

Rural Electrification Corporation Ltd.

Price Band	: Rs90 - 105 per share	February 19, 2008
Issue open between	: February 19 - 22, 2008	
Recommendation	: Subscribe with a medium term view	
Book Running Lead Managers	: IL&FS Investsmart, I-Sec, SBI Caps	
Grading (Crisil)	: 3 / 5	
To List on	: NSE & BSE	
Market Cap post-listing	: Rs90.16Bn or \$2.26Bn (based on the cap price)	

IPO of 156mn equity shares of Rs10 each, comprising of fresh issue of 78mn shares (Rs819Cr) and offer for sale of 78mn equity shares by GOI (Rs819Cr), aggregating to Rs16.38Bn or \$42Cr (at the cap price)

Shareholding Pattern

Shareholder Categories	Pre-issue		Post-issue	
	No. of shares	% Holding	No. of shares	% Holding
Government of India (GOI)	780,600,000	100.0%	702,540,000	81.8%
QIBs excluding Mutual funds	0	0.0%	86,763,690	10.1%
Mutual funds	0	0.0%	4,566,510	0.5%
Non-Institutional Investors	0	0.0%	15,221,700	1.8%
Employees	0	0.0%	3,903,000	0.5%
Public	0	0.0%	45,665,100	5.3%
Total	780,600,000	100.0%	858,660,000	100.0%

Recommendation - Subscribe with a medium term view

- REC is a leading power sector focused, public financial institution and NBFC. It finances power projects in power generation, transmission and distribution, throughout India.
- It has been designated as the nodal agency by the Government of India (GOI) for Rajiv Gandhi Gramin Viduytikaran Yojana (RGGVY).
- Loan disbursements grew at a CAGR of 78.3% during FY04-07. The transmission and distribution (T&D) sector accounted for 85% of disbursements. Public sector lending formed 97% of overall lending in FY07.
- NIM stood at 3.8% in H1-FY08. REC's role as an instrument of government policy results in low cost of borrowings.
- The 11th Plan envisages power demand of 78,577MW, with funds requirement of Rs10,316bn. This will translate into huge need of funds for investment in the power sector. Being the leading and exclusive provider of power finance in the country, REC expects to fund approx. 20% of the aggregate funds requirement.
- Comparison with closest peer PFC reveals the following
 - Both exclusively fund the power sector
 - NPAs for REC is 1.9% which is higher vis-à-vis 0.06% for PFC
 - Debt-equity ratio of 7.3x, vis-à-vis 3.4x for PFC. (maximum permissible 12x)
 - Average cost of funds for REC is 6.5% vis-à-vis 7.3% for PFC
- We believe there is scope for value creation / unlocking going forward, through recently set up, wholly-owned subsidiaries in transmission and distribution, which would undertake more profitable businesses. REC Power Distribution Co. Ltd., which provides consultancy services, recently won a Rs12.5Cr order from Punjab State Electricity Board (PSEB) for consultancy work. As per media reports, REC is also likely to acquire a 5% stake in Indian Energy Exchange, which is proposed to be launched soon.
- The IPO is reasonably priced at p/b of 1.7x FY08E, 1.4x FY09E and 1.1x FY10E vis-à-vis PFC (p/b of 2.3x FY08E, 2.0x FY09E and 1.1x FY10E). It is attractively priced at p/e of 9.8x FY08E, 7.5x FY09E and 6.1x FY10E compared to its peers PFC and leading lending institution IDFC (refer valuation table on page 7). We recommend subscribing with a medium term view.

Company Background

Promoted by GOI, REC was incorporated in 1969 and registered as a NBFC in 1998. The main objective is to finance rural electrification projects in India. As a PSU, it has been accorded Mini Ratna Grade-I status, with greater operational freedom and autonomy in decision-making.

REC has been playing a much larger role, beyond just village electrification. It provides technological and financial support to all the three sectors: generation, transmission and distribution, with emphasis on rural electrification. Since inception, REC has funded many transmission and distribution schemes across the country's districts and towns.

