Power Grid (PGRD.BO): Direct beneficiary of our transmission for transition thesis; initiate at Buy

Investment Thesis

US$500bn+ transmission TAM: Power Grid Corporation of India (PGCIL) stands to be the largest beneficiary of our US$500bn+ grid TAM estimate between FY24-50E (Exhibit 7) - 1/3rd of India's overall energy transition TAM, based on our estimates. It's large balance sheet, low cost of debt and strong annual free cash generation position it favorably to capture bulk of our TAM estimate. PGCIL also benefits from being eligible for direct nomination to execute large, complicated, multi-region projects – which, in our opinion can see material ramp up as India focuses on cross border grid interconnections.

Large balance sheet, low cost of debt = competitive advantage: Our analysis of PGCIL's cash flows implies PGCIL alone will be able to fund 30% of India's planned grid capex by FY32E, while maintaining its current dividend payout (Exhibit 13). PGCIL's cost of debt advantage is similar to that of NTPC in renewables, which has allowed PGCIL to capture 40%+ of the auction market share. We also expect PGCIL to benefit from an easing of competitive intensity in new project auctions as most private developers run out of balance sheet capacity due to the sheer quantum of capex we expect grid expansion will require.

Long-term beta not truly reflective of PGCIL's cost of equity: We believe PGCIL's long-term beta of c.0.6x not only compares poorly vs. global peers' median of 0.4x (Exhibit 18), but also materially increases the company's cost of equity - thereby impacting its fair value. If we substitute our assumed beta of 0.6x with the global median, our fair value estimate for PGCIL increases c.32% from Rs355 to Rs470. In fact, PGCIL's closest listed global peer, Elia Group (ELI.BR; Buy), has a long-term beta of just 0.15x - at which our fair value estimate for PGCIL increases to Rs695. While it is difficult to pinpoint the reason behind this discrepancy, we believe it was due to the high earnings growth period that PGCIL seen in FY09-21 (Exhibit 19, Exhibit 20). While we do not factor any beta reduction in our valuation, it could surprise positively.

Regulatory overhang removed; grandfathering of legacy asset base implies long-term comfort: The 2025-29 tariff notification by CERC (Central Electricity Regulatory Commission) reduced normative RoE of prospective transmission projects by 50bps and left PGCIL's large legacy asset base returns untouched. We see two positives for PGCIL from this: 1) the bulk of its asset base growth is expected to be auction driven, which will not be impacted by the RoE reduction; 2) more importantly, grandfathering of the legacy projects eases concerns about future regulatory uncertainty as it implies the central regulator realizes that a change in normative RoE would impair project economics based on which it was originally funded.

Where are we different: 1) Our thesis that the transmission grid expansion required for energy transition will be much larger and will continue for much longer, than government's current estimate of US$35bn transmission capex by FY29E (see our sector note for more). 2) Likely improvement in auction returns as competitive intensity subsides with pickup in transmission capex; and 3) belief that PGCIL will be the preferred partner for executing complicated, inter-regional and cross-border projects.

