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UPDATE

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Railways in a fix; container rate hike not the way out. Weak freight market, limited ability to stretch passenger fares, competition from air travel and stiff cost base are likely to limit the recovery in railways' financials following a very weak start in FY2017. This combined with a similar weak start in the gross budgetary spending would limit 50% of the sources budgeted for funding ₹1.2 tn FY2017E capex. While acknowledging the related risk to freight rates, we note the recent impetus of Indian Railways to develop the container market, and rightfully so. A 20% higher container rate may add 1% to IR's revenues though would weaken the prospects of adding 3-5% after commissioning of the DFC.

Revenues down 5% yoy in 4MFY17

Freight revenues for Indian Railways (IR) are down 10% yoy over 4MFY17 despite a 2-8% yoy decline in realizations. Passenger revenues are up a modest 4% yoy primarily on increase in tariff; key non-suburban passenger volumes run-rate remains stagnant at FY2015 levels. Large 11-12% tariff CAGR in both freight and passenger tariffs over FY2013-16 limits scope for IR materially outgrowing the weak market in the near term. We, however, note the potential for a decline in passenger volumes as the substitute in air travel starts competing against 2AC and 3AC rail fares. One-week forward Delhi-Mumbai air fare is at a 15-40% or ₹300-800 premium to these rail fares. Both these segments account for ~30% of Indian Railways' passenger revenues.

Costs up 3% yoy in 4MFY17; net earnings down in double digits

Costs for Indian Railways continue to increase given large share of personnel expenses (~50% share including pension expenses) and an increasing cost of diesel. The same is taking its toll on the net earnings (gross earnings less ordinary working expenses), which are down yoy in double digits over June-July 2016. Also, the gross budgetary support to Indian Railways for 1QFY17 has been half of the budgeted quantum. We note that internal accruals and gross budgetary support are expected to fund about 50% of the ₹1.2 tn capex targeted by Indian Railways for FY2017 (~40% yoy increase targeted).

Further rate cuts unlikely; IR may hike bulk freight rates but would likely spare container rates

Rationalization of prices has not led to a demand uptick until now, limiting scope for further cuts. A price hike appears unlikely in passenger segment given the sustained weakness in passenger volumes and risk of a swift shift to air travel. While Indian Railways may mull a price increase in the bulk segment, it is unlikely to increase container freight rates in the near term.

Past rate hikes for container transportation were taken in conjunction with other cargo classes (8-11% CAGR across key segments except coal, which had 15% tariff CAGR). It is only recently that Indian Railways has started focusing on container business, and rightly so. Container business accounts for 5% of its revenues though its relevance is going to increase with the commissioning of the DFC (accounts for majority of IR's volumes in the north-west freight corridor). A hike in container rail price would lead to killing of a potential market for limited near-term revenue gains. We do not factor in a large hike in container haulage rates prior to the commissioning of DFC on this basis though take the recent deterioration in railways' financials and impending impact of the Seventh Pay Commission a risk to our estimates.

In our view, rail operators would be better-placed to pass on/absorb any large cost hikes to customers once the DFC is commissioned on account of (1) having a superior time offering and (2) pricing levers (double-stacking, lower capital cost).

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Exhibit 1: Net earnings decline 15% yoy in July 2017

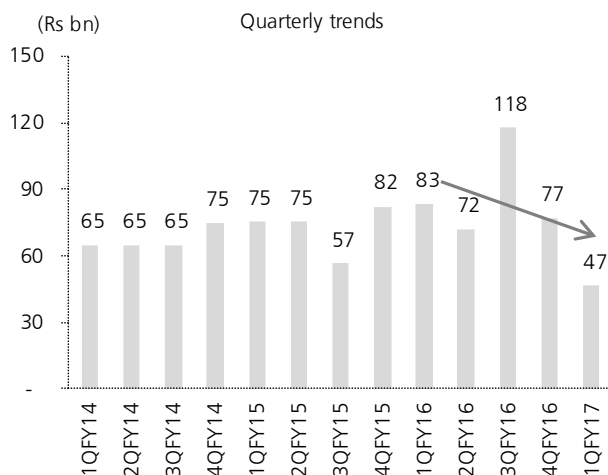
Key financial metrics of Indian Railways, March fiscal year-ends, 2014-Jul-2016

