Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

CESC Limited

Gradually powering up

Power	Sharekhan code: CESC	Company Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 605**	
Price Target: **Rs. 825**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

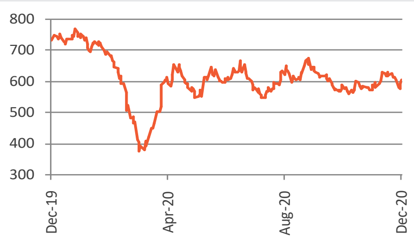
Company details

Market cap:	Rs. 7,564 cr
52-week high/low:	Rs. 784/366
NSE volume: (No of shares)	3.2 lakh
BSE code:	500084
NSE code:	CESC
Free float: (No of shares)	6.6 cr

Shareholding (%)

Promoters	50
FII	16
DII	26
Others	8

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	4	-4	-1	-17
Relative to Sensex	-4	-30	-36	-31

Sharekhan Research, Bloomberg

Summary

- CESC's management indicated that power demand in Kolkata (key area of operation) has normalised and impact of COVID-19 (lower PLF-related incentive) has passed; company has guided for 9% y-o-y growth in PAT in H2FY21.
- Turnaround of Dhariwal Infrastructure (guided for PAT of Rs. 75-80 crore for FY21 versus loss of Rs. 10 crore in FY20) to sustain as PLF of Chandrapur plant has improved. Rajasthan DF losses would reduce in FY21 and is expected to turn profitable by FY22. Consistent improvement in performance of subsidiaries would aid gradual re-rating of CESC.
- Concerns of higher receivables (at Rs. 2,000 crore as of September versus normal levels of Rs. 1,200 crore) to recede by Q4FY2021 as the company is receiving regular payment from customers (Rs. 125 crore/month since September).
- A regulated business model provides earnings visibility and valuation is also attractive at 0.7x FY2023E P/BV besides a healthy dividend yield of 3-4%. Hence, we maintain a Buy on CESC with an unchanged SoTP-based PT of Rs. 825.

We interacted with CESC's management to get an update on its business outlook. The management seems optimistic of recovery in standalone earnings in H2FY2021 as power demand in Kolkata (key area of CESC's operations) has normalised to pre-COVID-19 levels and the management expects flat to marginal y-o-y growth in power sales volume in Q3FY2021 and decent growth in Q4FY2021 as compared to a 22% y-o-y decline in volumes in H1FY2021. The management has guided for a 10% y-o-y decline in its FY2021 standalone PAT to ~Rs. 826 crore, which translated into a decent 9% y-o-y growth in earnings in H2FY2021. Moreover, the approval for capex (Rs.1,000 crore done over FY2019-FY2020) by the regulator is pending since the last two years and any positive development on that front would add ~5% to normalised standalone PAT. The management also expects turnaround at Dhariwal Infrastructure (PAT of Rs. 47 crore in H1FY2021 versus loss of Rs. 49 crore) to sustain given considerable improvement in PLF for Chandrapur plant (due to short-term power supply contract) while Rajasthan DF seems on track to achieve turnaround by FY2022 (loss expected to reduce by Rs20 crore in FY2021 and guidance of Rs. 15-20 crore PAT in FY2022). Consistent improvement in performance of subsidiaries bodes well for improvement in the consolidated earnings over FY2022E-FY2023E and would lead to gradual re-rating of CESC. We like CESC's business model as regulated RoE provides earnings visibility and the company is available at attractive valuation of 0.7x FY2023E P/BV and offers healthy dividend yield of 3-4%. Hence, we maintain our Buy rating on CESC with an unchanged SoTP-based PT of Rs. 825.

Our Call

Valuation - Maintain Buy on CESC with an unchanged SoTP-based PT of Rs. 825: We see a scope for gradual re-rating in CESC, led by recovery in earnings from the standalone business, sustained profitable operations at Dhariwal Infrastructure and potential turnaround of Rajasthan distribution franchisee by FY2022. Moreover, concern of rise in receivable (at Rs. 2,000 crore as of September versus normal level of Rs1,200 crore) is expected to subside by Q4FY2021 as the company is receiving regulator payment (Rs125 crore/month since September) from customers. We like the business model of CESC as regulated RoE provides earnings visibility and valuation is also attractive at 0.7x FY2023E P/BV along with a healthy dividend yield of 3-4%. Hence, we maintain our Buy rating on CESC with an unchanged SoTP-based PT of Rs. 825.