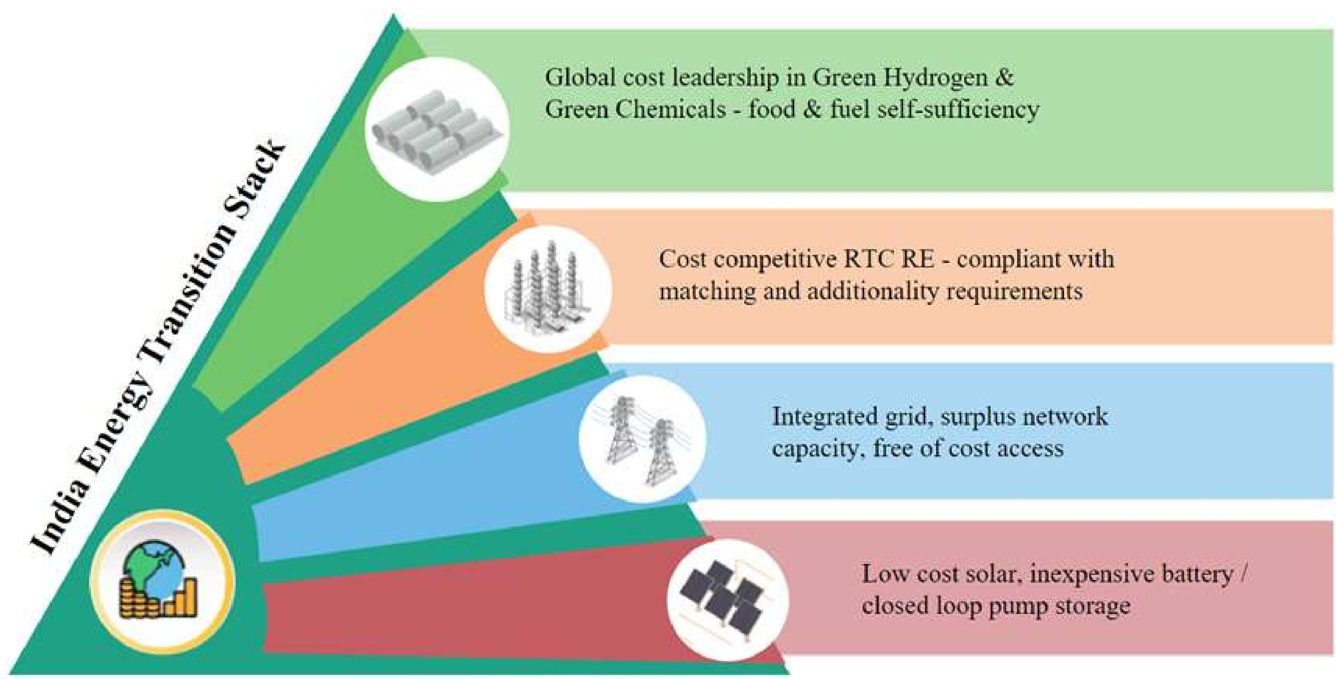
Risk-reward: Combination of steady cashflows from regulated business along with transition led potential transmission capex revival ensures favorable risk reward for PGCIL. Stock is trading at FY26E P/BV of 2.4x vs. 4.5x of domestic private gencos, despite offering superior RoEs and better growth prospects, in our opinion; we believe revival in transmission capex should more than offset this gap.

Earnings & valuation: We forecast a 2% earnings CAGR in FY23-26E, driven by c.3% regulated equity CAGR and 20% profit CAGR of auction-won projects. We initiate coverage with a Buy rating and a 12-month SoTP-based TP of Rs355/sh (book FY26E P/BV of 3.2x, vs. LT avg. of c.2x) and 3% dividend yield.

Key risks: Delay / slower than expected pick up in transmission project awards, rise in competitive intensity / cost of debt hampering TBCB project IRRs and shortage of transmission equipment affecting project execution.

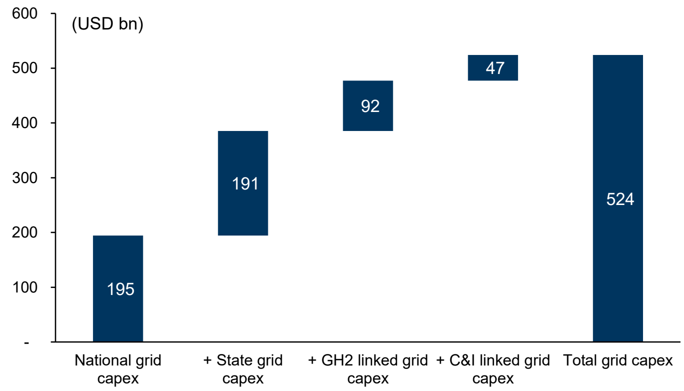
Our thesis in key charts

Exhibit 6: India Energy Transition Stack - how India is leveraging its national grid to attain energy and food self-sufficiency, achieve global new energy cost leadership



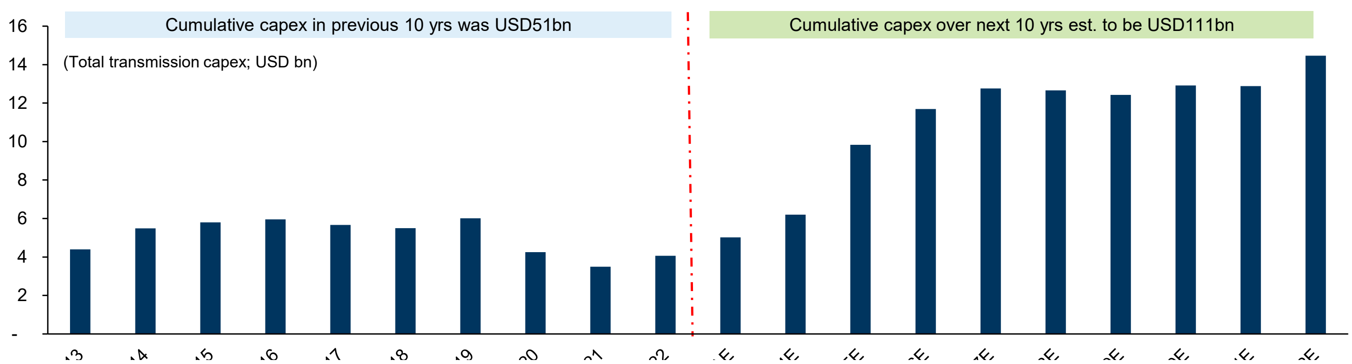
Source: Goldman Sachs Global Investment Research