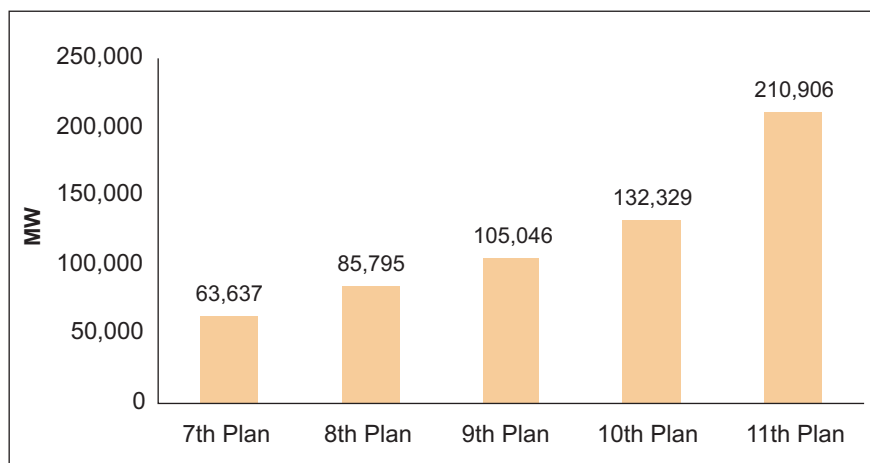
Management

Mr. Anil Lakhina is the Chairman and MD. The board has independent directors viz., Venugopal Dhoot, P.R. Balasubramanian, Dr. M. Govinda Rao and Dr. Devi Singh.

Power financing Industry

Indian power industry has been characterized by energy shortages.

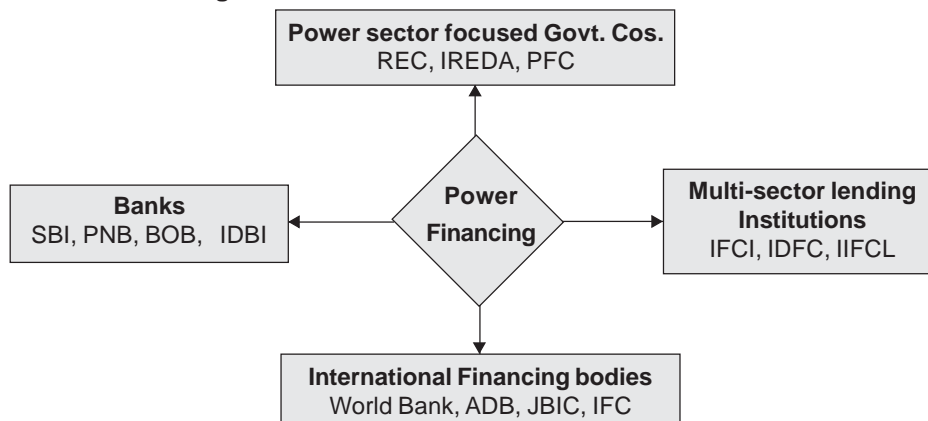
Installed Capacity in Power sector



As per GOI's mission of "power for all by 2012", India's installed generation capacity should be 210,906MW by end of its 11th five-year plan in 2012. Addition of 78,577 MW will be made in the 11th plan. Of this, around 39,500 MW is to be added by the Centre, while 10,700 MW is expected to come from private players. This will result in huge requirement of funds for investment in power sector.

Being the leading and exclusive provider of power finance in the country and having well-developed client base with healthy asset quality, REC is well placed to address this.

Institutions funding Power sector



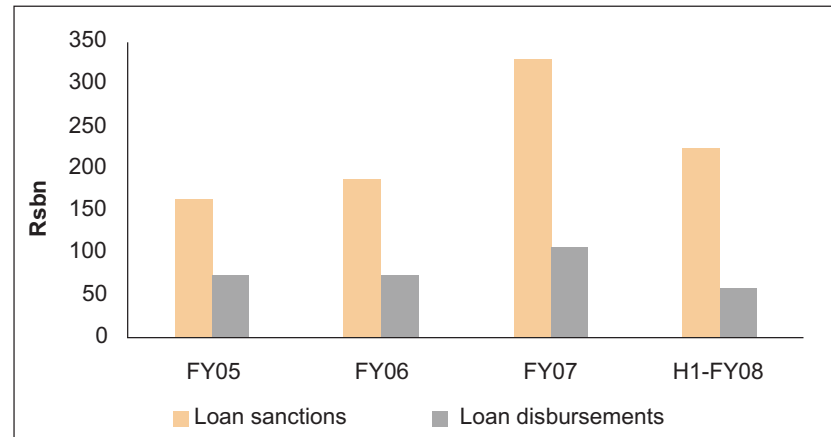
Government Initiatives

- National Electricity Policy 2012
- Electricity Act 2003
- Rajiv Gandhi Gramin Vidyutikaran Yojana (RGGVY)
- Competitive Bidding (Price mechanism has come in place)

Business Model

REC borrows funds from domestic as well as international sources and makes disbursements towards financing power projects in transmission, distribution and generation.

