Why Tata Power can be a **Turnaround Template for Cyrus Mistry**

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Turnaround Template

Tata Power has followed the Cyrus Mistry doctrine, sold foreign assets, taken goodwill hits and scripted a smart turnaround

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Tata Group power utility Tata Power is on the verge of a turnaround. It did not have a Corus on its books like Tata Steel did, nor a Jaguar Land Rover like Tata Motors did. Yet, in November 2013, Ashok Basu, independent director on the Tata Power board, described Tata Power as the biggest headache for group chairman Cyrus Mistry. Basu wasn't off the mark. In 2012-13, Tata Power had reported a consolidated loss of ₹85 crore on sales of ₹33,248 crore. In 2013-14 that loss jumped to ₹259 crore on sales of ₹35,900 crore.

A 4,000 MW ultra mega power project (UMPP) in Mundra, Gujarat, was doing to Tata Power what Corus was doing to Tata Steel – dragging the rest of the company down. Its high fuel cost was wiping out the surplus of the rest of the company.

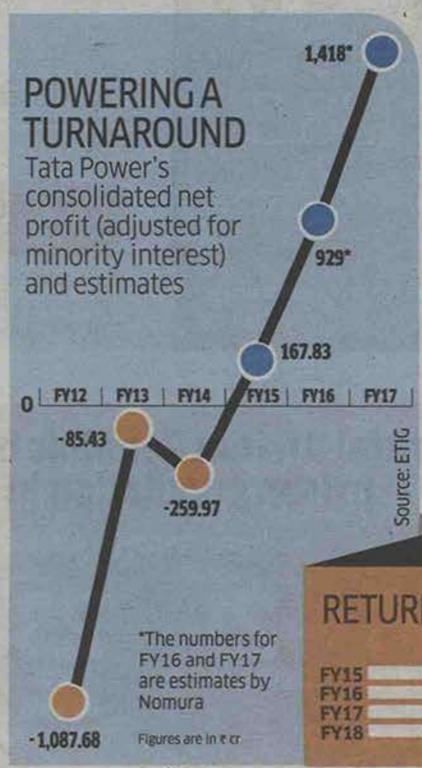
In the two and a half years since, Tata Power has seen a smart revival of fortunes. And it has followed a template, a blueprint that Mistry seems to have handed to all Tata companies. Sweat your existing assets, get rid of deadwood and at the same time keep looking for growth. If there are assets that have lost value, book the losses on the balance sheets.

Crucially, Tata Power was boosted by a tailwind of dropping coal prices and it is now on a course for clocking double-digit return on equity in fiscal year 2017 (see *Return on Equity*). In the first nine months of 2015-16 it has recorded a profit in excess of ₹500 crore.

Blood and Sweat

Mundra apart, Tata Power has a profitable generation business as well as a distribution licence for Mumbai and one for Delhi. It has thermal power plants in Maithon and Jojobera in Jharkhand, and Haldia in West Bengal, apart from a host of hydroelectric power plants near Mumbai. Outside India, it is present in Southeast Asia, West Asia and Africa. It is actively building a portfolio of renewable energy assets.

But the first task at hand for the Tata Power team led by managing director Anil Sardana is to stop the bleeding at Mundra. The company has around 10,000 MW of power utilities either operating or under construction today and Mundra alone accounts for 4,000 MW.

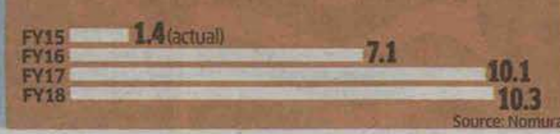


Of the four UMPPs planned by the earlier Congress-led United Progressive Alliance government, the Mundra UMPP is one of the only two that got built in India. Tata Power tied up imported coal from Indonesian mines in 2007 for the imported coal-based plant. It had invested ₹4,740 crore to acquire 30% stakes in two thermal coal producers PT Kaltim Prima Coal and PT Arutmin Indonesia as well as in a trading company belonging to PT Bumi Resources; and had inked supply agreements too. Then, in three years, it suffered a double whammy.

In 2010, the Indonesian government asked all coal miners to sell at prices indexed to the global spot price. This took away the benefit of having coal mines in Indonesia as coal for Mundra was now being bought at market price that was upwards of $120 per tonne instead of $32-34 per tonne as contracted in the deal.

