HARGREAVEHALE

INVESTMENT BULLETIN

Passage to India and back

7 December 2010

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A quick visit to Chennai, otherwise known as Madras, to see OPG's 77 megawatt (MW) plant. OPG is an Aim listed coal fired electricity generator (Higher risk).

It is a no brainer that India is short of power and you don't really have to have recourse to complex charts representing future supply of and demand for power to prove the point. You just have to sit in one of the best restaurants in the centre of a sophisticated urban sprawl called Madras and try to dodge the bullets or time the transfer of hot curry from plate to mouth before the lights go out again.

So the game is building power plants. A coal fired electricity generating plant is getting on for being a commodity item. There is skill in delivering a plant on cost and on time and there is skill in optimising output, but there is no technology risk. There is operating risk in terms of the price of raw material inputs such as coal and there is risk in terms of the pricing of output. But in a market in which it is difficult to see supply catching up with demand in the foreseeable future, the main immediate risk lies in the timing of and the delivered cost of the construction. Almost as important as construction in terms of risk is getting the right consents. Getting the land, getting the environmental consents, getting the agreements in place for groundwater, understanding and knowing how to interface with the local interests, political and otherwise who need to be onside. It goes without saying that debt and equity finance have to be in place.

By coincidence, on arrival there was a certain amount of discussion in the local press about corruption. No point in beating about the bush. Access Wikipedia and you get the following facts: Transparency International in India has found that over 50% of the population had first hand experience of paying bribes or influence peddling to get a job in a public office. It found that taxes and bribes are common between state borders, that truckers pay annually $5 billion in bribes. In July 2008, the Washington post reported that nearly a quarter of the 540 Indian parliament members faced criminal charges, "including human trafficking, immigration rackets, embezzlement, rape and murder". Puts the petty alleged venality of our own local UK and Euro members of Parliament into perspective.

The local press is also full of comparisons between China and India. In particular, why has China overtaken India so rapidly in terms of GDP growth. It is also hard not to get the impression in conversations with local business men that the Indians do not welcome with open arms Chinese competition on building, plant and material supply contracts. Getting down to the nitty gritty, Chinese success is largely put down to the lack of democracy and the ability of a dictatorship to push through and activate five or ten year plans successfully. The financial press moans about the over regulation of their society which they describe as a cancer which breeds corruption because only corruption can cut through the thickets of regulators when something practical needs to be done within a reasonable timespan.

By the time the British left in 1948, they had built an effective, national transport system based on the railways but unfortunately not on motorways. Very little seems to have happened since. Everything is clogged up in terms of access, the roads are antiquated, the bridges on motorways require two way traffic to fight it out single file and so on. Corruption and the inability of regional interests to compromise with national legislators in terms of national transport planning, has got in the way of progress. Become part of the political elite and take your money out of the country. An international watchdog conducted a study on the illicit flight of money from India, which was perhaps the first ever attempt at shedding light on a subject steeped in secrecy and concluded that India had been drained of $460 billion between 1948 and 2008.

Perhaps somewhat perversely herein lies the opportunity and it is a really big one. The electricity industry in India was restructured by the Electricity Act 2003, which unbundled the vertically integrated electricity supply utilities in each State into a transmission utility and into a number of generating and distribution utilities. The act also enabled open access on the transmission system allowing any consumer with a load greater than 1 MW to buy electricity from any generator. Effectively this opens up the market to independent power producers such as OPG. One imagines that the Indian State was reluctant to see this happening but there was inevitability about such a move as a result of the decline in foreign investment in India to around $5 billion a year compared with the $40 to $50 billion a year flooding into China. Indeed in contrast to China, the percentage of infrastructure contributions to fixed capital formation has been declining sharply. What an opportunity for private investment.

A unique feature of India is the number of well educated people with English language and technical skills. As a result, India has emerged as a leading exporter of software services and the information technology sector leads internal GDP growth. Electricity and telecommunications are the two key inputs for this growth and the problem has been that unpredictable electricity supply from the state sector has caused a lot of problems for start ups and entrepreneurs. These complain of having to pay large deposits to their local electricity boards to get supplies. Hence the need to facilitate private investment in electricity supply.

This is particularly the case because India continues to run big public sector deficits both at State and regional levels and despite large foreign currency reserves, capital controls and large public ownership of national banks, controlling the fiscal deficit and public debt remain the key concerns of Indian policy makers and this seems likely to continue.

