BARCLAYS CAPITAL

EQUITY RESEARCH

14 March 2012

INDIA BANKS

Discom restructuring: eventually, the piper must be paid

We remain concerned about the financial system's exposure to the state-owned electricity distribution utilities (discoms). The optimism based on recent news around debt restructuring (particularly from Rajasthan) and tariff increases from multiple states appear overdone, in our view. Specifically, we believe it is erroneous to conclude that state governments would take on additional liabilities as part of financial restructuring without imposing haircuts on lenders. Furthermore, while tariff increases will help bridge operating deficits, they will not be enough to repay past debts. The financial system's loans to discoms of over Rs1.5 trillion (primarily through PSU lenders) could require restructuring. Among PSU banks, SBI (1-OW) has the lowest relative share of SEB lending (as % of advances).

Other states are unlikely to follow Rajasthan example of guaranteeing utility debt: In Rajasthan, the state distribution utilities are in debt primarily because they have not received subsidy payments from the state government. Thus, in guaranteeing the utility's debt, the Rajasthan government is merely 'guaranteeing' that it will not default on its existing subsidy commitments. The nature of the problem in other states is different. For these, discom debts are either due to low pricing (even post subsidies) or large customer receivables, where recovery remains uncertain. State governments that guarantee such debts would be taking on additional liabilities. In our view, they are unlikely to do this without asking lenders to take haircuts.

Tariff increases will only offset current costs not past losses: Regulators and the Appellate Tribunal for Electricity have made it clear that tariff hikes cannot be used to offset past losses. In any event, state governments are reluctant to allow tariff increases (we see even the recent hikes as being driven by compulsion). So while the recent round of tariff hikes was to help bridge operating deficits, we do not expect subsequent hikes to be large enough to pay for historical losses.

Rs1.5 trillion of loans to state owned distribution companies could require restructuring: State owned discoms have debts of approximately Rs1.5trillion. Of these, ~Rs260bn has been borrowed to fund operating losses and customer receivables over FY08-FY11 and is particularly exposed. Public sector lenders (banks and NBFCs) have been the biggest players in this segment and stand directly exposed. Furthermore, if tariffs are not raised soon then discoms are likely to delay payments to generation companies and this could result in lending to gencos coming under strain.

Among PSU banks, SBI has the lowest relative exposure to SEB loans (~1% of advances, while other PSU banks have 2.5-5% exposure).

INDUSTRY UPDATE

Asia ex-Japan Banks
2-NEUTRAL
Unchanged

Asia Ex-Japan Banks

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Right lessons to draw from Rajasthan restructuring

In Rajasthan, the state distribution utilities are in debt primarily because they have not received subsidy payments from the state government. Thus, in guaranteeing the utility debt, the state government is merely 'guaranteeing' that it will not default on the state's existing commitments. The nature of the problems in other states is different. For these, discom debts are due to low pricing (even post subsidies) or high customer receivables. (Note: In most states with financially weak discoms, the incremental borrowings each year have been higher *than capex and have been used for funding operating deficits)*. State governments that guarantee such debts would be taking on additional liabilities. In our view, these states are unlikely to do this without asking lenders to take haircuts.

The Rajasthan utility has had to borrow to offset delays in subsidy payments

In Rajasthan, the primary reason for the state utility's debt is that it has not been paid subsidies to it owed by the state government. Specifically, in FY09–FY10, subsidies booked but not received by Rajasthan discoms aggregated to Rs178bn, which led to a steep increase of Rs192bn in bank/FI debt (from Rs137bn to Rs329bn). In effect, the state government's move to guarantee debts merely means that it agrees to not default on its existing liabilities.

Figure 1: There has been significant optimism from recent news about SEB restructuring (particularly in Rajasthan)

"I should bring it to the notice that … we have done (restructuring for) Tamilnadu last time, I think Rajasthan has come around for restructuring now. There has been a consortium fund; there have been excellent discussions with the government. Government has committed in terms of their own falling in line with these things.

And I think that bankers are now restructuring this book. And this restructuring will not call for any set-up or sacrifice higher cut from the design."

