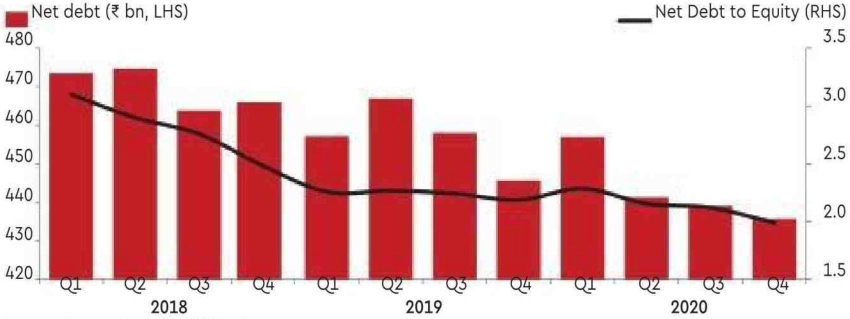
Tata Power – Net debt



Source: Company reports, HSBC estimates

TATA POWER RATING: BUY

Equity issuance a plus for investors

Given debt levels, deleveraging by company is expected to drive stock movement; 'Buy' retained with TP of ₹66

TPWR PLANS TO increase its shares by 18% through a fresh issuance at ₹53/share (a 15% premium to the closing price on 1 July, 2020). It is also setting up an infrastructure investment trust (InvIT) for its renewable business.

Valuation implications: The equity issuance is to be done at a 21% discount to its FY20 book value, and when completed, should dilute its book value by 3.2%. This would dilute our fair value estimate for Mar'21 by 5.7%.

Yet implications for stock appear significantly positive: In a recent report, we had highlighted that we expect debt reduction to drive stock performance. We assign a 15% discount to our fair value estimate derived from our SOTP approach to account for investors' aversion to high debt given TPWR's net debt/Ebitda for 2020 was at 5.5x. The equity issuance should reduce the net debt/equity multiple on a pro-forma basis (as of Mar'20) to 1.67x from 1.99x. With this, the promoters' shareholding will increase to 46.86% from 37.22%, which is a strong mark of confidence, in our view.

We believe an InvIT for its RE business will be even more positive from a debt reduction perspective and from a total return perspective as we see RE returns as being dilutive compared with returns for the regulated business. The RE business accounts for ₹108 bn of gross debt, and we value the equity part at ₹55 bn. We believe the InvIT structure should allow TPWR to deconsolidate its net debt from its consolidated business and allow its equity investments to be treated as cash equivalents, resulting in a total net debt reduction of c₹160 bn (c37% of net debt). When approved and executed, these developments should be significantly positive.

It is all falling into place: In our March note, we had argued that the separation and alteration of PPAs could reduce the overhang of losses from the Mundra plant. We are beginning to see some progress with Maharashtra approving the alteration of its PPA with TPWR. While the process is slow with four more states yet to agree, the near-term earnings impact is now likely to be less given lower coal prices. We also note the momentum in deleveraging from the sales of assets in the current quarter, which should reduce its debt by ₹24 bn.

Retain Buy and TP of ₹66: Our TP is based on a sum-of-the-parts approach in which we value the regulated, generation and other businesses at ₹83 per share for FY21e then discount to June 2020 at a rate of 15% to account for the discount investors ascribe for high levels of debt.

HSBC