Exhibit 7: ...which will lead to creation of a capex opportunity worth US$524bn b/w FY24-50E



Source: CEA, Goldman Sachs Global Investment Research

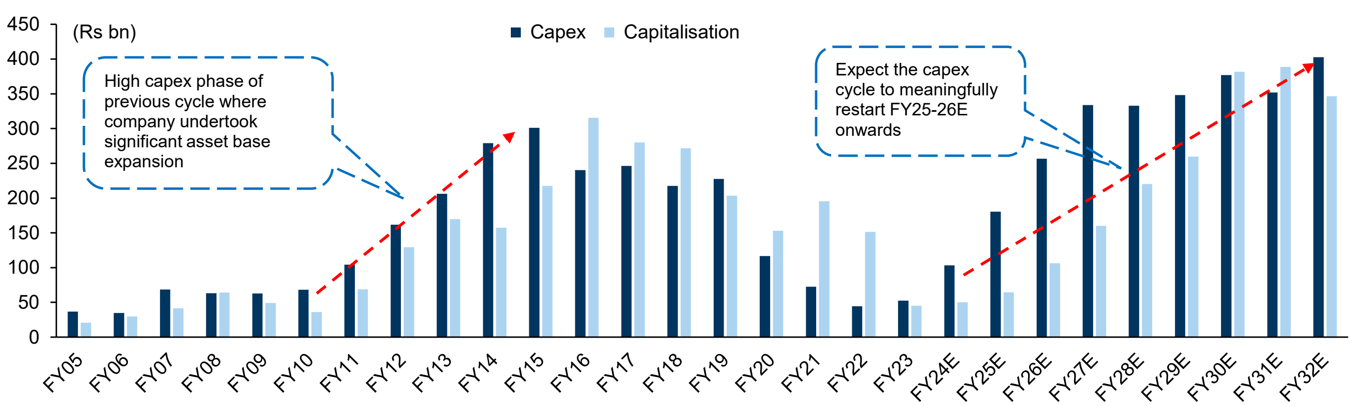
Exhibit 8: Over the next 10 years, we estimate India's grid capex to more than double vs. previous 10 years



Source: CEA, Goldman Sachs Global Investment Research

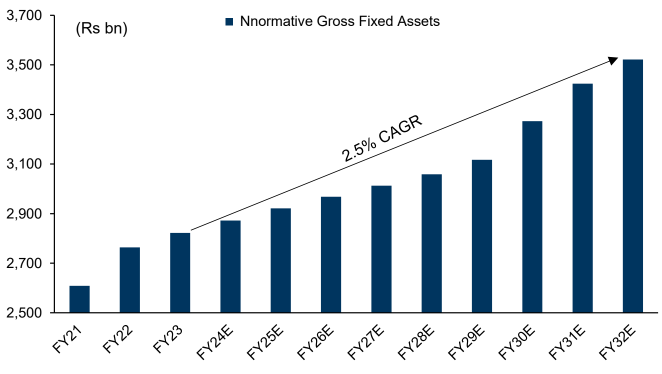
Exhibit 9: ...that should help restart Power Grid's transmission capex cycle - which previously peaked in FY15 & sharply contracted post FY19

Power Grid's annual capex and capitalisation data



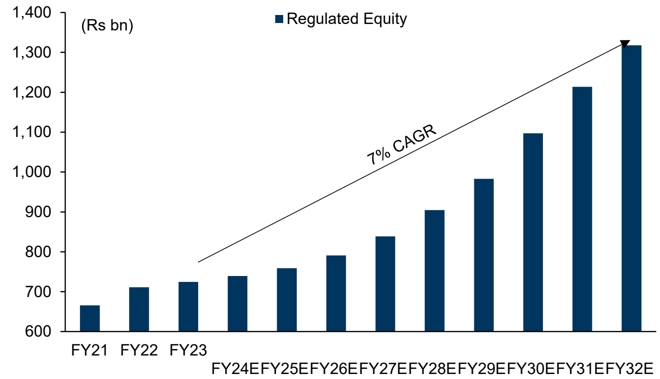
Source: Company data, Data compiled by Goldman Sachs Global Investment Research

Exhibit 10: We expect Power Grid's regulated gross asset base to increase at c.3% CAGR over FY24-32E...