CMD, Punjab National Bank (3Q FY12 Earnings Call)

Source: Company website, Barclays Capital

Figure 2: Rajasthan's discoms have high operating/investing deficit to cover subsidies/additional financing …

Rajasthan SEBs - operating cash deficit (Rs billion)	FY08	FY09	FY10
Additional debt raised (banks and Fis)	57	79	114
Less: Capital Expenditure	34	34	30
Net operating cash deficit	**23**	**45**	**85**

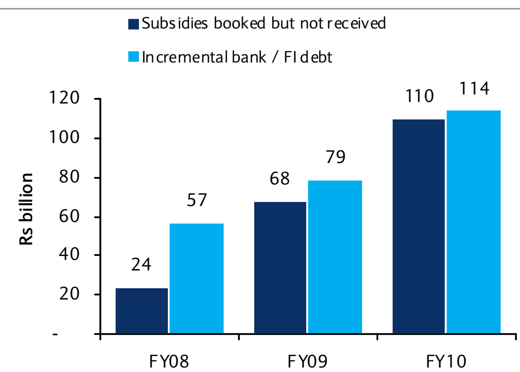
Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

Figure 3: … and subsidies not received from the state government have contributed substantially to its deficit

Rajasthan SEBs - sources of operating cash deficit (Rs billion)	FY08	FY09	FY10
PAT	0	0	0
Subsidies booked but not received	24	68	110
Revenues booked but not realized	1	3	5
Others (including payables, depreciation, etc)	(2)	(27)	(30)
Net operating cash deficit	**23**	**45**	**85**

Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

Figure 4: Pending subsidies have directly led to increases in bank/financial institution debt over FY08-FY10



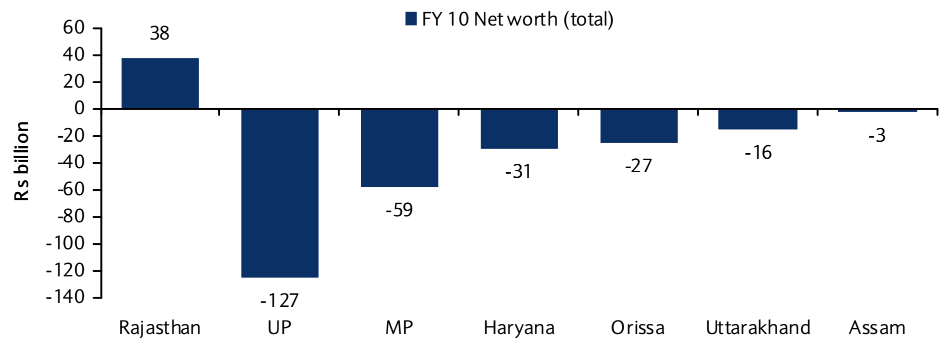
Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

In other states, utility debts reflect losses and customer receivables

It is unlikely that other state governments will follow the Rajasthan script. The causes of the debt buildup in the other states are different from those in Rajasthan. If these state governments were to guarantee the utilities' debts, they would be taking on incremental liabilities. In our view, they are unlikely to do this without asking lenders to take a haircut.

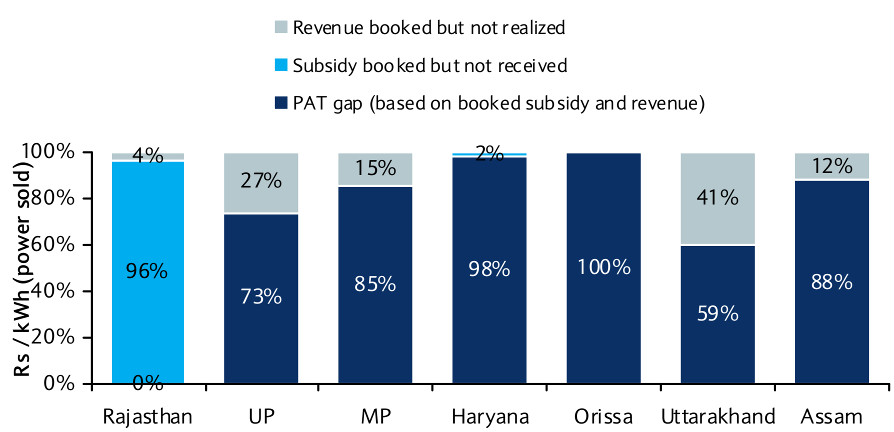
In other states with financially weak state utilities (especially discoms with negative net worth, such as those of UP, MP, Haryana), the outstanding debts are due to low tariffs (even after the subsidy receipts) or high customer receivables. They are not on account of delays in receiving subsidies. Furthermore, a relatively small part of the borrowings have been used to fund capex in most of the financially weak states.