Key Risks

Delay in signing of long-term PPA for the Chandrapur plant and sustained losses in the distribution franchisee for an extended period.

Valuation (Standalone) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenues	7,754	7,836	7,663	8,798	9,483
OPM (%)	17.5	18.3	18.8	18.8	18.5
PAT	937	918	822	1,042	1,192
% y-o-y growth	8.4	(2.0)	(10.5)	26.8	14.4
EPS (Rs.)	70.3	68.9	61.7	78.2	89.5
P/E (x)	8.6	8.8	9.8	7.7	6.8
Price/ Book (x)	0.8	0.8	0.8	0.7	0.7
EV/EBITDA (x)	8.7	8.3	7.6	6.1	5.2
RoCE (%)	8.3	8.0	6.9	8.4	8.5
RoE (%)	9.8	9.3	8.0	9.6	10.2

Source: Company; Sharekhan estimates

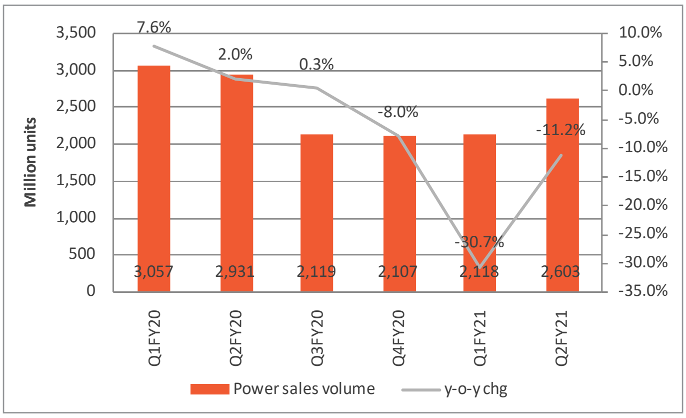
We interacted with the management of CESC. Following are the key takeaways.

Standalone Kolkata distribution business – improving power demand; expect earnings recovery in H2FY2021

The management has indicated that power demand in Kolkata has normalised and is now at pre-COVID-19 level as economic activities normalise. With this, management expect its power sales volumes to witness flat to marginal y-o-y growth in Q3FY2021 and decent growth in Q4FY2021 as compared to a 22% y-o-y decline in H1FY2021. The improvement in volumes would mean improvement in incentive bases income (PLF incentive income of Rs. 60-65 crore on quarterly basis).

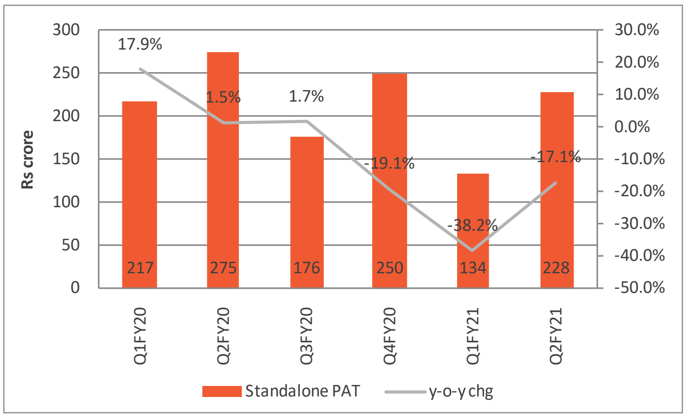
CESC has done capex of Rs. 1,000 crore over FY2019-FY2020 in its standalone business but the approval of the same is still pending from power regulator. Approval of the capex would result into an increase in regulated equity base by Rs. 300 crore (30% of capex as per tariff guidelines) as compared to regulated equity base of Rs4000 crore as of September 2020. Assuming regulated RoE of 16.5%, incremental regulated equity would add Rs. 50 crore to PAT (5% of normalized PAT). The management has guided for 10% y-o-y decline in FY2021 PAT to ~Rs. 826 crore, which implies a PAT growth of 9% y-o-y in H2FY2021 and expects normalized PAT in FY2022.

