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CESC demerger: investors get cold feet

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Are investors having second thoughts about CESC Ltd's demerger? Investors who drove up the stock 56% in the five months to Wednesday sent it 15% lower on Thursday after the firm said it is going to split itself into four units—power generation, distribution, retail and other ventures—and list on the stock exchanges. Is it a classic case of "selling the news"?

The split will unshackle the generation and distribution business. They will no longer have to bear the burden of the loss-making retail venture and the non-core businesses. This will help them become more focused and conserve earnings better. As a consequence, these two units stand a chance to get better valuations, say analysts.

"We would now have a first pure play listed distribution company, which will help the company attract a new set of long-only investors (like the Canadian pension fund acquiring a stake in Reliance Infrastructure's Mumbai distribution business) who like a business with assured returns, relatively lower risk, consumer facing with sustainable cash flows," says Deepak Agrawala, senior vice-president (utilities, renewables and industrials research) at Elara Securities (India) Pvt. Ltd. According to Agrawala, regulations allow higher post-tax return on equity for the distribution business vis-à-vis the generation business.

In CESC's generation business, barring one unit, all plants have longer power purchase agreements, which assure steady cash flows. Similarly, as the retail business turns profitable (it achieved break-even in the last eight months), the unit is expected to get a valuation boost upon listing. But as the steep correction in the stock price suggests, not everyone is convinced.

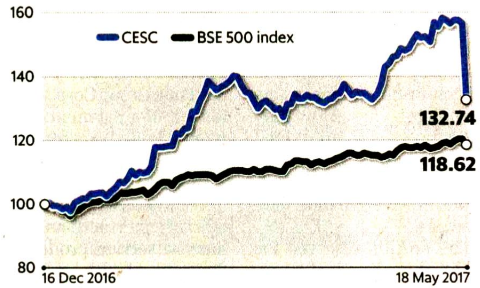
Why? The Street is yet to get a grip on demerger benefits. Technically, the retail business is still making losses. If it does not stop making losses by listing time, it may not get good valuations. "In this scenario, they may not get good valuations," says Rupesh Sankhe, an analyst at Reliance Securities Ltd. If losses continue even after the demerger, then the unit will either have to borrow funds or raise fresh capital, diluting the current shareholding.

Second, only two of the five power distribution franchises are making money right now (the rest of them are new franchises). The management expects this business to start making money in 18 months. While the guidance should comfort investors, the fact is that two (distribution and retail) of the four entities post demerger will still be in the transformation phase by the time of listing. Also, the fourth unit (other ventures) will hold stakes in Firstsource Solutions Ltd and other investments, making it more of a holding company. Unless these units display strong earnings trajectory and build investor confidence, they may not get the kind of valuations markets are expecting till now.

That brings us to one question. Wouldn't CESC investors be better off if the units were listed gradually one by one, as they stabilize and become sustainable?

Separation pangs

The CESC stock, which rallied 56% in five months to Wednesday, lost over a fourth of those gains on Thursday.



Base value taken as 100

Source: BSE

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