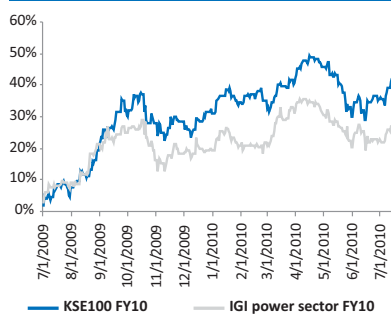


## Power Incorporated

**Relative return KSE-100 vs IGI Power Univ**



Source: Bloomberg, IGI Research

**Sector Snapshot**

		HUBC	KAPCO
Last Close*	(PKR/share)	33.09	42.02
TP Jun11	(PKR/share)	57.5	55.3
Free Float		28%	18%
M. Cap	(USD mn)	450.41	435.03
EPS - PKR	FY10 E	4.90	5.78
	FY11 E	4.91	6.77
	FY12 E	6.18	8.03
DPS - PKR	FY10 E	4.50	5.49
	FY11 E	4.80	6.00
	FY12 E	5.75	7.63
BVPS - PKR	FY10 E	25.92	26.51
	FY11 E	26.03	27.28
	FY12 E	26.47	27.68
ROE	FY10 E	18.9%	21.8%
	FY11 E	18.9%	24.8%
	FY12 E	23.4%	29.0%
PE (x)	FY10 E	6.75	7.27
	FY11 E	6.74	6.21
	FY12 E	5.35	5.23
PB (x)	FY10 E	1.28	1.58
	FY11 E	1.27	1.54
	FY12 E	1.25	1.52
Div. yield	FY10 E	13.6%	13.1%
	FY11 E	14.5%	14.3%
	FY12 E	17.4%	18.2%

Source: IGI Research

\* as of Jul15'10

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### Compelling Dividend Opportunity

In the wake of recovering volumes in the bourse, we recommend Pakistan's power sector scrips, HUBC and KAPCO. The power sector offers double digit dividend yields which provide investors with considerable downside protection. Historically, dividend yields in the sector have averaged in excess of 10% and we expect the high payout to continue, moving forward. At current levels, the IGI Universe offers an FY11 dividend yield of 14.41%; an attractive 187 bps spread over 10yr PIB bonds, which stand at 12.53%.

### Resilient Revenues: Protected Payouts

Despite facing cash flow constraints in the near term, the power sectors earnings in the longer term are guided by pre-determined tariff structures. The Power Purchase Agreements (PPA) for HUBC and KAPCO provide a hedge over major exogenous variables such as international fuel price volatility, exchange rate depreciation and inflationary pressure. Hence, earnings for the power sector remain resilient to macroeconomic volatility increasing the certainty of stable dividends, moving forward.

### Demand Deficit necessitates Expansion

The demand and supply gap, currently estimated at 4,000-5,000 MW for Pakistan, provides the power sector ample opportunities for new additions and expansions of existing facilities. Moreover, investments in the power sector are guided by a well crafted power policy offering expansive returns. Hence, with HUBC already on its way with Narowal Project and Laraib Energy, we cannot rule out future investment possibilities by existing players.

### Circular debt nags; pace of accumulation slows

The government has remained firm in doing away with the circular debt enforcing the third phase of power tariff hike effective from Jul1'10. Although recent efforts have failed to completely eradicate the problem, the regulators have assigned it as high priority and are working actively with advisors and international/multi lateral agencies in efforts to design a solution. Meanwhile, we believe that the government will continue to make periodic payments to continue operations in the energy chain and enable IPPs to operate at their sustainable load factors.

### HUBC: TSR provides Electrifying Returns

We maintain our liking for HUBC due to its substantial dividend cushion and defensive nature. In addition, earnings will witness contribution from the Narowal expansion, while possible surprises could arise from production bonuses for maintaining a higher than expected load factor. We re-iterate our BUY stance for HUBC with a target price of PKR 57.5 per share for Jun11, which presents a 74% upside at current levels.

### KAPCO: The Next Best Bet

We upgrade our recommendation for KAPCO from NEUTRAL to BUY. Although the relative attractiveness of the scrip is superseded by HUBC and carries greater exposure to the circular debt issue, we believe most negatives are priced in at its current price. We value the scrip at PKR 55.3 per share for Jun11, which presents a 32% upside at current levels.

