	4.5	3.9	3.9	3.9
ROE	20.2	14.8	15.2	15.5
ROA	3.0	2.3	2.3	2.3

Rating Criteria

Large Cap.	Return	Mid/Small Cap.	Return
Buy	More than equal to 10%	Buy	More than equal to 15%
Hold	Upside or downside is less than 10%	Accumulate*	Upside between 10% & 15%
Reduce	Less than equal to -10%	Hold	Between 0% & 10%
		Reduce/sell	Less than 0%

* To satisfy regulatory requirements, we attribute 'Accumulate' as Buy and 'Reduce' as Sell.

* RECL is a large-cap stock.

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