Figure 5: Several other Indian states* are financially weak …



*Includes Rajasthan and all states with unbundled utilities which have negative net worth
Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

Figure 6: … and have high accumulated debts due to high receivables or low tariffs



Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

Figure 7: Indian distribution utilities – relatively small proportions of borrowings are used for funding capex spending

Operating cash deficit - FY10 (Rs billion)	Rajasthan	UP	MP	Haryana
Additional debt raised (banks and Fis)	114	14	26	47
Less: Capital Expenditure	30	12	9	22
Net operating cash deficit	**85**	**2**	**16**	**25**
Sources of operating cash deficit				
PAT	0	53	33	15
Subsidies booked but not received	110	0	0	0
Revenues booked but not realised	5	19	6	0
Others (including payables, depreciation, etc)	(30)	(70)	(23)	9
Net operating cash deficit	**85**	**2**	**16**	**25**

Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

Tariff increases will only offset current costs, not past losses

The recent ruling (November 2011) by the Appellate Tribunal for Electricity, while making it obligatory for state discoms/regulators to increase tariffs, has also made it clear that the tariff hikes cannot be used to offset past losses (in line with the policy on SEB dues in 2001).

Furthermore, the recent round of tariff increases will only help plug the discoms' operating deficits. Many state discoms have been running operating cash flow deficits with additional borrowings exceeding capex. This is only sustainable as long as lenders are willing to lend the required amounts. If (as appears to be the case now) lenders refuse to provide incremental lending, the recent increases would only help plug operating deficits.

For example, Haryana's discoms raised tariffs by 15-20% in FY11 and 0.5% in FY12 (till date). However, a retrospective analysis of the FY09 and FY10 cash flow situation shows that if it had not received incremental institutional funding, the required tariff increases just to maintain cash breakeven would have been 24-28% every year (overall about 59% of increase across FY09-FY10) just to finance its operating and investing activities. Even to achieve accounting breakeven (ie, zero profit after tax), the required tariff increase would have been 18-21% every year (overall about 43% across FY09-FY10).

Overall, the upcoming tariff hikes by states would be driven by compulsion (given the state governments' reluctance to allow increases in the past) and are not expected to be large enough to pay for discoms' historical losses.

Figure 8: Tariff hikes by discoms cannot be used to offset past losses (as was the case in the 2001 round of restructuring)

"The Tribunal has repeatedly held that regular and timely truing-up of expenses must be done since…the burden / benefits of the past years must not be passed on to the consumers of the future"

Source: Appellate Tribunal for Electricity Judgment dated 11th Nov 2011 (Paragraph 57)

"The Group noted that regulatory authorities were unlikely to agree to build in a cushion in future tariffs to allow for payment of past dues. Besides, any such effort could be challenged by consumers in judicial courts, since they could legitimately object to being made to pay for covering past inefficiency of the SEBs"