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## Dividend yields; a win-win situation

For the power sector, we base our investment case around attractive dividend yields offered by both HUBC and KAPCO. Currently, with uncertainty on the regulatory front we recommend the low risk/high yielding power sector scrips till further clarity is achieved on CGT, VAT and margin financing initiatives. Historically, dividend yields in the power sector have averaged in excess of 10% and we expect their high payout ratio to continue, moving forward.

### Healthy Payouts on the cards

In 1H FY10, HUBC and KAPCO disbursed PKR 2.5 per share and PKR 2.25 per share as dividends and we expect another PKR 2 per share and PKR 3.25 per share with the full year result announcement. Moving into FY11, we expect conservative payout ratios relative to their historical averages. At current levels, HUBC and KAPCO offer FY11 dividend yields of 14.5% and 14.3%, respectively. In comparison to fixed income proxies and equities in the IGI universe, power sector dividend yields stand out and provide downside risk protection.

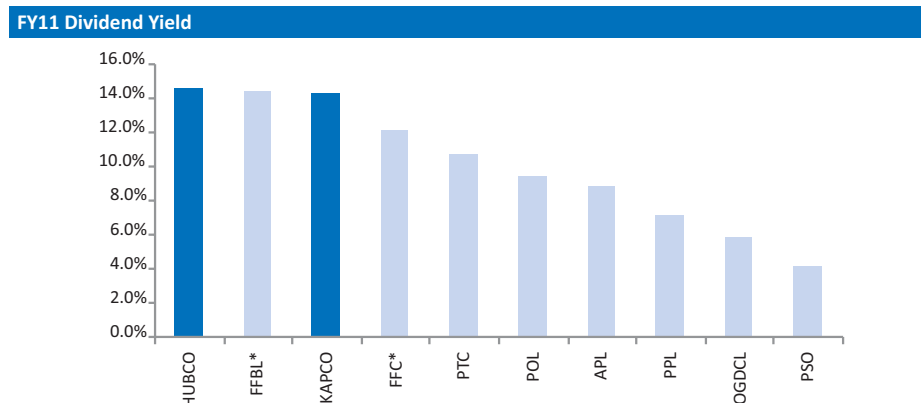
### Leading the IGI universe for Dividend Plays

Even amongst our IGI universe of listed equities, dividend yields in the power sector stand out. With FY11 expected dividend yields of 14.5% and 14.3%, HUBC and KAPCO place themselves as the top dividend players. Hence, with the market expected to be marred by regulatory uncertainties till 2Q FY11, high dividend yielding scrips, such as HUBC and KAPCO, provide stable returns for investors to capitalize.

IGI Universe - FY11 Dividend Yields		
	FY11E	FY11 Yield
HUBCO	4.80	14.5%
FFBL*	4.20	14.5%
KAPCO	6.00	14.3%
FFC*	13.00	12.1%
PTC	2.00	10.7%
POL	21.25	9.4%
APL	26.00	8.9%
PPL	13.75	7.1%
OGDCL	8.50	5.8%
PSO	11.00	4.1%

