

## **Insanity of Reliance Power**

Unless Reliance Power has discovered some magic wand by which it would generate electricity, long term holders of the stock are due for massive capital loss. Reliance Power operates in regulated sector. The returns on investment and tariffs both are regulated. The company has about Rs 13,000 crores as cash and some projects of rather doubtful economics. A valuation of Rs 90,000 crores for that seems wildly optimistic if not insane. We analyze the valuation below.

The IPO was sold by selling big dreams which had little connection with reality. The company says that around 28,000 MW capacity is under various stages of development. Since this is the present capacity of NTPC, there was a general opinion among the speculators in the IPO that Reliance Power would have a valuation close to that of NTPC. A valuation close to NTPC would have meant a share price of close to Rs 850. There are two very obvious flaws with this line of reasoning. First, the total fund requirement for developing 28,000 MW would be close to Rs 140,000 crores, ignoring inflation. Even with 2:1 debt equity ratio this would require an equity contribution of more than Rs 45,000 crores. The company would require more than that considering the kind of inflation we have. The fund with company would at best fund one third of intended capacity. So the valuation should be adjusted accordingly to one third that of NTPC. Second, the capacity would come up by 2017. Even the third of the capacity for which funding is available would come up by 2012, while NTPC's present capacity is 28,000 MW. The valuation of present capacity of 28,000 MW would be substantially more than 28,000 MW capacity which is supposed to come up by 2017.

That was for relative valuation of Reliance Power compared to NTPC. If we look at the absolute valuation which makes more sense for holders of shares the outlook is worse. The return on equity for most well managed power companies is comparable. That is not very surprising given the regulated nature of the business. So let us estimate the profits of Reliance Power by using this metric. Reliance Energy (now Reliance Infrastructure) used almost Rs 9,500 crores of equity in 2006-07 to generate a profit of Rs 800 crores. By this estimate the profit of Reliance Power (when it uses it fund fully in 2012) would be close to Rs 1200 crores. NTPC had used Rs 48,000 crores in 2006-07 to generate a profit of Rs 6800 crores. Using this figure as a reliable estimate we can expect the profit of Reliance Power to be around Rs 2000 crores in year 2012. Both these estimates point out the case of over valuation of Reliance Power shares. Our best case value for Reliance Power is Rs 20,000 crores. That implies an over valuation of about four times.

The promoter group initially paid less than Rs 17 for acquiring 90 per cent stake in the company. Outside investors paid at least Rs 430 to get the same just after couple of months. This must be the most amazing "value creation" that has happened anywhere in the world. In about 2 months Rs 3,300 crores was converted to Rs 80,000 crores. What happened after the IPO was almost as amazing. When share prices fell the company announced bonus shares. Though these shares would correct the situation somewhat they cannot make up for the 25 times higher price paid by outside holders of stock. The share prices have gone back to IPO level recently. Our opinion is that investors are fast asleep for only in their dreams can they think of holding the share at Rs 440. The reality would force them to sell out. In our opinion the valuation for pre bonus shares is nowhere close to these levels. There is a high chance that holders of shares would suffer more than 50 per cent depreciation from current level when the reality sinks in. It might take some time. But it would almost certainly happen, unless of course Reliance Power is able to sell its shares at even higher price to even bigger fools. Chances are slim but you never know.

"Uncertainty is not a pleasant state of mind but certainty is absurd" – Voltaire