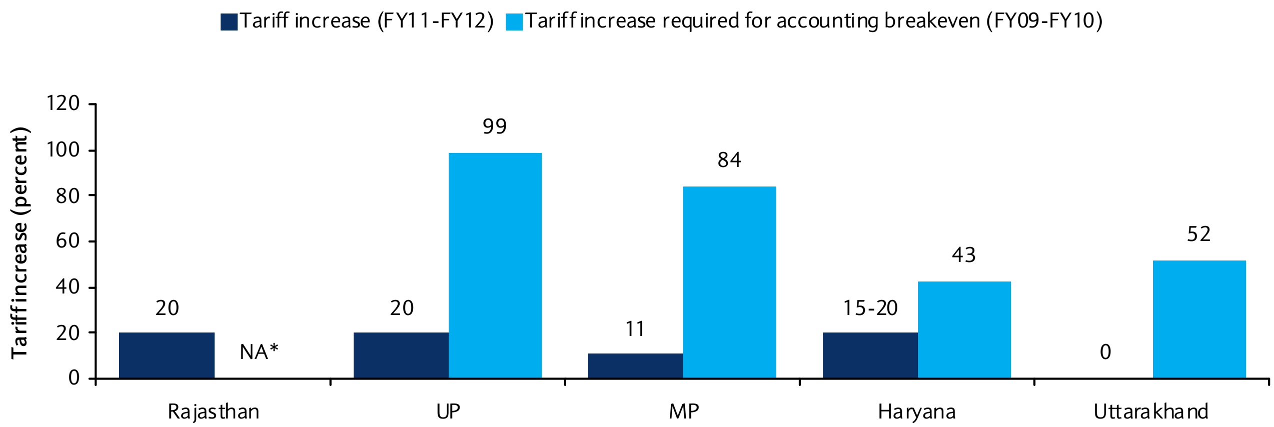
Source: "Report of the Expert Group on Settlement of SEB Dues – May 2001", Barclays Capital

Figure 9: India's distribution utilities – multiple states have raised tariffs over FY11-FY12 to manage deficits

Discom	Price increases
Andhra Pradesh	Aug 2010: In Aug 10, prices increased for industries and 60 paisa for commercial establishments and railway traction. No change for domestic and agricultural sector Mar 2011: Tried to increase tariffs in March 2011 but did not get approval from CM for increasing prices for domestic consumers (slab of 201-300 units) and cottage industries. Average 8-10 % increase.
Bihar	June 2011: 15-20% increase (applied fuel surcharge again with retrospective impact) Dec 2011: 10% increase
Orissa	April 2011: 20% average increase
Delhi	Aug 2011: 22% average increase
Chattisgarh	April 2011: 15% increase (22% increase for domestic consumers and 12% for industrial)
Gujarat	April 2010: 2.36% average increase Sep 2011: 4-5% average increase
Rajasthan	Sep 2011: 20% average increase
Maharashtra	Sep 2010: 3% increase (had sought 14%) November 2011: 40 paisa increase (about 8-10%)
MP	June 2010: 10.66% increase May 2011: 40% increase requested
Delhi	Aug 2010: 22% increase
Punjab	April 2010: 13% increase; was 10% earlier but was asked to roll part of the increase back; approved again in budget May 2011: 10% increase (about 37 paisa increase)
Haryana	Oct 2010: About 15%-20% increase (7 paisa increase) May 2011: 0.5% increase. Another increase is being sought
Karnataka	Oct 2011: Increase of an average of 7% (average increase of Rs27paisa) Dec 2010: Average increase of 22 paisa, but this was put on hold for some time
Tamilnadu	Aug 2010: Increased power price for first time in seven years in Aug 2010; increase of 30 paisa to Rs1.1/unit; increase for consumers using more than 300 units and industrial consumers; average of 10% increase Nov 2011: Applied for a 38% tariff increase (about 74-110% in some slabs) in Nov 2011
West Bengal	April 2010: 10-15% April 2011: 11% increase (about 38-46 paisa average increases) Dec 2011: Another increase likely from April 2012
Uttar Pradesh	April 2010: 20% increase
Jharkhand	15-50 paisa plus increase in fixed tariff by 12-40 per month

Source: India's state electricity boards, Barclays Capital

Figure 10: India's state electricity boards – tariff increases in most states have not been sufficient enough to achieve accounting breakeven



*Rajasthan discoms managed zero PAT (due to subsidies booked), hence no tariff increase required for accounting breakeven
Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