Mundra UMPP recorded a loss of ₹748 crore in 2014-15 and is expected to report a net loss of a little over ₹300 crore for the current financial year.

Even as Tata Power fought legal battles with the buyers of its power (five neighbouring states' government distribution companies) to get some compensatory tariff for this change in fortunes, coal prices started dropping slowly 2013 onwards. Today they are 65-70% off their 2011 peak.



What was bought as a hedge against high coal prices by Tata Power began working to its disadvantage. Coal for Mundra was being procured at market price while the downward trend in coal prices now was hurting the valuation of its coal mine business in Indonesia. Whenever coal prices are on a downward spiral, the valuations of coal mining businesses fall faster.

In 2014, Tata Power decided to sell its stake in Arutmin and later also inked a deal to have an option to sell 5% in Kaltim Prima Coal. But the Arutmin deal is yet to fructify. Finally, in the quarter of October-December 2015, Tata Power recorded this loss in value and booked impairment on assets and goodwill of ₹187 crore.

The Mundra UMPP's business, meanwhile, got a few boosts. By August 2015, thermal coal prices had dropped to 12-year lows, helping Mundra run on a more sustainable basis. A January 2016 report by Nomura on Tata Power forecast the Mundra plant to become profitable in the current financial year.

It got another boost when the Appellate Tribunal on Electricity said in April that a "force majeure" clause in its power purchase agreement with the state power distribution companies should be used to decide the increase in tariff for the power being produced. This may mean Tata Power will get a better compensatory tariff than what had been allowed already by the Central Electricity Regulatory Commission for the loss due to the changes in Indonesian rules.

MUNDRA: FORTUNE FLUX

2006 — Tata Power wins the 4GW Mundra Ultra Mega Power Project by quoting a levellised 25-year tariff of ₹2.26 /kwh. 55% of fuel cost and 90% of capacity charge (fixed costs) were non-escalable

2007 — Tata Power acquired 30% stake in Bumi's KPC/Arutmin coal mines along with 12-year supply contracts for 10.1 million tonne of coal per annum. 55% of it was to be at $32/ tonne with a 2.5% yearly escalation clause and the rest at $34.15/ tonne indexed to escalation notified by India's CERC

2010 — The Indonesian government issued new regulation that mandated all coal-mining permit holders to sell coal referring to a benchmark price and spot price of coal in international market and asked all contracts to be re-written within a year

2011 — The year saw a 65-70% spike in international coal prices making the bid tariff for Mundra inadequate for recovering its costs

2012 — Tata Power petitioned the CERC seeking relief due to the changes in rule by the Indonesian government that led to increase in the cost of its coal supply and also sought a mechanism for dealing with such costs in future

2013 — CERC decided to grant a compensatory tariff for ensuring viability of the project and directed a committee to be formed to work out the mechanism. It refused relief under the clause of "change of law" in the power purchase agreement, that was sought referring to the change in Indonesian regulations

July 2014 — A Deepak Parekh-led committee issued detailed orders for this mechanism for fixing the compensatory tariff. The distribution companies or discoms from five states challenged the order at the Appellate Tribunal for Electricity (APTEL)

Aug 2014 — APTEL's interim order allowing current compensatory tariff was challenged in the Supreme Court. The Supreme Court stayed it and asked APTEL to also reexamine if there is a case for relief under "change in law" or "force majeure" clause

April 2016 — APTEL, in its order in April 2016, said the tariff relief has to be decided under the "change of law" or "force majeure" clause. It is likely that relief under this will be more than the ₹0.524/kwh it got under compensatory tariff earlier

Anil Sardana is a veteran of 14 years at the Tata Group, and leading Tata Power in his second stint with it. He is not one to rejoice early. Sardana sees this struggle to get some extra dough from the state distribution companies for Mundra finally ending at the Supreme Court. Sardana points out that his strategy was not only to stop the bleeding at Mundra but also sweat his other assets.

Take, for example, Maithon Power Ltd, a 1,050 MW thermal power plant near Dhanbad in Jharkhand in a joint venture with the Damodar Valley Corporation. Tata Power managed to bring down its heat rate by 50 kilocalories in a year to 2,345 kilocalories per kilowatthour (the heat rate shows how much heat is needed to produce 1 kwh of electricity. A lower rate indicates better efficiency). The plant load factor, or the level at which the plant is operating, was also improved from 69-70% to 76-79%.