Loans Sanctions & Disbursements



Funding

Power generation projects

It finances all types of power generation projects like Thermal, Hydel, Renewable Energy, etc without limit on size or location. The tenure of loans for generation projects varies from 10 to 15 years. Till date, it has yet not financed Renewable energy.

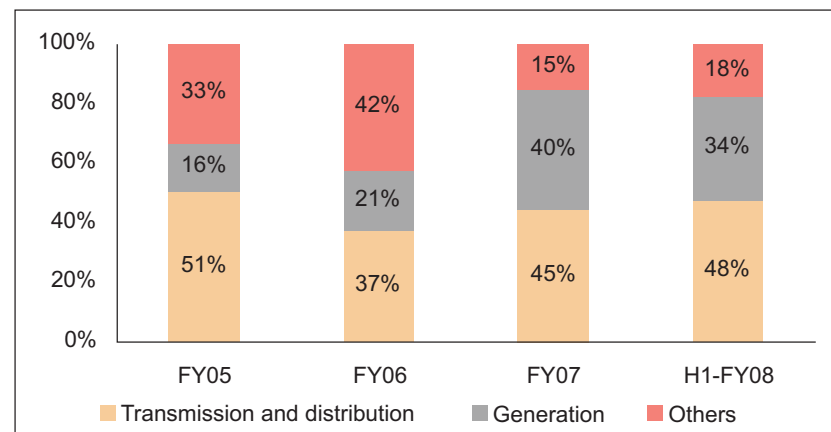
Transmission projects

These relate to transmission of electricity at higher voltages over relatively long distances, from generation facilities to sub-stations or between sub-stations. REC finances projects related to transmission systems, sub-transmission systems, power evacuation lines and transmission links.

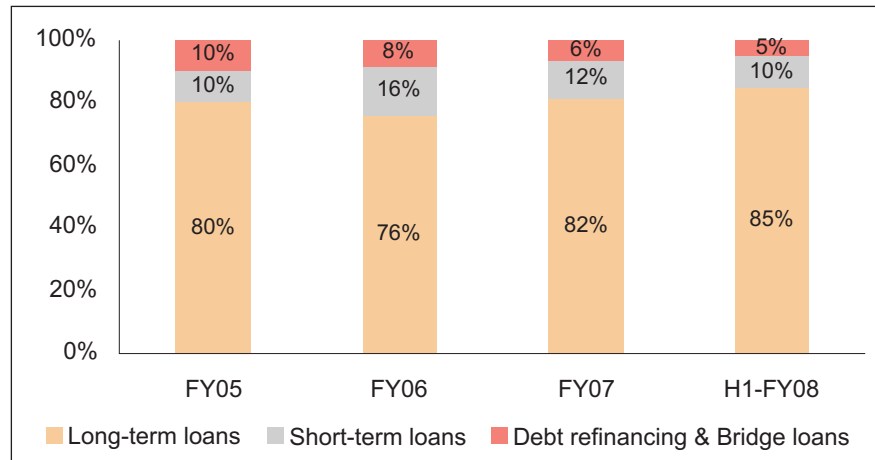
Distribution projects

These relate to distribution of electricity at lower voltages over shorter distances, from sub-stations to end-users or between sub-stations. REC creates infrastructure through erection of new sub-stations and lines and improvement of existing distribution systems by upgrading existing sub-stations and lines to increase capacity and reduce losses. It also funds pump set energisation projects.

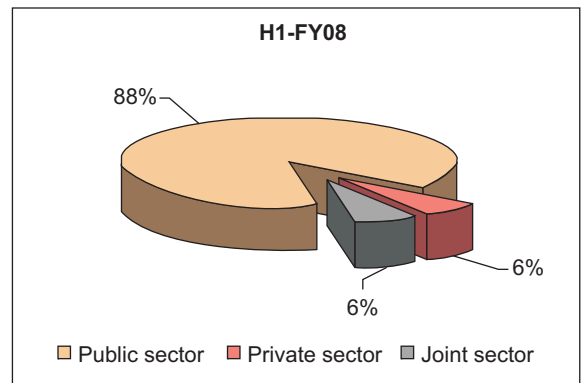
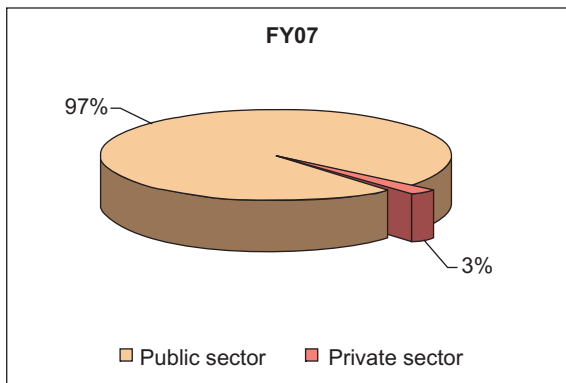
Break-up of Loan Disbursements



