Power Finance Corporation Ltd. (PFC) – FPO Note: "SUBSCRIBE"

10th May, 2011

PFC is a leading financial institution in India focused on the power sector and is registered with the RBI as a non-deposit taking systemically important NBFC ("NBFC") and was classified as an IFC in July 2010. Earlier, the company was conferred with the status of Nav-Ratna PSU by Government of India on 22nd June, 2007. It has been identified as the nodal agency by the Ministry of Power for R-APDRP and for implementation of Ultra Mega Power Projects (UMPPs). Being present in power sector for over two decades, it has well established relationships with the GoI and State governments, regulatory authorities, major power sector organizations, Central and State power utilities, as well as private sector power project developers. It currently enjoy the highest credit ratings of "AAA" and "LAAA" for its long-term domestic borrowings and "P1+" and "A1+" for its short-term borrowings from CRISIL and ICRA, respectively. PFC's loan assets has witnessed a CAGR of 22.4% over the period FY06-10, to touch Rs. 798.5bn in FY10. As on December, 2010, it loan assets stood at Rs. 1,580bn. In addition, its loan asset portfolio has increasingly become diversified by sector and customer base. As of December, 2010, 65.3%, of its total loan assets relate to state sector, 19.5% relates to central sector, 8.1% is to joint sector borrowers while 7.1% relates to private sector borrowers. The company has a major loan exposure to power generation projects accounting for 75%, whereas transmission projects and distribution projects account for 7.5% and 4.4% respectively. PFC's total income has been robust and has registered a CAGR of 26.9% to touch Rs. 81.2bn. On the other hand, PAT clocked a CAGR of 22.6% over the period FY06-10 to touch Rs. 22.5bn in FY10. NIMs stood at healthy 4.1% whereas Gross NPAs stood at 0.01% as on December, 2010. At the upper end of the price band of the issue price, the stock is valued at 1.4x its post issue Book Value. With due consideration to the above factors, we believe that valuations are justified and recommend investors to "SUBSCRIBE" the issue.

Issue date	10th May, 2011- 13th May, 2011
Issue size	Rs.46.5bn
FV	Rs.10
Price Band	Rs.193-203 per share
CMP	Rs. 211 per share
Fresh issue	172.1 mn equity shares
Offer for sale	57.3 mn equity shares
Issue structure	50% - QIBs 35% - Retail 15% - Non Institutional Bidders
Discount	5% for retail investors and eligible employees
Lot size	28 shares
Equity shares prior to issue	1,147.7 mn
Equity shares post issue	1,319.9 mn
Post issue market capitalization	Rs. 267.9 bn at upper price band
Promoter	President of India acting through Ministry of Power, Government of India
Key Management	Mr. Satnam Singh – CMD, Mr. Mukesh Kumar Goel, Director (Commercial)
Book Running Lead Managers	DSP Merrill Lynch, Goldman Sachs (India), ICICI Securities, JM Financial
Registrar to the issue	Karvy Computershare

Shareholding (%)	Pre Issue	Post Issue
Promoters	89.7	73.7
Others	10.3	26.3
Total	100	100

Financial summary (Consolidated)

Y/e 31 Mar (Rs. mn)	FY09	FY10	FY11
Total income	65,660	81,030	101,285
PBT	20,117	30,639	35,433
Reported PAT	14,696	22,501	26,188
Equity Capital	11,477.67	11,477.67	11,477.67
Networth	109,966	125,174	154,118
NIMs (%)	3.9	4.0	4.1*
Gross NPAs (%)	0.02	0.02	0.01*
Capital Adequacy Ratio (%)	17.15	18.3	17.38*
RoE (%)	13.4	17.9	16.9
Book value (Rs.)	96	109	134

*Source: RHP, Ajcon Research, Note:*9MFY11*

Peer Analysis

Segment	CMP (Rs.)	FV (Rs.)	Book value (Rs.)	P/BV(x)	EPS (TTM)	PE(x)	RONW (%)
PFC Ltd.	193-203	10	143	1.35-1.42	22.8	8.5-8.9	17.9
REC	223	10	112	1.99	25.2	8.8	24.8
PTC Indian Financial Services	19	10	18	1.05	0.75**	25	4.7

*Source: RHP, Ajcon Research, *9MFY11 annualized, #post issue Book Value, **9MFY11 Annualized*

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Objects of the Issue

1) It intends to utilize the FPO proceeds in augmenting its capital base to ensure compliance with requisite capital adequacy norms and for future capital requirements.

2) Offer for sale to carry out disinvestment process.

Key positives

Power sector to drive growth, Comprehensive financial assistance platform focused on the Indian power sector

PFC provides a comprehensive range of financial products and related advisory and other services from project conceptualization to the post-commissioning stage, to its clients in the power sector, including for generation (conventional and renewable), transmission and distribution projects as well as for related renovation and modernization projects. It provides various fund-based financial products including long-term project finance, short-term loans, buyer's line of credit and debt refinancing schemes, as well as non-fund based assistance including default payment guarantees and letters of comfort. It also provides various fee-based technical advisory and consultancy services for power sector projects.

Power sector, a key infrastructure area, is perceived as the main driver of India's higher economic growth. The 11th Plan (2007-12) targeted 78,700 MW installed power generation capacity addition, while the 12th Plan (2012-17) aims at adding 1,00,000 MW. Ultra Mega Power Projects (UMPPs), would result in significant generation capacity addition, particularly from 12th Plan onwards, and Large Independent Transmission Projects on the lines of UMPPs will enable significant strengthening of transmission infrastructure.