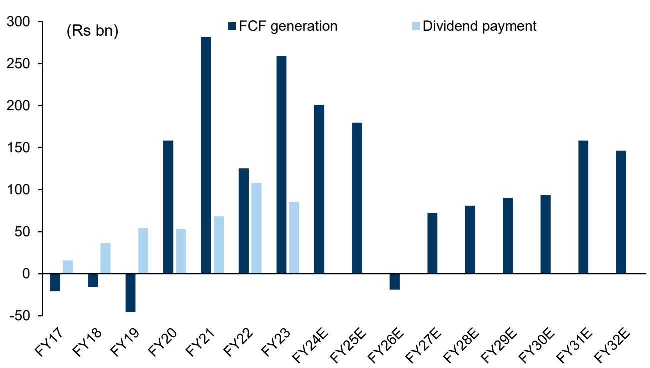
Source: Company data, CEA, Goldman Sachs Global Investment Research

Exhibit 11: ...which will result in 7% CAGR in regulated equited over the same period



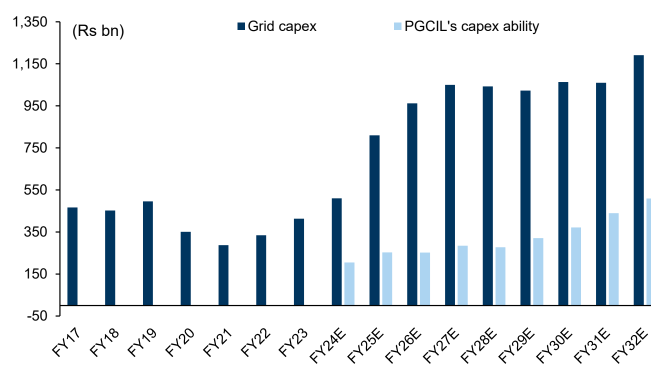
Source: Company data, CEA, Goldman Sachs Global Investment Research

Exhibit 12: Power Grid's FCF generation has been positive since FY20 when capex peaked; we expect it to remain positive once the next cycle restarts around FY25-26E



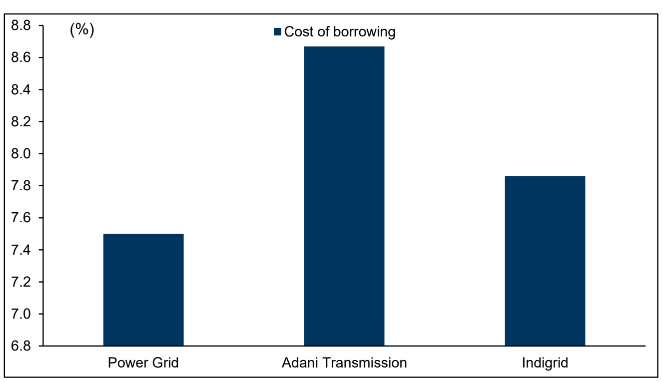
Source: Company data, Goldman Sachs Global Investment Research

Exhibit 13: We estimate PGCIL's annual cash generation to be adequate to fund c.30% of India's overall grid capex b/w FY24-32E, even when maintaining its current dividend payout



Source: Company data, Goldman Sachs Global Investment Research

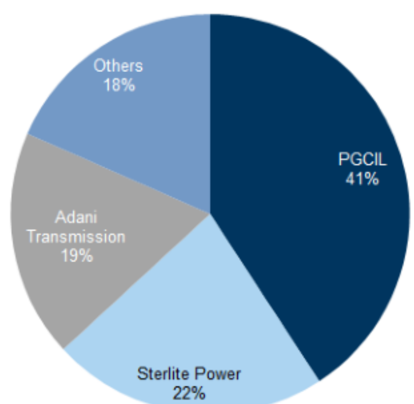
Exhibit 14: PGCIL's debt cost is materially lower than private competitors...



