

## **Power Stock Powerless to give Returns**

Companies engaged in power generation like NTPC, Tata Power, Reliance Energy (now Reliance Infrastructure) etc. have seen significant appreciation in price of their shares in recent past. Shares of companies like Tata Power and Reliance Energy have more than doubled in value over last 12 months while shares of NTPC have appreciated by more than 35 % on compounded basis since its IPO three and a half years ago. That seems like a lot value creation. But the question to be asked is whether this is sustainable or whether prices are ripe for correction?

We think the share prices are due for a correction. The basis of this conclusion is not very difficult to understand. The return on investment on power projects can be maximum 14% of the capital invested. So if the company does not pay any dividends the core profit can rise about 14% every year. In case company pays dividends, as most companies do (a significant portion of profits of power company is paid as dividends) the core profit growth would less. The growth of core profits for power companies has been close to 10% in last 3-4 years. If profits are growing at 10% and share prices are growing at 35% it is not too difficult to predict that share prices have to correct sooner or later.

It was not that these shares were under priced to begin with. The share prices of all these companies were at a premium to their book value. Their valuation was comparable to their global peers. Also the return on investment that has been mandated by the government has not been increased. In fact it was reduced from 16% to 14%. There were also some proposals recently to reduce the return to 12%. Though this was not done we can be almost sure given the number of power projects that are proposed that returns are unlikely to be hived up.

We will take the case of NTPC and analyse the growth of its profit. Book value represents a good indicator of the worth of a power company since it is a regulated enterprise with somewhat fixed returns. The book value of NTPC has increased from Rs 40 per share in 2003 to approximately Rs 63 per share in 2008. This is an annual increase of little less than 10% when adjusted for issue of IPO share at Rs 62. The profit growth per share has been similar as one would expect it to be. There is no policy change that would suggest that it would be any different in future. The return on investment has only come down. At the same time inflation has increased. Both are negatives for long term holders of the stock. However the share prices have gone up. Unless there is some change in policy this could be disappointing for current holders and buyers of the stock.

Power sector has been associated with optimism in recent past. Existing companies have announced new projects at rapid rate and a number of new companies have made an entry. This has increased the pipeline of new projects. This is likely to reduce the rate which companies would get on their investments in future. As mentioned there has been a proposal to reduce the return in power projects to 12%. The best the companies can hope for is tempered increase in tariffs. Note that high share prices have also contributed to this by making capital freely available for power projects. The longer the share prices remain high more will be the damage done. Unless the holders of stock want to sell now or near future the high share price would not be good for them too.

Apart from policy change there is another way in which share holders can limit their downside. If company sells shares at the current elevated price the companies can increase their value. If somebody sells shares worth X at 3X the current holders benefit because of capital infusion at elevated prices. However the new holders would have been short changed in that case as has happened in case of Reliance Energy IPO in which shares worth Rs 17 was sold for Rs 450.