H1FY21 volume de-growth of 22% y-o-y



Source: Company, Sharekhan Research

PAT impacted by lower PLF incentive



Source: Company, Sharekhan Research

CESC's Kolkata distribution business is steady and earns regulated RoE of 16.5%

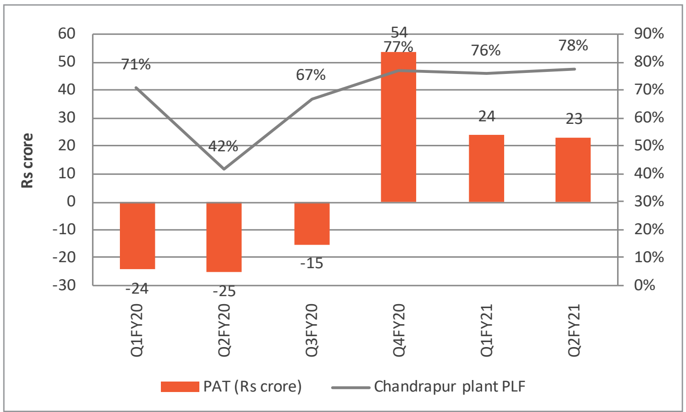
Regulated Business	**120+** years of experience	**Area:** **567** sq.km.	**21,000+** ckt km of network
Customer Base: **33** lakhs	**Peak power demand** **2,337** MW in FY20	**Units sold** **10,000** MUs	**Revenue** **>7,900** Cr
Tariff Rs. **7.31**/KWh	**Power Procurement:** CESC's Own Stations, Haldia TPP and others	**Assured post-tax equity return:** **16.5%** on normative equity approved by WBERC	**Distribution Loss:** T&D : <9% Collection Efficiency >99%

Source: Company

Dhariwal Infrastructure revived with H1FY21 PAT of Rs. 47 crore; full-year guidance of Rs. 75-80 crore versus loss of Rs. 10 crore in FY2020

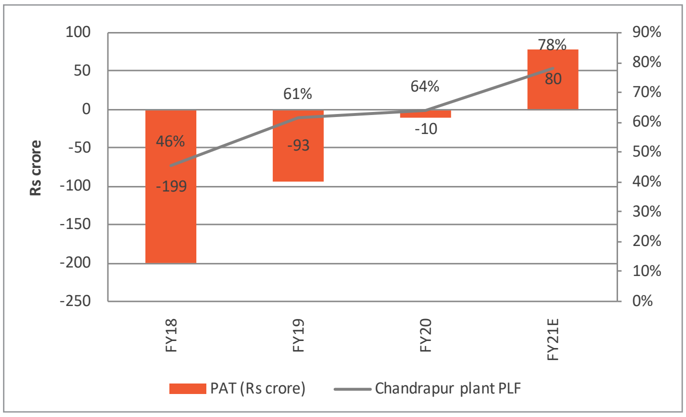
Dhariwal Infrastructure Ltd, a 100% subsidiary of CESC, has a 600 MW thermal power project in Chandrapur district, Maharashtra. The management has successfully turned around the subsidiary, clocking a PAT of Rs. 47 crore in H1FY2021 as compared to loss of Rs49 crore in H1FY2020 as the plant load factor (PLF) for Chandrapur plant has improved increased to 77.5% in Q2FY2021 versus 64% in FY2020. Dhariwal Infrastructure would continue to remain profitable over FY2021E-FY2023E given a firm contract for a 300 MW capacity and an improving outlook for short term power purchase agreements (which helps to cover fixed overheads). Any potential long- term power contract for remaining 300MW (tied for short-term contract) would mean higher earnings as it would start earning returns on regulated equity.

Consistently making profits over Q4FY20-Q2FY21



Source: Company, Sharekhan Research

Turnaround with FY21 PAT guidance of Rs75-80 cr



Source: Company, Sharekhan Research

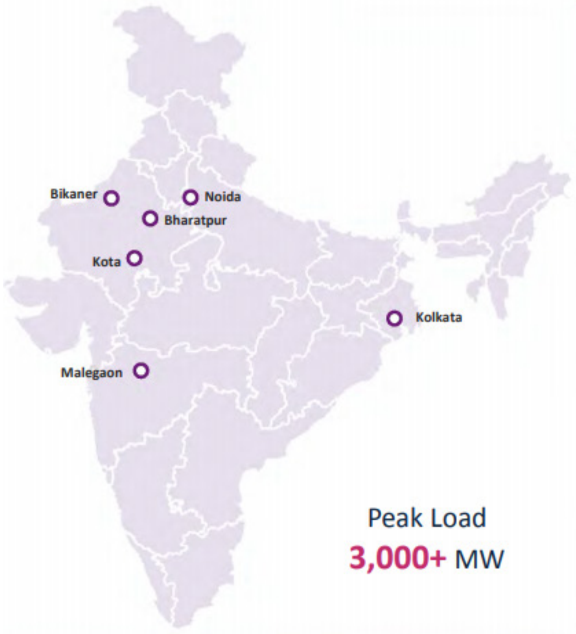
Distribution franchisee – moderating losses with reduction in T&D loss; Rajasthan DF expected to turn profitable in FY2022

