Divestment drive: PFC-REC deal could push both into trouble

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The Centre's drive to meet its disinvestment target could land two of the leading power sector financers in trouble, executives fear. While for Rural Electrification Corporation (REC), it would mean losing concessional line of credit that it uses for financing flagship energy schemes, the disinvestment could strain the Power Finance Corporation's (PFC's) finances.

Besides, there are apprehensions of money rotation — the Centre putting back part of the funds it earned from this deal into the merged entity since the proposed merger would lead to its holding in the new company coming down to around 45 per cent, thereby making it a private company. If the Centre raises its stake in the merged company to 51 per cent, it will need to infuse roughly ₹7,000 crore for the same.

Alternatively, the government equity share could be increased by PFC buying back a part of the current floating equity. "Instead of the Centre increasing its stake in the new company after the merger, PFC will acquire more stake in REC till the merger is completed. This will impact the share-swap ratio to such an extent that the Centre's stake in the new company will be at 51 per cent when the merger is complete," said a senior official, requesting anonymity.

The official said PFC could utilise the dividend that REC pays it after the acquisition to buy back REC shares from the market. PFC is buying the Centre's entire 52.63 per cent stake in REC.

The merger process could take more than a year. PFC in its latest investor presentation also indicated "current focus is to complete acquisition deal. Timelines for the merger will be considered subsequently".

REC, too, is facing financing troubles and a merger would aggravate it, said senior executives. "After this decision, several rating agencies have put REC on "credit watch negative". This has hurt the company's borrowing plans significantly at a time when it is at conclusive stages of various government flagship energy access programmes. REC has been lending to the states and executing these programmes. All of that would be in a limbo soon," said an executive.

REC runs the village and household (both rural and urban) electrification schemes: SAUBHAGYA and DDUGJY. The Centre provides 60 per cent of the project finance to states for giving free connections to households. As most state-owned power companies are loss-making, they seek lending from REC to execute this.

Moody's Investors Service in December said the acquisition by PFC of the government stake in REC is credit negative for PFC, because it will materially weaken its consolidated capital ratios. "While transaction could also create some operational synergies, as both PFC and REC operate in the same business segment, Moody's believes that the negative impact from lower capital levels will outweigh any potential synergies," it said.

Alongside, PFC is battling non-performing assets in the power generation sector. Sector experts have expressed concerns on PFC's capitalisation after the acquisition.

S&P Global in its report putting PFC on 'Credit Watch' said, "We may lower our rating of PFC if a moderate weakness in capitalisation is not offset by an improvement in business franchisee. In a scenario that the PFC's capitalisation drops so sharply that risk-adjusted capital (RAC) declines below 7 per cent, we may lower the rating."

The finance ministry, however, has turned down these claims, saying PFC would remain unaffected. "For NBFCs, Tier-1 capital adequacy is needed to be 7 per cent and for an infrastructure finance company, the capital adequacy required is 10 per cent. PFC is fulfilling those post-acquisition also and its RAC would remain 10 per cent," said a official.

He said for Tier-II capital adequacy ratio, PFC will be short of that mark by about ₹2,000 crore. "For that, they will issue bonds, which they are raising and getting over with before March," the official said.

In December 2018, the Cabinet Committee for Economic Affairs (CCEA) approved the sale of central government's existing 52.63 per cent of the total paid-up equity in REC to PFC, along with transfer of management control.