

Rationale for CRISIL IPO Grading

(One time assessment)



Rural Electrification Corporation Limited (REC) CRISIL IPO Grade 3.0/5.0

Public Issue of 156,120,000 equity shares of face value Rs 10 targeted at an issue price of Rs 90 to Rs 105 per share

Bid/Offer Opens *

Bid/Offer Closes *

Shares Offered 156,120,000

As % of post issue Equity 18.18 per cent

Shares Outstanding (Post issue) 858,660,000

Lead Managers

IL&FS Investsmart securities limited, ICICI Securities Limited and SBI Capital Markets Limited

Registrar to the Issue

Karvy Computershare Private Limited

Background: Rural Electrification Corporation Limited (REC) is a non banking finance company, which does not accept deposits. REC is wholly-owned by the Government of India and operates under the administrative control of the Ministry of Power (MoP). The company was established in 1969 with the sole objective of financing rural electrification schemes in the country. It services its clients through a network of 17 project offices spread across India.

Highlights

Business prospects

- REC's business prospects benefit significantly from government support for its borrowing programme. This is a consequence of its developmental role in the government policy in the power sector, especially in non-urban areas.
- REC along with PFC is the largest lender to state government power utilities in India. REC will benefit from the government's increased focus on power sector investment.
- The weak financial profile of the state government power utilities, REC's main clients, remains a significant business challenge for REC.
- The scope of REC's business operations will continue to be defined within the boundaries of its developmental role over the medium term.

Financial performance

- REC has seen a moderate growth in asset book over that last 2 years – a CAGR of about 20%.
- Limits on the investments in capital gains tax exemption bonds and on banks' exposure to NBFCs, to increase the cost of funds for REC in future
- The rising share of market borrowings in REC's funding mix will increase the company's borrowing costs.
- The adoption of RBI's prudential norms for NPA provisioning could hurt the company's bottom-line given the weak financials of its major borrowers - state utilities

Management capability

- REC's management has a strong understanding of the dynamics of the transmission and distribution business in the Indian hinterland.
- The company has access to management personnel from other government-owned power sector companies.
- REC's business operations are susceptible to the effects of frequent top management changes as is the case with many other government run entities.
- REC needs to significantly strengthen its internal control systems and loan pricing mechanisms to support the planned increase in the size of the business.
- As REC seeks to transform its operations from having a developmental orientation to encompass a commercial focus, it will need to strengthen its credit appraisal and credit pricing skills to meet the competitive forces of the market.

Corporate governance

- The government of India is the largest shareholder of REC. CRISIL expects that REC will continue to have a significant role in government policy over the medium term.
- REC's shareholders remain vulnerable to the possibility of REC's business operations being used by the government more as a tool for public policy than an engine for profit maximization
- REC's independent directors have joined the board recently. They bring a wealth of experience and strong capabilities of management oversight to REC's board. However, CRISIL believes that the government will continue to play a key role in REC's governance.

Detailed Rationale

RESEARCH

REC: Shareholding pattern

Particulars	Pre-Issue		Post-Issue	
	No. of equity shares (mn)	Percentage share-holding	No. of equity shares (mn)	Percentage share-holding
Promoters				
Government (President of India, acting through the MoP (including nominees))	780.6	100%	702.5	82%
Others				
Public (including Eligible Employees)	0	0%	156.1	18%
Total	780.6	100%	858.6	100%

Source: Company prospectus

REC: Past financial performance

		Mar-06	Mar-07
Fund based income	Rs. Bn.	22.4	28.3
Gross spread/ Avg. funds deployed	Per cent	3.24	3.22
Profit after tax	Rs. Bn.	6.7	7.7
NPM	Per cent	3.0	2.9
Capital Adequacy Ratio (CAR)	Per cent	16.4	12.4
RONW	Per cent	15.9	18.9
Basic EPS	Rs	8.5	9.9
Diluted EPS	Rs	8.5	9.9
No. of equity shares	Mln.	780.6	780.6
Net worth	Rs. Bn.	41.9	40.1
Book Value pr share	Rs	53.7	51.4
Dividend per share	Rs	2.7	2.6

Note: Financials have been reclassified as per CRISIL's analytical framework

Source: CRISIL Research

In order to arrive at the overall grade, CRISIL has considered the following broad parameters:

- Business prospects and financial performance
- Management capability
- Corporate governance

CRISIL has assigned a CRISIL IPO Grade “3/5” (pronounced “three on five”) to the proposed initial public offer of Rural Electrification Corporation Limited. This grade indicates that the fundamentals of the issue are average in relation to the other listed equity securities in India.