Rajasthan distribution franchisee (DF) - CESC had won three distribution franchisees (DF) in Rajasthan including Kota (became operational in September 2016), Bharatpur (became operational in December 2016) and Bikaner (became operational in May 2017). The management has guided for reduction in loss for Rajasthan DF to Rs. 20 crore in FY2021 (versus a loss of Rs. 38 crore in FY2020) and expects the same to turn profitable in FY2022 with PAT of Rs. 15-20 crore. The management expects long term PAT potential (over next 3-5 years) of Rs100 crore from Rajasthan DF with volume growth and likely reduction in T&D loss by 300 bps from 17.5% currently. We highlight here that for every 100 bps improvement in T&D would add Rs16 crore to PAT for Rajasthan DF. We expect the Rajasthan DFs to create value in the next 2-3 years for CESC, given its strong track record to reduce T&D losses.

Malegaon distribution circle - The company has also won the Malegaon distribution circle (which has a T&D loss of 45%) for a concession period of 20 years. The company has guided for loss of Rs50-60 crore and Rs25 crore in FY2021 and FY2022 as the operations at Malegaon DF has recently started and expect a break in FY2023.

Noida Power Distribution - The management expects PAT from the Noida Power Distribution to normalise at Rs100 cr PAT in FY2021 versus Rs140 crore over last two years as regulated RoE has been reduced to 15% from 16% earlier by the regulator. With an annual capex plan of Rs. 150 crore, the company expects 10% annual growth in regulated equity (Rs400 crore currently), which would drive sustainable growth for Noida Power Distribution.

Overview of CESC's power distribution business



City/ Location	Kolkata	Noida	Rajasthan – (KOTA, Bharatpur, Bikaner)	Malegaon
Distribution Contract	Licensee	Licensee	Input based franchisee	Input based franchisee
Area	567 sq. km	335 sq. km	381 sq. km	25 sq. km
Consumer Base	33 lakhs	1 Lakh	5 lakhs	1 lakhs
Peak Load	2300+ MW	~400MW	500+ MW	~150 MW

Source: Company

CESC Rajasthan DF overview

Three wholly owned subsidiaries in the three cities–
- Kota Electricity Distribution Ltd
- Bharatpur Electricity Services Ltd and
- Bikaner Electricity Supply Limited

Particulars	Kota	Bharatpur	Bikaner
Area (Sq. Km.)	176	50	155
Population (Nos. Lakh)	11.76	2.52	6.44
Consumer Count (Nos. Lakh)	2.59	0.70	1.78
Energy Input (Million Units)	1277	282	798
Units Sold (Million Units)	1016	253	690
T&D Loss (%)	20.4	12.3	14.4
Revenue (INR Crores)	870	212	549
Peak Load (MW)	297	61	170
Avg. Billing Rate (INR/Unit)	8.32	8.24	7.70
DF Handover Date	01-Sep-2016	01-Dec-2016	16-May-2017

- DFA signed for a period of 20 years
- Power Purchase: JVVNL (Kota & Bharatpur), JdVVNL (Bikaner)
- Quickest ever takeover on compliance
- Current focus on commercial turn around

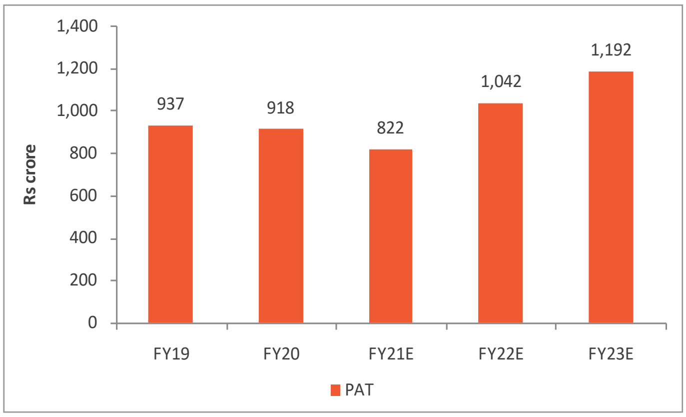
Source: Company

Receivables to normalise by Q4FY2021

The company's standalone receivables rose to Rs. 2,000 crore as of September 2020 from normal level of Rs. 1,000-1,200 crore due to delayed payment from customers amid COVID-19. Since September, the company has seen a reduction of Rs. 125 crore/month in receivables and expects it to normalize by Q4FY2021.

