

NTPC Current Status

July 29, 2010

Stock Market Scenario

Rating: Sell (Date: 29th July 2010, Price Rs 200)

NTPC sells at about 2.85 times its book value of Rs 70. It trades at about 18 times its trailing twelve months (TTM) earnings. Our fair value estimate for this company is in the band of Rs 120-140 at about 11-13 times it's trailing twelve months core earnings.

Nature of business

NTPC is a utility company whose Return on Equity (RoE) is capped by the regulator at 14%. So for every Rs 100 invested in the company the charges for power would be such that it can earn Rs 14 after tax. This is the basic limiting factor for valuation of the company's shares. It is important to remember that a power generating company generates profit only through the capital that it invests in its business. The machine produce power that is sold to consumers. The brand value of the company does not add anything to its pricing power.

Further capacity addition has to be done using either internal accruals or capital infusion in terms of debt or equity. The internal accruals would increase the capacity by 3-4 % every year. It is only by taking on more debt or by issuing more shares can the company increase it's capacity at faster pace. If the company issues debt its risk profile increases. Higher debt increases the risk component for equity holders. If the company issues shares, the EPS gain would be muted as any incremental profit would have more claimants.

Therefore having a TTM of 18 is hardly justified, as this implies that the EPS would continue to grow at more than 15% compounded every year. Given a 14% RoE and about 30% payout 8-9% growth in EPS is more likely. Therefore a price of around 120 - 140 looks justified.

We had made similar argument for Reliance Power at the time of its IPO. There was no reason to pay a premium for its shares as the RoE was capped at 14%. Our predictions have been truer than Mr. Market's irrational expectation. Despite a bonus which effectively reduced the issue price of shares trade at a significant discount to IPO price. Even then Reliance Power's shares are over priced.

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