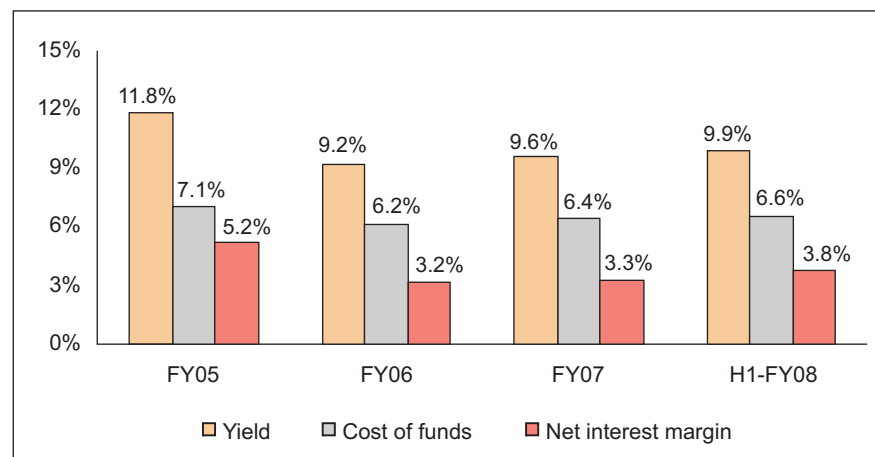
Break-up of disbursements by financial products



Loan Disbursements to private sector on the rise...



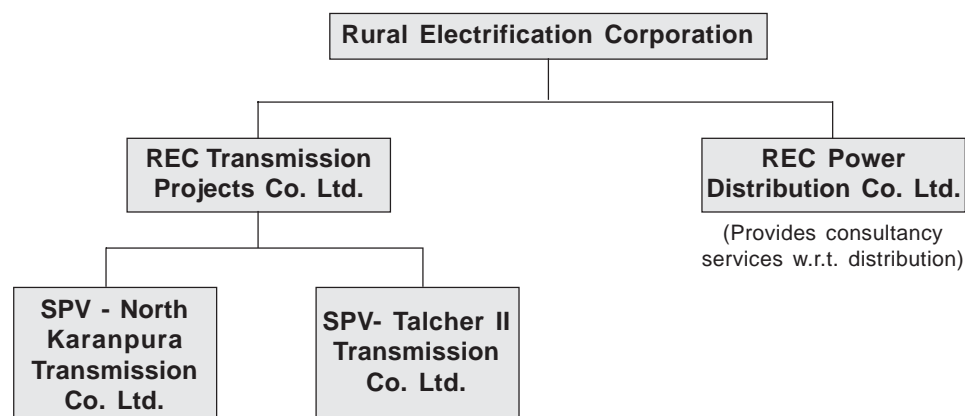
Important Ratios



Client Portfolio (Sept.30, 2008)

Name of Borrower	% total outstanding loans
Punjab State Electricity Board	9.0%
Maharashtra State Electricity Distribution Company Ltd.	7.8%
Andhra Pradesh Transmission Co.	7.6%
Tamil Nadu State Electricity Board	7.1%
Tehri Hydro Electric Development Corp.	4.8%
Andhra Pradesh Power Generation Corp. Ltd.	3.6%
Uttar Pradesh Power Corp. Ltd.	3.5%
Chhattisgarh State Electricity Board	3.4%
Maharashtra State Electricity Transmission Corp. Ltd.	3.0%
Jodhpur Vidyut Vitran Nigam Ltd.	2.9%
Total	52.7%

Subsidiaries and SPVs



REC Transmission Project Co. Ltd.

In fiscal 2007, the Government of India initiated a scheme that involved inviting private sector investment in major transmission projects. The scheme entailed private developers eventually becoming transmission service providers on a 'Build, Own and Operate' basis. Till date, 14 projects have been identified under this scheme. REC has been appointed nodal agency for two of the projects identified: the North Karanpura Transmission Project and the Talcher Augmentation System Transmission Project. As a result, REC Transmission Projects Co. Ltd. has commenced operations.