The previous Government initiative on energy had pitiful results. The plan was to create 41,000 MW of electricity over five years and the actual result was less than half that. As GDP growth continues and judging by recent figures accelerates, something has had to give and this gives corporates like OPG what looks like a serious opportunity.

The way to look at OPG probably is as a private equity investment at this stage rather than as an equity delivering immediate dividends. As a start up the company is in the relatively early stage of building up a critical mass of electricity output. To some degree the fact that there may be some project delays and or load factor disappointments for whatever reason is pretty well irrelevant as long as demand for power remains in excess of supply. It may or may not cause minor disappointments or hiccups which may or may not from time to time cause some analysts to downgrade earnings occasionally but judging this group on an earnings multiple at this stage of its development is a mistake. This company is at the beginning of a race to build critical mass in terms of electricity supply.

The validation of the original business model has come with the recently commissioned 77MW plant in Chennai and the capacity roll out has been accelerating with the civil works underway for both the second 77MW module in Chennai and the two 150 MW plants in Kutch. OPG will have 480 MW of capacity once these plants are commissioned by 2014.There may or may not be teething problems but the additional capacity now being put in at Chennai is not greenfield, it is being incorporated into the existing plant structure both cutting costs and reducing time lines. There will for example be no need to obtain additional groundwater rights or environmental permits and the existing storage capacity for coal can accommodate the increased generating capacity. Tata Power, the largest power utility contractor in India is building the Kutch Plants to a fixed price and with liquidated damages if there is a delay.

The scope therefore for disappointments in terms of costs and time delays should be reduced. Certainly walking around the existing 77MW module in Chennai and looking at the structures already built on the second, adjacent module gave confidence that delivery by the end of the second quarter of 2011 was more than feasible.

Once all the plants in development are commissioned over the next two years, OGP will have 482 MW of power in operation. Furthermore, because of its business model of being self financed without recourse to State funding, OPG has the flexibility to negotiate short term off-take agreements for up to half or more of its output at higher prices in the same way that merchant plants operate enabling OPG to capture premium prices. For example, OPG has recently taken advantage of high spot prices by negotiating a deal with a local electricity board to supply electricity at a premium price of over 40%.

This pricing flexibility is clearly extremely important. OPG has established its plants as "self financed Group captives" because it has the ability to access equity financing from its institutional investors thus providing the competitive edge over other debt financed electricity suppliers.

There must be a temptation for the Group to take advantage of a favourable financing edge, a favourable pricing environment and a close relationship with Tata Power, to accelerate the build. This is possibly the key to share price performance.

If the Group completed the existing build programme as planned and did nothing else, then it could become highly cash generative. The existing programme could deliver ebitda of £135m within four years, compared with a current market cap of £180m. This would enable the creation of a very healthy dividend yield if nothing else. However, this is an unusual company and the probability is that the new build programme will be accelerated requiring more equity financing. Arguably it does make sense to do this whilst the opportunity is there. And importantly the Group has a sophisticated institutional investor profile who understand the dynamics of the Group, people like Stuart Sharp of Rensburg, Audley Capital, masters of the coal universe following the sale of Western Coal, and the British Steel Pension fund, part of the Tata Group.

Seeing the board interacting together was interesting. It is an unusual blend of Anglo/Indian skill sets. In Arvind Gupta and Narayan Swami respectively CEO and Finance Director, two very experienced and able individuals with powerful connections within the Indian establishment. Mike Grasby who has been responsible for running Drax, the largest coal fired plant in Europe, Martin Gatto, the finance Director of British Energy who played a major part in the successful restructuring of the UK Group. A heavyweight board for such a small company.

Obviously there is serious risk attached to such a stock not least because the real pay off for investors is in the longer term when the critical mass of the build capacity is sufficiently large to finance out of cash flows any new build. Depending on the mix, dividends should then flow. However, in the next three years new build will expand and it is important that equity holders step up to the plate when equity is offered because it is the equity element of the plant financing which provides the competitive edge in terms of cost and in terms of subsequent pricing flexibility. On the longer term view, given the experience of the Board and the close relationship with the Tata Group providing fixed price contracts for new build, this company does look very interesting on a prospective PER of 3 for 2014.

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