"You improve on parameters like heat rate and auxiliary power and then focus on selling as much of the power as possible, so your per unit rate comes down," says Ashok Sethi, executive director and chief operating officer of Tata Power. The company has also invested in its Mumbai operation, introducing modern measures like a computerised self-healing system for its distribution network in the city. It is also about to launch an app for Mumbai customers, who will be able to check their consumption and pay bills from their mobile phones. And in April Tata Power announced the sale of its 50% stake in a geothermal energy joint venture in Indonesia.

It's Getting Complicated

Tata Power may have been short-changed in its effort to hedge its Mundra UMPP's hunger for thermal coal by buying into coal mines. But it has not given up on hedging for its entire business model. Sardana says that the company is looking to increase its revenues from non-regulated business and raise its renewables energy portfolio to 35-40% of its generation capacity. "Today the non-regulated portfolio has profits of ₹50 crore. We want them to contribute ₹500 crore by 2022," Sardana says. These businesses include a trading subsidiary in Delhi with a 40-member team, a defence business known as Tata Power SED (Strategic Engineering Division) and services businesses. The defence arm has already invested in two factories in Karnataka. "These businesses do not need huge capital investments for growth. We will only need to provide more working capital," says Sardana.

He is also planning to grow the company by doubling power capacity under construction or operation to 20,000 MW by 2025 and is open to seeking capital from outside. "If the opportunities come in a heap, we will have to seek funds from outside the company."

BHARAT CHANDA

TURNAROUND TRIGGERS

- Sweat domestic assets like Mumbai or Maithan, seeking efficiencies and increasing plant load factor to get more out of them
- Boost sales and profits from other non-regulated businesses like trading, defence and services — with aims to boost it by 10 times by 2025
- A sustained downward turn in the international coal prices
- Lowering exposure to international assets like Arutmin coal mines and geothermal power joint venture in Indonesia
- Favourable judgment on Mundra UMPP from the Appellate Tribunal that will allow Tata Power to recover costs even better

Such ambitions growth plans immediately after a turnaround may seem outrageous. The question that arises is, has Tata Power done enough to fireproof its future profitability? Harshvardhan Dole, analyst with IIFL, a financial services firm, says: "Their biggest drag was Mundra and that has come down sharply. The parent Tata Power has also waived off interest on a loan to Mundra and it has also changed the method of depreciation. All of its other businesses are profit-making."

But Dole adds a cautionary note: "Tata Power should focus all their energies on Mundra. As of now half of its net worth is blocked in Mundra. What will happen if international coal prices rebound now? Their focus should be on selling off non-core assets and building up the power portfolio."

IndiaNivesh Securities came up with a report on the company on April 22, taking into account the Appellate Tribunal order on April 14. The report has put out a target of ₹104 for the Tata Power scrip, currently trading around ₹69-70. In its rationale for business, it notes that the sale of the Arutmin mine stake in Indonesia can bring in $500 million as and when it materialises and it is likely to get a favourable tariff order for Mundra as well.

Nomura Equity Research had in January 2016 put a buy on Tata Power scrip with a target of ₹85. However, in its detailed report Nomura analysts complained that some parts of Tata Power's expanding universe are inaccessible to analysts, and compared the accounts of Tata Power to a black box, which cannot be deciphered.

Its analysts Anirudh Gangahar and Archit Singhal wrote: "Diversified businesses, unlisted entities, multiple geographies, accounting standards and limited disclosures in respect of the coal business make the build-up of consolidated financials difficult to decipher. Going ahead as several assets under jointly controlled entities get commissioned, financials provided under 'share of JVs' would increasingly become a black box unless Tata Power provides additional disclosures." A prime example would be Tata Power's hydropower JV in Georgia that will supply electricity to Turkey.

The report calls out Tata Power's business model as complicated even while it predicts high profitability in the short run (see *Turnaround Triggers*). Sardana says as a Tata company he would prefer to make more disclosures, but is sometimes constrained by joint ventures where it is a minor partner. But as some other Tata companies would confess, complications in smaller doses are always easier to manage. With profits backing him, Sardana and Tata Power could, for now, well turn out to be the poster boy of the Tatas under Mistry. ■