This would provide company with good financing opportunities to fund projects with a long gestation period. The company's future strategy will be to accelerate growth by expanding the business in power sector and also by spinning off the new business units/ subsidiaries into individual companies with significant income stream, which will remain focused exclusively in their domain of operations

Strategic role in GoI initiatives and established relationships with power sector participants

The company was established as an integral part of, and has played a strategic role in, the GoI's initiatives for the promotion and development of the power sector in India for more than two decades. It has been involved in the development and implementation of various policies and structural and procedural reforms for the power sector in India. It was also involved in various GoI programs for the power sector, including acting as the nodal agency for the UMPP and the R-APDRP and as a bid process coordinator for the ITP scheme. As a result, the company has developed strong relationships with the Central and State governments, various regulatory authorities, significant power sector organizations, Central and State power utilities, private sector project developers, as well as other intermediaries in the power sector.

The company's wide experience in implementing government policies and programs provides it with industry expertise that enables it to leverage its project risk assessment capabilities to effectively evaluate projects, structure appropriate financing solutions, develop effective loan disbursement and project monitoring methodologies, as well as provide regulatory and related advisory services.

Operational flexibility to capitalize on both fundraising and lending opportunities

PFC is registered with the RBI as an NBFC and has also been classified as an IFC. Its NBFC and IFC classification enables it to be operationally more flexible than some of its competitors and effectively capitalize on available financing opportunities. As an NBFC, it is governed by regulations and policies that are generally less stringent than those applicable to commercial banks, including with respect to liquidity requirements and the requirement to hold

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a significant portion of funds in relatively low yield assets, such as government and other approved securities and cash reserves. In addition, as a government-owned NBFC, loans made by PFC to Central and State entities in the power sector have been exempted from RBI's prudential lending (exposure) norms applicable to other non-government owned non-deposit taking systemically important NBFCs. Such exemptions, unless further extended by the RBI, are currently applicable until March 31, 2012. In compliance with RBI's directive in this regard, it is in the process of formulating and submitting a roadmap (in consultation with the MoP) to the RBI prior to March 31, 2012, that sets out the manner in which it intends to comply with (including further capitalization) such prudential regulations of RBI. PFC follows prudential lending norms and guidelines approved by the MoP with respect to loans made to Central and State entities in the Indian power sector, while the loans made to the private sector are generally consistent with lending (exposure) norms stipulated by the RBI.

The above competitive advantages help the company in providing project financing for large, long-gestation power sector projects. For example, an IFC is entitled to lend up to 25.0% of its Owned Funds to a single borrower in the infrastructure sector, compared to 20.0% of Owned Funds by other NBFCs categorized as a Loan Company. As an IFC, it is also eligible to raise, under the automatic route (without the prior approval of the RBI), ECBs up to US$500 million each fiscal year, subject to the aggregate outstanding ECBs not exceeding 50% of its Owned Funds. As an IFC, it is also required to maintain CRAR of 15.0% (with a minimum Tier I capital of 10%)

Favorable credit rating and access to various cost-competitive sources of funds

PFCs primary sources of funds include equity capital, internal resources and domestic and foreign borrowings. CRISIL and ICRA have granted it, the highest credit ratings of "AAA" and "LAAA", respectively, for its long term domestic borrowings and "P1+" and "A1+", respectively, for its short-term borrowings. International credit rating agencies Moody's, Fitch and Standard & Poor's have provided PFCs long-term foreign currency issuer ratings of "Baa3", "BBB-" and "BBB-", respectively, which are at par with the sovereign ratings for India. PFCs borrowings reflect various sources, maturities and currencies, and include bonds and term loans, as well as commercial paper. The company's primary sources of funds are Rupee-denominated bonds and commercial borrowings raised in India. In addition, as an IFC, it is able to further diversify its borrowings through the issuance of Rupee-denominated infrastructure bonds that offer certain tax benefits to bondholders. Further, subject to certain restrictions it is also eligible to raise, under the automatic route (without the prior approval of the RBI), ECBs up to US$500mn each fiscal year. It also accessed various international funding sources including the World Bank, the Asian Development Bank and Kfw. Its cost of funds in FY08, FY09, FY10 and in the nine months ended December 31, 2010 was 8.0%, 8.7%, 8.1% and 8.4%, respectively, which is competitive. In addition, historically most of its borrowings have been on an unsecured basis.

KEY NEGATIVES

Significant concentration of outstanding loans to public sector power utilities, many of which are historically loss-making, and if these loans become non-performing, the quality of its asset portfolio may be adversely affected.

As of December 31, 2010, its single largest borrower accounted for 8% (Rs. *73.5bn) of its total outstanding loans, and the top five and top ten borrowers accounted for, in the aggregate, 32.4% (Rs. 298.7bn) and 54.1% (Rs. 498bn), respectively, of its total outstanding loans.* PFC's past exposure has been, and future exposure is expected to be, concentrated towards these borrowers. As of December 31, 2010, state sector, central sector, joint sector and private sector borrowers accounted for 65.3%, 19.5%, 8.1% and 7.1%, respectively, of its total outstanding loans. Historically, public sector utilities have had a relatively weak financial position and have in the past defaulted on their indebtedness. Consequently, it had to restructure some of the loans sanctioned to certain SPUs and SEBs, including rescheduling of repayment terms. In addition, many of its public sector borrowers, particularly SPUs, are susceptible to various operational risks including low metering at the distribution transformer level, high revenue gap, high receivables, low plant load factors and high aggregate technical and commercial ("AT&C") losses, which may lead to further deterioration in the financial condition of such entities.

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