Figure 11: India's state electricity boards – tariff increases barely sufficient to maintain cash flow position; Haryana example

All numbers in Rs mn	1. Actual scenario		2. Alternative scenario (tariff increase for cash breakeven in event of constrained bank / FI financing)		
Haryana discoms - cash breakeven	FY09	FY10	FY09	FY10	Rationale
Operational surplus / deficit*	-13,080	-13,930	3,490	10,870	Assuming tariff increase sufficient to help maintain same cash flow position
Capital expenditure	-13,600	-21,700	-13,600	-21,700	
Debt financing (from banks, FIs)	30,170	46,500	13,600	21,700	Additional financing limited to 1.0x capex (in line with healthy SEB benchmarks)
Net cash surplus / deficit	**3,490**	**10,870**	**3,490**	**10,870**	Net cash flow maintained at previous levels
Additional revenue generated			16,570	24,800	Additional operational cash generated
Base revenue			69,110	87,990	
Required tariff increase for cash breakeven (%)			24%	28%	In contrast, Haryana raised tariffs by only 15-20% in FY11 and 0.5% in FY12

Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

Figure 12: India's state electricity boards – even achieving accounting breakeven would require significant tariff increases; Haryana example

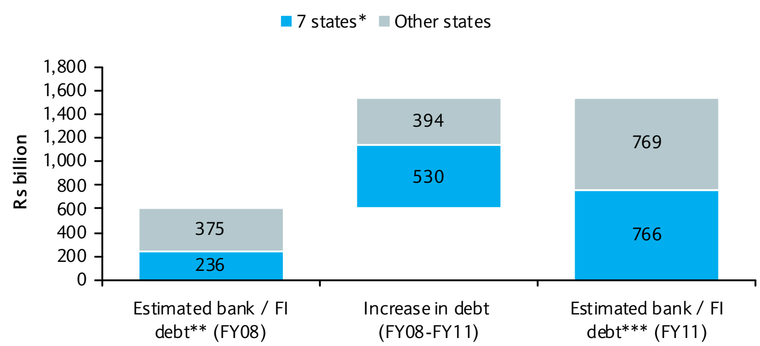
All numbers in Rs mn	Tariff increase for accounting breakeven		
Haryana discoms - accounting breakeven	FY09	FY10	Rationale
Reported PAT	-14,830	-15,450	
Additional revenue required for accounting breakeven	14,830	15,450	Assuming no change in cost structure
Base revenue	69,110	87,990	
Required tariff increase for accounting breakeven (%)	21%	18%	In contrast, Haryana raised tariffs by only 15-20% in FY11 and 0.5% in FY12

Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital

Loans to discoms could require restructuring

The financial position of state electricity boards (SEBs) remains a serious challenge. State-owned discoms have bank and NBFC debt of approximately Rs1.5 trillion. Of this amount, Rs260 billion has been borrowed to fund operating losses and customer receivables over FY08-FY11 and is particularly exposed. Although restructuring involves just allocating the impact from the discoms' losses to the state governments and lenders, there is uncertainty over states' shares of the burden and compensation for lenders.

Figure 13: India's state electricity boards – discoms raised significant debt in FY08-FY11



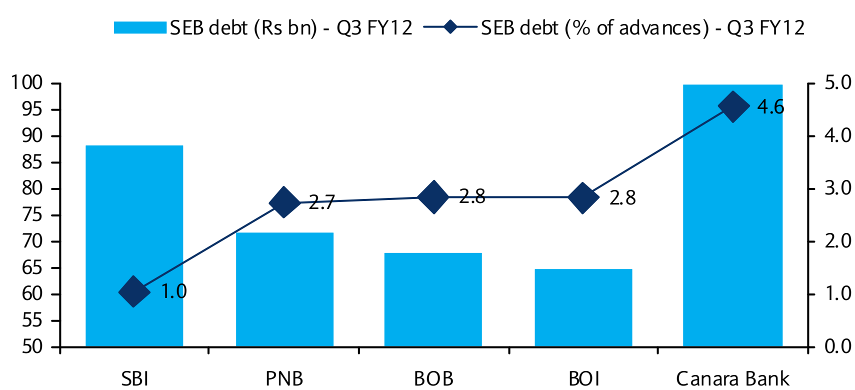
*Includes financially weak 'unbundled' states only: Rajasthan, UP, MP, Haryana, Orissa, Uttarakhand, Assam
**Assuming discom debt is ~40% of total debt for bundled SEBs ***FY11E assuming linear increase from FY09-FY11
Source: PFC Report on Performance of State Power Utilities (FY08-FY10), Barclays Capital estimates