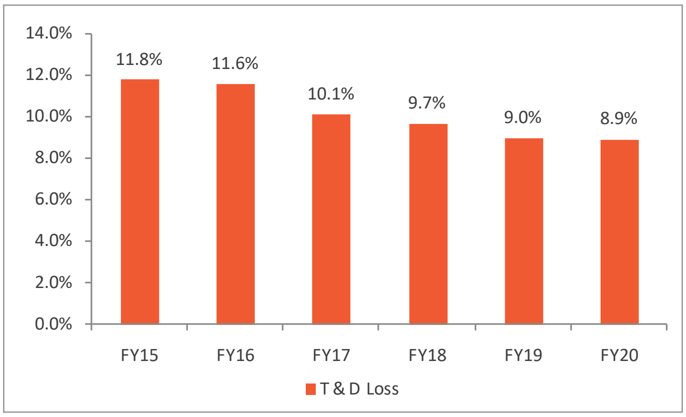
Financials in charts

Steady earnings contribution from standalone business



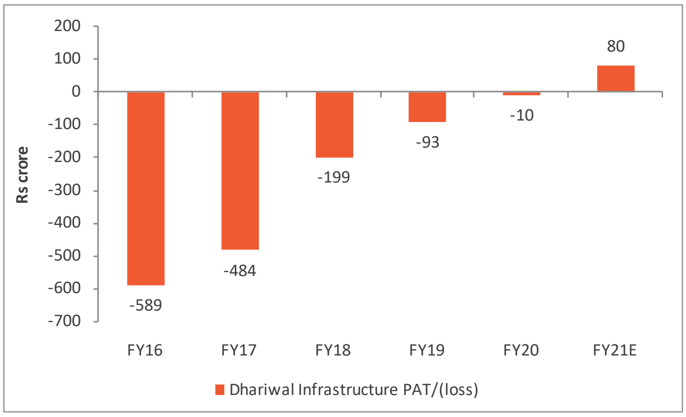
Source: Company, Sharekhan Research

Strong track record of reducing T&D loss



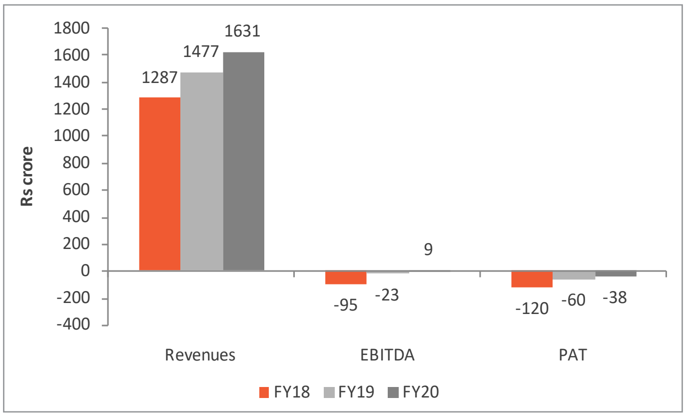
Source: Company, Sharekhan Research

Dhariwal Infrastructure started making profit in H1FY21



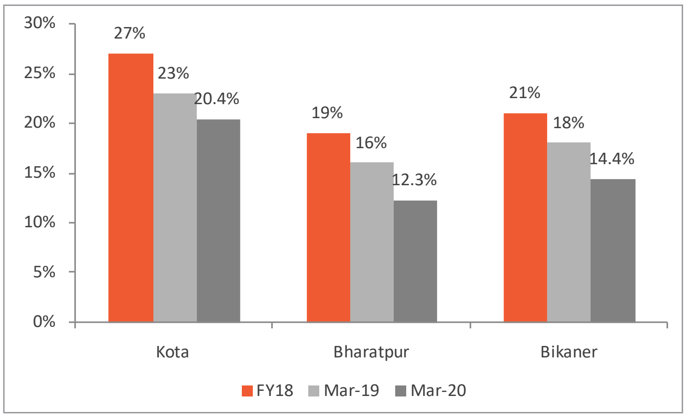
Source: Company, Sharekhan Research

Turnaround of Rajasthan DF underway



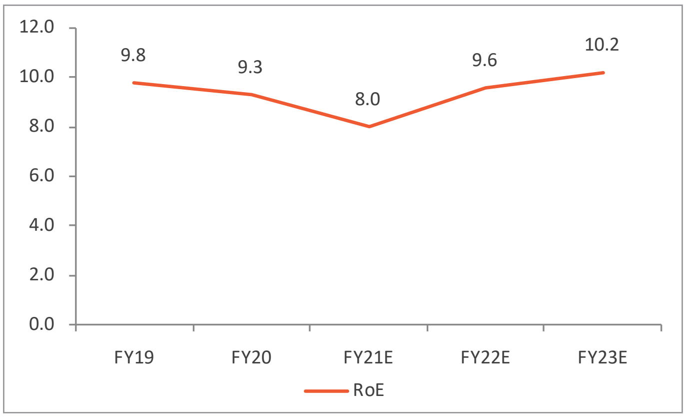
Source: Company, Sharekhan Research

Reducing T&D losses in Rajasthan DFs



Source: Company, Sharekhan Research

Improvement RoE trend over FY22E-FY23E



Source: Company, Sharekhan Research

Outlook and Valuation

■ **Sector view - Regulated tariff model provides earnings visibility for power generation companies**

India's power sector is regulated by CERC with availability-based earnings model (fixed RoE on power generation assets) and, thus, regulated tariff model provides strong earnings visibility for power-generation companies such as CESC. Moreover, power demand in India has recovered sharply to 5% y-o-y growth as compared to 26%/15% y-o-y decline in April/May 2020 due to the lockdown. Improved power demand would result in higher PLF for power-generation companies and improve PLF incentive income in H2FY2021. Additionally, receivables of power generation companies are likely to reduce in H2FY2021 as recovery in economic activities would result in timely receipt of dues from customers.

■ **Company outlook - Earnings to recover in H2FY2021; Turnaround of subsidiaries to improve consolidated earnings**

PLF has recovered to above 90% level and lockdown norms in Kolkata (key area of operations) have been relaxed, which has resulted into normal power demand with flat to marginal y-o-y growth in power sales volume of CESC. With improving power demand, we expect CESC's standalone earnings to recover fully in H2FY2021. Stable earnings from standalone operations, reduction of losses at distribution franchisee led by lower T&D losses, and higher utilisation at Dhariwal Infrastructure is expected to improve consolidated earnings of CESC over FY2022E-FY2023E.