	2014	2015	2016	Jun-16	Jul-16	YTD-FY2017	Comment
Passenger							
Volume (mn)	8,426	8,230	8,152	697	702	2,742	
Yoy growth (%)	(1)	(2)	(1)	(1)	1	0	
Suburban	4,550	4,504	4,459	387	382	1,475	With number of passengers flattening out and limited scope of increasing fares, the passenger business is unlikely to grow in double-digits.
Yoy growth (%)	2	(1)	(1)	0	(0)	1	
Non-suburban	3,876	3,726	3,693	310	320	1,266	
Yoy growth (%)	(4)	(4)	(1)	(3)	1	(1)	
Earnings (Rs bn)	365	422	442	39	41	157	
Yoy growth (%)	16	16	5	7	5	4	
Freight							
Tonnage (mn tonnes)	1,050	1,095	1,101	92	89	360	
Yoy growth (%)	4	4	1	3	(2)	(1)	With tonnage growth flattening in spite of tariff rationalization, the volume benefit (if any) is yet to flow in
Earnings (Rs bn)	935	1058	1090	84	76	330	
Yoy growth (%)	10	13	3	(9)	(9)	(10)	
Total (including other sources)							
Earnings (Rs bn)	1,391	1,571	1,634	130	124	514	
Yoy growth (%)	12	13	4	(4)	(4)	(5)	Negative operating leverage has led to a sharp 30%+ yoy decline in net earnings; ability to re-invest would reduce materially
Working expenses (Rs bn)	979	1,060	1,077	82	85	408	
Yoy growth (%)	17	8	2	(0)	2	3	
Net earnings (Rs bn)	412	511	557	48	39	107	
Yoy growth (%)	3	24	9	(9)	(15)	NA	

Source: Indian Railways, Kotak Institutional Equities

Exhibit 2: 1QFY17 spending is down 44% yoy

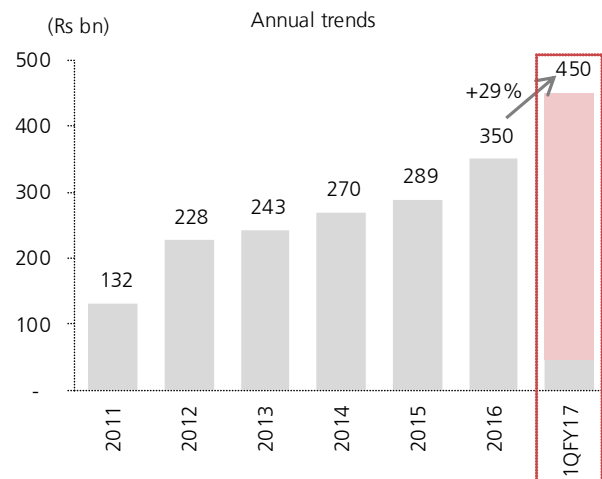
Trends in budgetary support to Indian Railways, March fiscal year-ends (Rs bn)



Source: Ministry of Finance, Kotak Institutional Equities

Exhibit 3: 1QFY17 spending is one-tenth of the annual target

Trends in budgetary support to Indian Railways, March fiscal year-ends (Rs bn)



Source: Ministry of Finance, Kotak Institutional Equities

Exhibit 4: Gross budgetary support and internal accruals account for 50% of the funding for FY2017 capex plans

Break-up of funding for planned outlay of Indian Railways, March fiscal year-ends, 2013-17BE

	2013	2014	2015	2016 RE	2017 BE
Absolute quantum (Rs bn)					
Gross budgetary support/cess	257	281	316	347	450
Internal resources	95	101	154	166	127
EBR/PPP	151	151	183	213	410
Institutional finance			—	96	183
Total	504	533	652	822	1,170
Relative share (%)					
Gross budgetary support/cess	51	53	48	42	38
Internal Resources	19	19	24	20	11
EBR	30	28	28	26	35
Institutional finance	—	—	—	12	16
Total	100	100	100	100	100

Source: Indian Railways, Kotak Institutional Equities

Exhibit 5: One-year air fare is about 40% more expensive than 3AC rail fare

Details of the pricing and share of AC passenger rail classes

	Rail	One-week forward air price
		Rs per passenger km
AC first class	2.8	1.9
AC Sleeper	1.6	1.9
AC 3 tier	1.3	1.9
AC Chair car	1.4	1.9
Total	1.4	1.9

Notes:

(a) Delhi-Mumbai air fare considered for the above analysis.

Source: Indian Railways, Kotak Institutional Equities

Exhibit 6: 12% tariff CAGR taken by IR for passenger fares

Change in passenger rail fares, March fiscal year-ends, 2013-16

	Passenger kms (mn)				Revenues (Rs mn)				Rs/ passenger km				2013-16 CAGR (%)	Share of revenues (%)
	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016		
1AC	1,892	1,629	1,552	1,611	4,997	4,652	4,580	4,501	2.6	2.9	3.0	2.8	2	1
2AC	18,280	18,749	21,366	21,135	23,468	26,362	31,602	34,827	1.3	1.4	1.5	1.6	9	8
3AC	52,286	58,190	67,009	66,284	52,126	61,890	77,261	87,769	1.0	1.1	1.2	1.3	10	21
AC chair car	8,673	9,352	10,273	10,162	9,019	10,824	12,679	14,228	1.0	1.2	1.2	1.4	10	3
Sub-total	81,131	87,920	100,200	99,192	89,610	103,729	126,122	141,325	1.1	1.2	1.3	1.4	9	33
Others	871,318	902,233	895,215	885,426	203,514	238,987	270,842	286,484	0.2	0.3	0.3	0.3	11	67
Total Non-suburban	952,449	990,153	995,415	984,618	293,124	342,716	396,964	427,809	0.3	0.3	0.4	0.4	12	100