The grading reflects REC's status as a government run company that has a significant role in public policy. REC's borrowing programme benefits from the government's support that is available to it as a consequence. These advantages impart REC with a business advantage over competitors who do not enjoy this benefit. Further, REC's management has a strong understanding of the dynamics of the transmission and distribution business in the Indian hinterland. The grading is tempered by the fact that REC is required to lend to the state government power utilities that have a weak credit history. It also factors in REC's weaker net interest margins, compared to peers, despite the access to low cost funds. REC's business operations are also susceptible to effects of frequent top management changes. It will also need to significantly strengthen its internal control systems and loan pricing mechanisms to support the planned increase in business volumes. REC remains vulnerable to the possibility of its business

operations being used by the government more as a public policy tool than as an engine for profit maximization.

REC plays an important role as an instrument of government policy

REC is a government-owned entity and is the main vehicle for channeling credit to rural electrification projects. The company, along with PFC, is the largest lender to state government power utilities in India. It also administers grants and provides loans as the nodal agency for the Rajiv Gandhi Grameen Viduytikaran Yojana (RGGVY), which is aimed at the electrification of all villages in the country. Government of India (GoI) has accorded REC special status to raise tax-free bonds and capital gains tax exemption bonds (under section 54) based on the developmental role of the company. REC's own borrowings also benefit from the strong sovereign credit support available to it.

Developmental motive could hamper profit maximization objective

The company occupies an unique position in the government's policy for development of the power sector in the country. It currently plays an integral role in implementing the GoI's rural electrification strategy. Going forward, we believe, it will continue to be a vital part of government's initiatives in the development of the power sector in the country. As such, REC's shareholders remain vulnerable to the possibility of REC's business operations being used more as a tool for public policy than an engine for profit maximization by the government.

Strong growth momentum in the power sector would benefit REC's business volumes

Though REC was established in 1969 with the purpose of developing power infrastructure in rural areas, its mandate has evolved to permit it to finance all segments of the power sector. The company business volumes would benefit from the government's strong focus on power sector investments. This is due to REC's strong share in the borrowings by state government power utilities and given that these utilities still account for a large share of India's power sector.

However, the weak credit quality of state government power utilities remains a business challenge

Borrowings by state utilities account for almost 98 per cent of REC's total loan book as on March 31, 2007. As on this date, gross NPA was higher than its peers, at around 1.98 per cent, even though the company used to follow its own accounting policies (and not the more stringent RBI guidelines). Since the company is likely to continue to be a major source of funds for state utilities, its profitability would be vulnerable to NPA's arising out of the poor credit quality of its main client segment.

Need to strengthen systems and processes to support company's planned business growth

The company's auditors have opined that its internal control in certain areas of business need further strengthening. The company needs to improve its credit appraisal and credit pricing skills to support the planned increase in business volume. Moreover, as REC seeks to transform its operations from having a developmental orientation to encompassing a commercial focus, these skills will become crucial to its competitive position.

Access to personnel from other government run power companies, but prone to the effects of frequent changes in the top management

REC has access to management personnel from other government-owned power sector companies. However, the company's business operations are susceptible to the effects of frequent top management changes as is the case with many other government run entities. Some of the key personnel at the senior management level are appointed or deputed by the GoI. Though the current CMD - Mr Anil Kumar Lakhina - has brought about many positive changes at REC in his less than three-year tenure, he is due to retire in February 2008. The fact that the company has seen more than 5 CMDs in the past 6 years is a significant challenge for the continuity of business strategy. In addition to the CMD, the Director Technical - Mr Bal Mukand is due to retire in November 2008. While the search for the replacement of Mr Bal Mukand has been initiated, there is no information on Mr Lakhina's replacement as on date. The Director (Finance) - Mr H.D Khunteta is also among the final two short-listed candidates for the post of CMD of PFC.

Business profile

Rural Electrification Corporation Limited (REC) is a public sector non-banking finance company (NBFC). REC operates under the administrative control of the Ministry of Power (MoP) and is wholly-owned by the Government of India (GoI). The company was established in 1969 with the sole objective of financing rural electrification schemes in the country. It services its clients through a network of 17 project offices spread across India.