Subsidiaries of transmission are incorporated for competitive bidding in transmission services sector. SPV are created for the projects in which it is the nodal agency.

REC Power Distribution Co. Ltd.

This subsidiary will provide consultancy services with respect to distribution systems. The aim is to capitalize on the private sector demand for REC's specialized knowledge.

Competitive Strengths

- **Government backing**
Because a government promoted company, it can avail direct and indirect benefits including tax concessions for bonds.
- **Strong financial background**
- **Good credit rating**
Highest domestic credit rating for long-term borrowings from domestic and

international credit agencies

- **Well-developed client base**

Clients include public sector power utilities at central and state levels and private sector power utilities. Additionally, it funds power projects for joint sector clients.

- **Lower cost of funds**

REC is eligible for benefits under Sec 54EC, enabling access to lower cost funding and foreign currency loans from bi-lateral and multi-lateral agencies viz. Japan Bank for International Cooperation. The average cost of funds was 6.6% for H1-FY08, which is favourable compared to its peers.

Objects of IPO

To augment capital base to meet future capital requirements

Means of Finance

The objects of the issue will be funded from the IPO proceeds. Shortfalls, if any, shall be met through internal accruals.

Growth strategies

To capitalize on increased investment in Indian power sector

REC's growth is driven by substantial investment in the power sector in India. The Gol's 11th plan anticipates substantially increasing India's power capacity by year 2012. It is estimated that implementation of the Gol's power sector plans will require overall funds of Rs10,316bn for investment in transmission, distribution and generation. REC proposes to fund approx. 20% of this entire amount.

To diversify asset portfolio

Diversification will be brought about by financing new business areas viz., renewable energy.

To increase private sector participation as well as consortium lending in Indian power industry

To enter equipment financing business

Investment Concerns

- Any change in the Government and / or political instability could affect economic conditions in the country and the sector too.
- India's inability to achieve the targets of capacity addition would lead to reduced financing opportunities. During the 10th plan, capacity added was 21,110 MW, which was just 51.7% of the targeted 41,110 MW.
- Being a power financing institution, any negative trends in the power sector could adversely affect its business operations.
- Any volatility in interest rates will have adverse impact on business operations.
- If there is withdrawal of the benefit of Sec. 54EC of the Income Tax Act, it would increase the cost of funds leading to a hit on NIM.
- Top 10 borrowers accounted for 52.7% of total outstanding loans. Any negative trends or financial difficulties particularly among large borrowers could increase the level of NPAs.
- It has reported negative cash flows from operations since FY03.

Keynote Capitals's estimates

(RsCr)

Particulars	FY08	FY09	FY10
Operating Income	3,577.66	4,823.76	6,210.12
Net Profit	919.14	1,194.89	1,489.86
EPS(Rs)	10.70	13.92	17.35
P/e (x)	9.8	7.5	6.1
P/b (x)	1.7	1.4	1.1

Valuation table

	PFC	REC*	IDFC
EPS FY08E (Rs)	11.11	10.70	5.86
EPS FY09E (Rs)	13.52	13.92	7.81
EPS FY10E (Rs)	16.14	17.35	10.19
P/e FY08E (x)	16.9	9.8	33.9
P/e FY09E (x)	13.9	7.5	25.4
P/e FY10E (x)	11.6	6.1	19.5
P/b FY08E (x)	2.3	1.7	4.6
P/b FY09E (x)	2.0	1.4	4.0
P/b FY10E (x)	1.1	1.1	3.4

Source: Keynote* and Bloomberg estimates

REC vis-à-vis PFC

Key Data

	PFC	REC
Incorporation Year	1986	1969
Business	i) Financing power generation, transmission and distribution ii) consultancy services.	i) Financing power generation, transmission and distribution ii) advisory & consultancy services.
Sanctions (RsCr)	31,146	32,925
Disbursements (RsCr)	14,055	10,733
Loan Assets (RsCr)	43,903	35,990

Comparison of Key Financial Ratios

	PFC	REC
Yield of advances	9.3%	9.9%
Cost of funds	7.3%	6.6%
Spread	1.9%	3.3%
NIM	3.5%	3.8%
CAR	18.3%	N.A.
Net NPA	0.06%	0.67%
Debt-Equity Ratio	3.4	7.3

PFC numbers as of FY07 and REC numbers as on H1-FY08

Peer comparison

(RsCr)