PSUs (public sector banks) and NBFCs have been the biggest lenders to state owned distribution companies. These are likely to be directly impacted by haircuts imposed as part of a debt restructuring by state governments.

Furthermore, delays in raising tariffs will also impact generation companies through delayed payments on receivables. For example, Lanco Infratech defaulted on its partly operational Udupi thermal project in January 2012 due to Rs5bn in receivables from Karnataka discoms.

Among PSU banks, SBI (1-OW) has the lowest relative exposure to SEB loans (SBI's SEB loans are ~1% of advances, while other PSU banks have 2.5-5% exposure).

Figure 13: Public sector banks are biggest lenders to SEBs* - Q3 FY12 (not exhaustive)



*Data includes exposure to both bundled and unbundled distribution utilities, hence not 'pure distribution' exposure
Source: News reports, management discussions / analyst calls

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Materially Mentioned Stocks (Ticker, Date, Price)

State Bank of India (SBI.NS, 13-Mar-2012, INR 2327.65), 1-Overweight/2-Neutral

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HDFC Bank (HDBK.NS)	HSBC Holdings PLC (0005.HK)	ICICI Bank (ICBK.NS)
Industrial & Commercial Bank of China Ltd. (1398.HK)	Industrial Bank of Korea (024110.KS)	KB Financial Group (105560.KS)
Korea Exchange Bank (004940.KS)	Mega Financial Holding (2886.TW)	Punjab National Bank (PNBK.NS)
Shinhan Financial Group (055550.KS)	SinoPac Financial Holdings (2890.TW)	Standard Chartered PLC (2888.HK)
State Bank of India (SBI.NS)	Taishin Financial Holding (2887.TW)	Wing Hang Bank Ltd. (0302.HK)
Woori Finance Holdings (053000.KS)		

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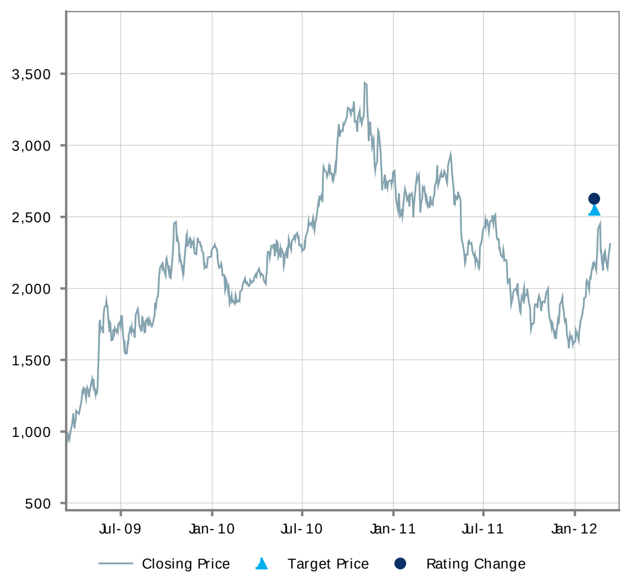
State Bank of India (SBIN IN / SBI.NS)

INR 2327.65 (13-Mar-2012)

Stock Rating **1-OVERWEIGHT**

Sector View **2-NEUTRAL**

Rating and Price Target Chart - INR (as of 13-Mar-2012)



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Currency=INR

Date	Closing Price	Rating	Price Target
09-Feb-2012	2181.95	1-Overweight	2550.00

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