*for FY23

Source: Company data, Goldman Sachs Global Investment Research

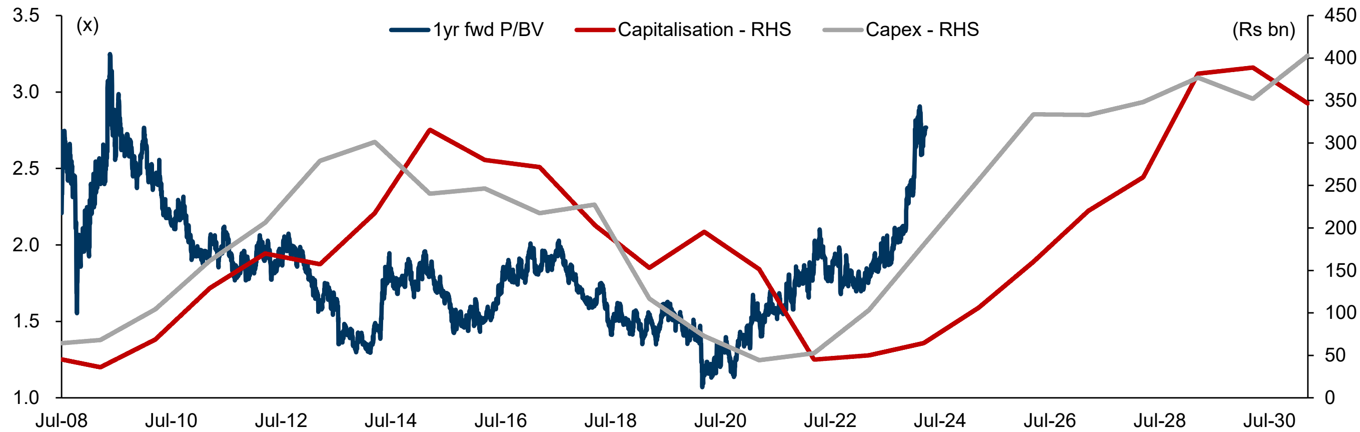
Exhibit 15: ...allowing it to capture 40%+ mkt share in auctions till date



*data till 1HFY24

Source: CEA, Goldman Sachs Global Investment Research

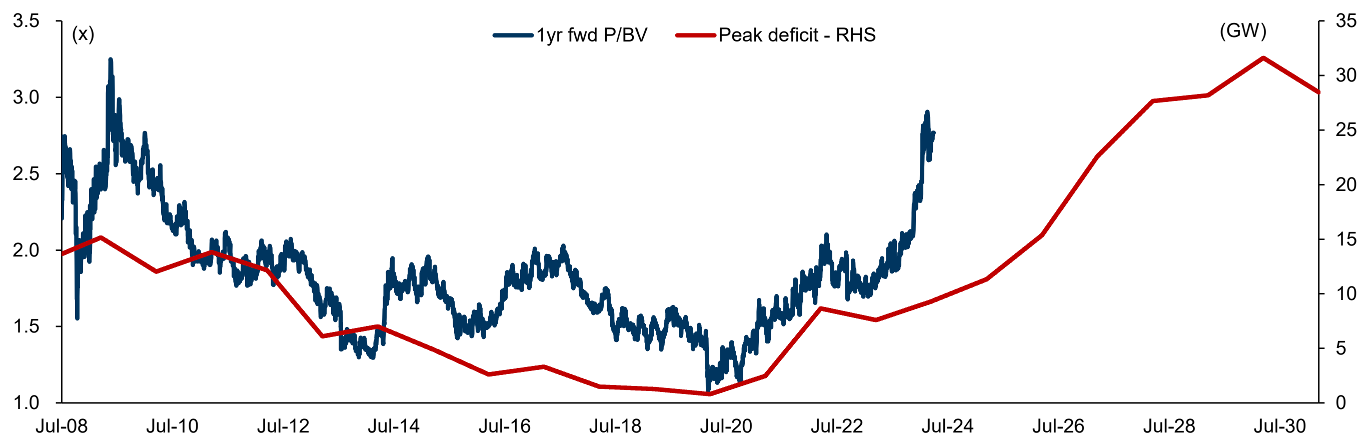
Exhibit 16: Power Grid's valuations tracks transmission capex momentum; we believe it is yet to fully price in the expected capex uptick