The company's schemes are primarily aimed at extending and improving the supply of electricity by providing adequate funds for transmission and distribution projects, especially in rural areas. However, over a period of time its mandate evolved, permitting it to finance all segments of the power sector throughout the country. In line with its overall objective of assisting the government's rural electrification strategy, REC also acts as the nodal agency for disbursing grants provided under the Rajiv Gandhi Grameen

Vidyutikaran Yojana (RGGVY). The company enters into a Memorandum of Understanding with MoP, which outlines its yearly performance targets and the commitments from the government.

Financial profile

The total assets and net worth of REC, as on March 31, 2007, was Rs 362.19 billion and Rs 40.13 billion, respectively. REC's capital adequacy ratio stood at 12.4 per cent as on March 31, 2007.

For 2006-07, the company's fund-based income and net profits were Rs 28.3 billion (Rs 22.4 billion in 2005-06) and Rs 7.7 billion (Rs 6.7 billion in 2005-06), respectively. The operating income of the company has grown at a CAGR of 11.4 per cent over the past 5 years, while PAT has grown at a CAGR of 14.5 per cent in the same period. The gross spread/average funds deployed and return on equity (ROE) for 2006-07 stood at 3.22 per cent, and 18.91 per cent, respectively.

Profile of Management and Board

Some of the key personnel at the top and middle management level are appointed or deputed by the GoI. The company's management is headed by Mr. Anil Kumar Lakhina- CMD. There are two whole time directors, namely, Mr. Bal Mukand – Director Technical and Mr H.D Kunteta-Director Finance.

The company's Board consists of 8 directors. Besides the CMD, director (Finance) and director (Technical) there is one government nominee director and four independent directors. The whole-time directors have been associated with the company for over 2 years and have immense expertise in their area of operation. The independent directors on the board of the company have an excellent standing in their respective fields. Since they have been recently appointed on the board of the company, their knowledge about the company's operations is very limited as they have just attended one board meeting of the company.

Board of directors

Name of Directors	Designation	Age (years)	Date of Joining	Qualification	Previous Employment
Mr Anil Kumar Lakhina	Chairman and Managing Director	59	1st August 2005	IAS	Chairman and Managing Director (CMD) of State Industrial Investment Corporation of Maharashtra
Mr Hari Das Khunteta	Director (Finance)	55	5th May 2004	CA	Executive Director (Finance and Accounts) in National Hydroelectric Power Corporation Limited (NHPC)
Mr Bal Mukand	Director (Technical)	58	24th May 2004	B Sc Engg (Mechanical) from Kurukshetra University	Executive Director (Planning and Consultancy) in NHPC
Mr Devendra Singh	Director (Govt. Nominee)	45	29th August 2007	IAS	Joint Secretary, Ministry of Power (MoP)
Dr Devi Singh	Independent Director	55	7th January 2007	MA (Eco), Fellow IIM (A)	Director (IIM Lucknow)
Shri Venugopal N Dhoot	Independent Director	56	20th December 2007	B.E (Electrical)	CMD Videocon Group of Companies.
Shri M Govinda Rao	Independent Director	60	20th December 2007	Ph.D. Economics	Director, National Institute of Public Finance and Policy
Shri P R Balasubramanian	Independent Director	63	20th December 2007	B Sc Engg (Mechanical)	Retired CMD FACT

Disclaimer

A CRISIL IPO grading is a one-time assessment and reflects CRISIL's current opinion on the fundamentals of the graded equity issue in relation to other listed equity securities in India. A CRISIL IPO grading is neither an audit of the issuer by CRISIL nor is it a credit rating. Every CRISIL IPO grading is based on the information provided by the issuer or obtained by CRISIL from sources it considers reliable. CRISIL does not guarantee the completeness or accuracy of the information on which the grading is based. A CRISIL IPO grading is not a recommendation to buy / sell or hold the graded instrument; it does not comment on the issue price, future market price or suitability for a particular investor.

CRISIL is not responsible for any errors and especially states that it has no financial liability whatsoever to the subscribers / users / transmitters / distributors of CRISIL IPO gradings. For information on any IPO grading assigned by CRISIL, please contact 'Client Servicing' at +91-22-66913561, or via email: clientservicing@crisil.com.

For more information on CRISIL IPO gradings, please visit <http://www.crisil.com/research/research-faqs-ipo-grading.htm>