■ **Valuation - Maintain Buy on CESC with unchanged SoTP-based PT of Rs. 825**

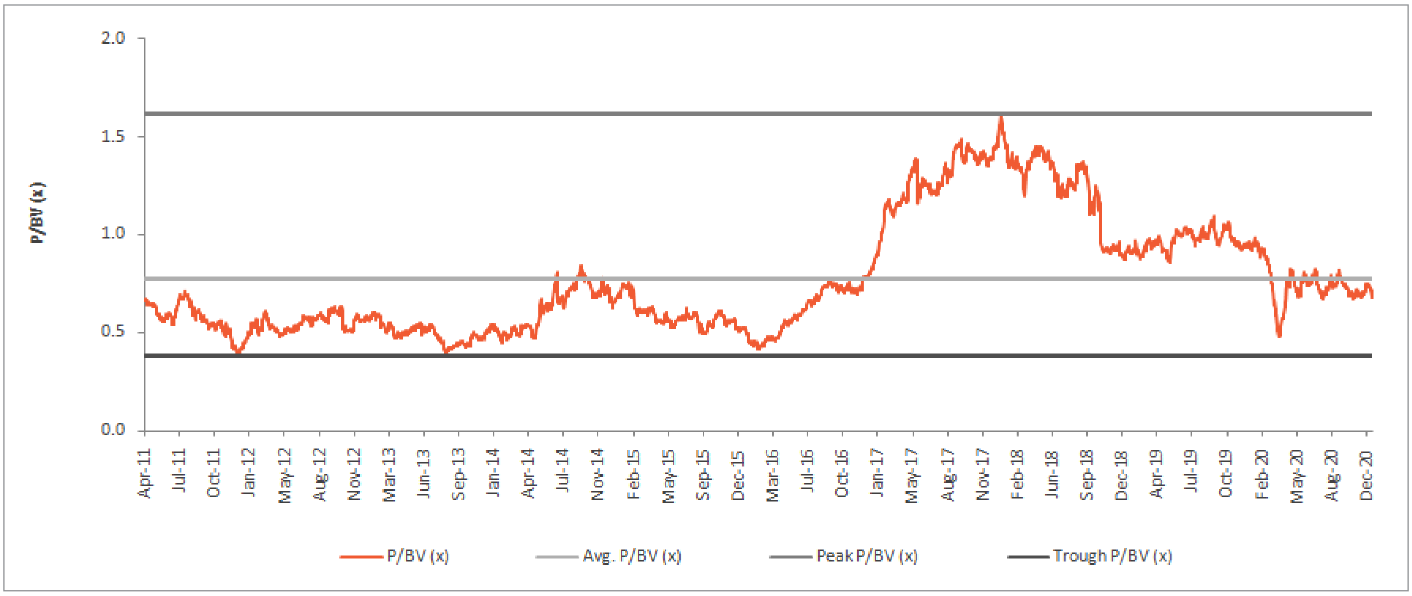
We see a scope for gradual re-rating in CESC, led by recovery in earnings from the standalone business, sustained profitable operations at Dhariwal Infrastructure and potential turnaround of Rajasthan distribution franchisee by FY2022. Moreover, concern of rise in receivable (at Rs. 2,000 crore as of September versus normal level of Rs1,200 crore) is expected to subside by Q4FY2021 as the company is receiving regulator payment (Rs125 crore/month since September) from customers. We like the business model of CESC as regulated RoE provides earnings visibility and valuation is also attractive at 0.7x FY2023E P/BV along with a healthy dividend yield of 3-4%. Hence, we maintain our Buy rating on CESC with an unchanged SoTP-based PT of Rs. 825.

SoTP-based PT of Rs. 825

Particulars	Value (Rs./share)	Methodology
Standalone business	550	7x FY22E EPS
Haldia	130	1.7x regulated equity of ~Rs. 1,150 crore
Dhariwal	75	1x regulated equity of ~Rs. 1,000 crore
Crescent Power	10	6.5x FY20 PAT for 67.8% stake
Noida	30	2.5x regulated equity of ~Rs400 crore for 49.6% stake
DF	30	1x Investments
Price target	**825**	

Source: Sharekhan Research

One-year forward P/BV (x) band



Source: Sharekhan Research

About company

CESC Limited started operations in 1899. The company is a fully integrated power utility company. The company is the sole distributor of electricity within an area of 567 sq. km of Kolkata and Howrah and serves 3.3 million consumers (including domestic, industrial, and commercial users). The company owns and operates three thermal power plants with generation capacity of 1,125 MW for its Kolkata distribution business. Additionally, CESC has independent power plants at Haldia (600 MW) and Chandrapur (600 MW) along with renewable energy (174 MW wind projects). CESC has distribution license within an area of 335 sq. km of Noida and serves 82,000 consumers. The company also has distribution franchisee in three cities of Rajasthan (Kota, Bikaner, and Bharatpur – all are operational) and one city in Maharashtra (Malegaon – operations expected to start soon).

Investment theme

CESC has stable earnings contribution from standalone operations with regulated power generation and distribution businesses getting assured RoE of 15.5% on generation assets and 16.5% for distribution assets. Reducing loss at Dhariwal Infrastructure and Rajasthan DF makes CESC an attractive investment proposition. CESC's valuation is also attractive.

Key Risks

- Delay in signing of long-term PPA for Chandrapur plant.
- Sustained losses in DF for an extended period.

Additional Data

Key management personnel

Sanjiv Goenka	Chairman
Rajarshi Banerjee	Chief Financial Officer
Rabi Chowdhury	Managing Director – Generation
Debasish Banerjee	Managing Director – Distribution

Source: Bloomberg, Company website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Co Ltd	9.0
2	Nippon Life India Asset Management	4.0
3	ICICI Prudential Asset Management	2.8
4	Sun Life Financial Inc	2.7
5	BNK Capital Markets Ltd	2.2
6	Life Insurance Corp of India	2.1
7	STEL Holdings Ltd	1.9
8	Franklin Resources Inc	1.8
9	Vanguard Group Inc/The	1.5
10	Emirate of Abu Dhabi United Arab	1.5

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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