Parameter	PFC	REC	IDFC
Operating Income	4796.27	2,651.70	2254.22
Net Profit	1279.66	775.03	631.01
Paid-up-Equity capital	1148	859#	1294
Price (19 Feb 08)	188	105	199
Market Cap	21578	9016	25692
EPS (Rs)	11.15	9.03	4.88
Book Value (Rs)	85.6	56.47	38.52
P/B (x)	2.2	1.9	5.2
P/E (x)	16.9	11.6	40.7
P/S (x)	4.5	3.4	11.4
52 week High (Rs)	297	-	235
52 week Low (Rs)	101	-	74
FVPS (Rs)	10	10	10

post-issue capital

Profit & Loss Statements**(RsCr)**

For period ending	31.3.2005	31.3.2006	31.3.2007	30.09.2007
Interest Income	2,189.27	2,058.36	2,651.70	1,561.28
Profit on Sale of Assets	0.00	0.00	0.04	0.00
Other income	1,466.67	391.46	281.10	230.46
Total Income	3,655.95	2,449.81	2,932.84	1,791.74
Expenditure				
Interest expense	1,205.95	1,340.33	1,715.50	964.97
Establishment Exps	33.94	35.40	50.09	32.03
Administrative Exps	11.50	12.05	14.38	8.89
Loss on Sale of assets	0.02	0.00	0.00	0.00
Resource mobilization Exps	15.20	16.64	22.06	4.32
Prov. for debts	0.00	0.00	21.05	38.07
Depreciation	1.15	1.10	1.13	0.69
Prov. for Decline in value of invst.	0.33	0.51	0.00	0.00
Total expenditure	1,268.08	1,406.04	1,824.21	1,048.96
Operating Profit	2,387.86	1,043.78	1,108.63	742.78
Current Year	232.70	169.98	215.21	166.67
Earlier Years	12.81	0.00	0.00	0.00
Deferred Tax	128.62	75.27	116.27	53.02
Fringe Benefit Tax	0.00	0.75	0.67	0.22
Profit after tax before EO	2,013.73	797.78	776.47	522.87
EO	8.12	10.15	-1.44	0.00
Profit after tax after EO	2,021.86	807.92	775.03	522.87
EPS (Rs)	25.90	10.35	9.93	6.70
Book value (Rs)	35.29	42.21	49.81	56.47
OPM	65.3%	42.6%	37.8%	41.5%

Balance Sheets**(RsCr)**

As at,	31.3.2005	31.3.2006	31.3.2007	30.09.2007
Sources of Funds				
Paid-up Equity Share Capital	780.60	780.60	780.60	780.60
Reserves & surplus	1829.97	2342.68	2902.1	3395.69
Reserve for Bad Debts	144.19	171.69	205.69	231.62
Total Shareholders funds	2,754.76	3,294.97	3,888.41	4,407.90
Secured Loans	17449.38	21749.59	26533.97	27559.16
Unsecured Loans	1929.01	2289.63	3745.20	4414.94
Total Debt	19,378.40	24,039.21	30,279.17	31,974.10
Total Liabilities	22,133.15	27,334.18	34,167.58	36,382.01
Applications of Funds				
Gross Block	34.18	34.81	67.55	82.16
Depreciation	10.04	11.06	12.19	12.88
Net Block	24.15	23.76	55.37	69.29
Capital Work in Progress	1.41	40.64	8.26	8.29
Investments	1416.89	1324.99	1194.54	1196.63
Loans	21249.45	25110.80	31974.45	35989.65
Curr. Assets, Loan & Adv.				
Cash and Bank Balances	485.45	1913.65	2297.27	755.39
Loans & Advances	798.16	997.37	236.49	390.88
Other Current Assets	294.99	305.67	312.36	313.42
Total Current Assets	1,578.61	3,216.69	2,846.12	1,459.69
Current Liabilities	554.94	616.721	714.45	919.93
Provisions	1032.88	1127.19	457.06	628.90
Net Current Assets	-9.21	1,472.77	1,674.61	-89.15
Deferred Tax Liability	549.53	638.77	739.65	792.69
Total Assets	22,133.15	27,334.18	34,167.58	36,382.01

Keynote Capitals Ltd.

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Ratings structure

Subscribe & Hold	:	subscribe for listing gains, hold for further appreciation
Subscribe for listing gains	:	expect decent appreciation on listing
Subscribe with a medium term view	:	stock can deliver only over 6-8 months after listing
Subscribe with a long term view	:	value can only be realised over 12-18 months
Await listing	:	good fundamentals; consider valuations on listing

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