Source: Indian Railways, Kotak Institutional Equities

Exhibit 7: 11% CAGR in tariff has led to traffic declining in FY2016 in key segments
Change in freight rates, March fiscal year-ends, 2013-16

	Tonne- kms (bn)				Revenues (Rs bn)				Rs/ tonne- km				2013-16 CAGR (%)	Share of revenues (%)
	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016		
Coal	303	272	302	291	359	391	479	521	1.2	1.4	1.6	1.8	15	47
Cement	63	61	59	57	80	85	87	94	1.3	1.4	1.5	1.7	9	8
Foodgrains	71	71	67	57	70	80	81	77	1.0	1.1	1.2	1.4	11	7
Fertilizers	39	35	39	48	43	41	52	61	1.1	1.2	1.3	1.3	6	5
Iron ore	38	37	37	33	74	77	79	66	2.0	2.1	2.1	2.0	0	6
POL	28	30	27	28	47	53	55	59	1.7	1.8	2.0	2.1	8	5
Pig iron, finished steel	34	35	37	38	48	56	65	58	1.4	1.6	1.8	1.5	3	5
Container goods	50	52	48	46	40	38	43	50	0.8	0.7	0.9	1.1	10	4
Total	691	666	682	668	852	939	1,058	1,119	1.2	1.4	1.6	1.7	11	100

Source: Indian Railways, Kotak Institutional Equities

Exhibit 8: Indian Railways books large share of the revenues of Rs50-55 bn from the western freight corridor from container cargo

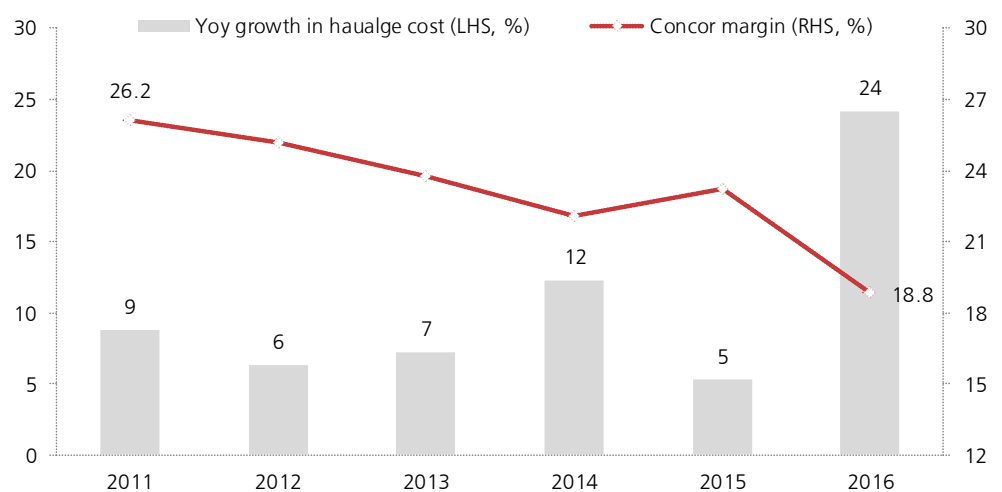
Break-up of volumes on the western freight corridor at present

	Cargo (mn tonnes)	Lead distance (km)	Revenues (Rs bn)
Container	30	919	35
Non-container	20	570	18
Revenues	50.0	779	52.9

Source: Dec-2014 presentation of DFCCIL, Kotak Institutional Equities

Exhibit 9: Haulage cost for Indian Railways has grown at 11% CAGR over FY2010-16; Concor margin down 700 bps over this period

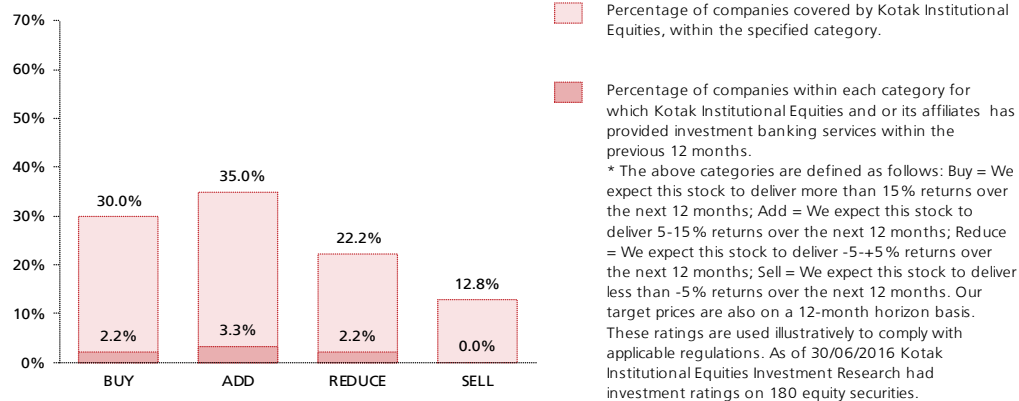
Trajectory of haulage cost per unit activity, March fiscal year-ends, 2011-16



Source: Indian Railways, Concor, Kotak Institutional Equities

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As of June 30, 2016

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