*priced as on April 16th, 2024

Source: Company data, Datastream, Goldman Sachs Global Investment Research

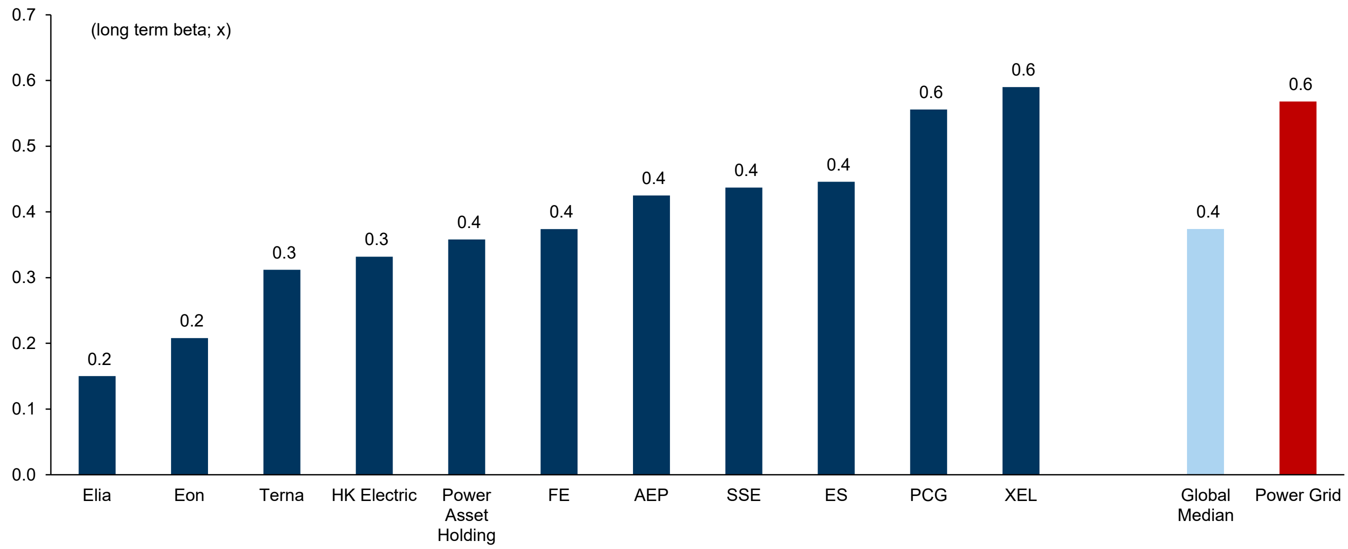
Exhibit 17: Rising peak deficit tide is lifting Power Grid's boat as well



*priced as on April 16th, 2024

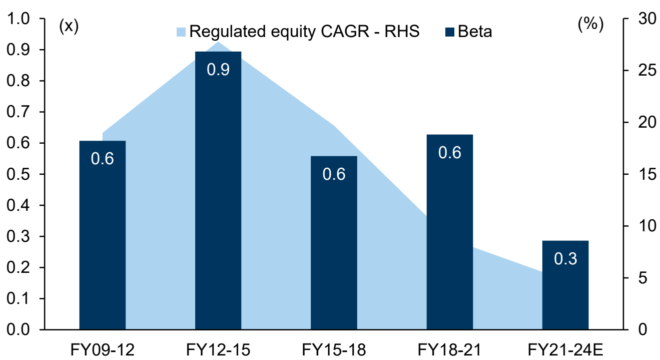
Source: Company data, Datastream, Goldman Sachs Global Investment Research

Exhibit 18: PGCIL's long term beta is c.55% higher than that of global peers with a similar business profile, resulting in materially higher cost of equity even after factoring country risk profile...
till date



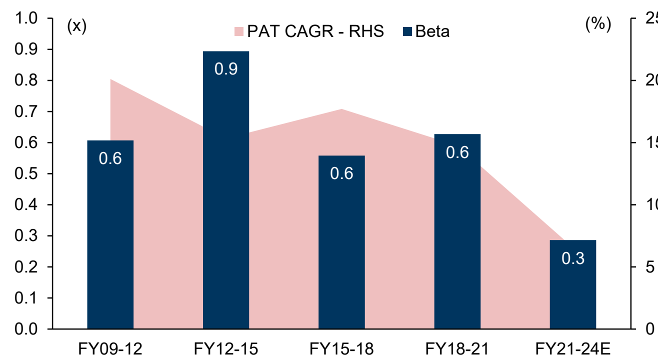
Source: Bloomberg, Data compiled by Goldman Sachs Global Investment Research

Exhibit 19: ...which seems to be the outcome of company's high asset base growth in FY09-21....



Source: Bloomberg, Company data, Goldman Sachs Global Investment Research

Exhibit 20: ...and is also reflected in Beta reduction with earnings growth slowdown since FY21



Source: Bloomberg, Company data, Goldman Sachs Global Investment Research