Source: IGI Research

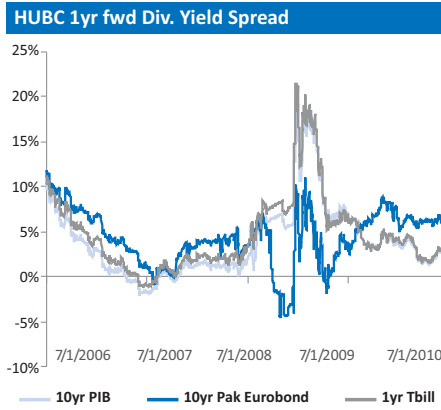
\* CY Companies



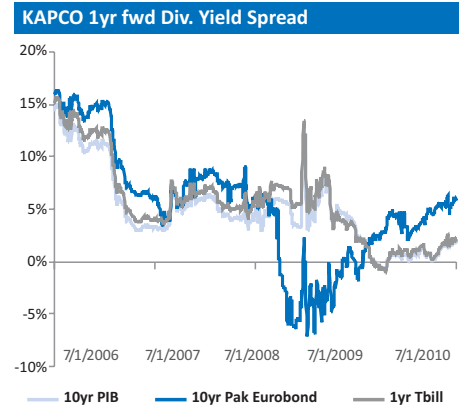
Source: IGI Research

### Spreads against Fixed Income proxies can't be beat!

Following the volatility in commodity prices, we witnessed a spike in the power sectors' earnings with 22% depreciation in the PKR against the USD in 1H FY09. In this time, the spread of 1yr fwd dividend yields of the power sector over fixed income proxies jumped to double digits. However, a later increase in the discount rate to curb inflationary pressure narrowed these spreads. With the easing of policy rates since the previous fiscal year coupled with improved dividend expectations in the power sector, the spread of 1yr forward dividend yield over the 10yr PIB has stretched to 305bps and 186bps for HUBC and KAPCO, respectively. Moreover, in an expected declining interest rate regime, we can expect dividend yields in the power sector provide an exciting investment opportunity at current levels.



Source: Bloomberg, IGI Research



Source: Bloomberg, IGI Research

**Payout Plan to continue**

In the period FY05-09, HUBC and KAPCO have maintained an average payout ratio of 103% and 98%, respectively. Although recent liquidity constraints from the circular debt issue have cast doubts over the payout capacity of these two entities; moving forward, we believe periodic injections into the energy chain and the eventual resolution of the circular debt will enable HUBC and KAPCO to maintain their high payout, on average, if not each year.

**Hedge your Bets with Power!**

Our confidence in earnings certainty for HUBC and KAPCO in the longer term, on the other hand, stems from the pre-determined power tariff structure guiding their profitability. Both companies remain hedged against major exogenous variables such as international fuel price volatility, exchange rate depreciation and inflationary pressure. Furthermore, the strength of HUBC and KAPCO's balance sheets are reinforced by a sovereign guarantee on their receivables and payables.

## Power deficit fueling growth

Power: Demand - Supply Deficit (MW)		
Year	Generation Capacity (MW)	Surplus/(Deficit) (MW)
<b>Actual figures</b>		
FY07	13,292	(1,846)
FY08	12,442	(4,396)
FY09*	12,822	(4,503)
<b>Projected Figures</b>		
FY10	15,300	(4,052)
FY11	17,367	(3,506)
FY12	18,913	(3,546)
FY13	21,299	(2,827)
FY14	21,668	(4,250)

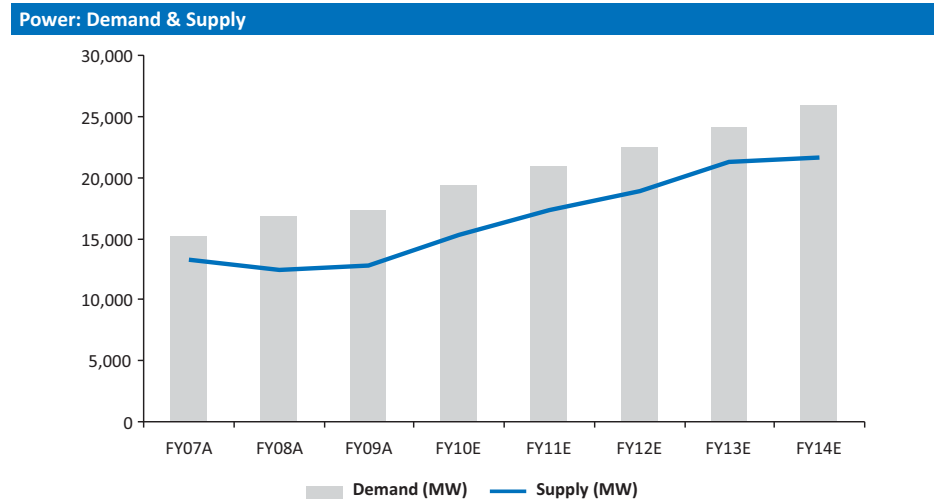
Source: NEPRA State of Industry Report 2009  
 \* Actual figures available upto Mar30'09

### Demand gap necessitates new powergen capacity

Deficit supply in the power sector has been well documented in Pakistan. With demand for power in the country having grown at a CAGR of 5.4% over the last decade and supply at a meager 2.25%, the shortfall of power has recently stretched to 4,000 – 5,000 MW. The government has designated high priority to bridge the shortfall, simultaneously working on short term and long term initiatives in coordination with international/multi lateral agencies. However, a number of factors such as i) unavailability of finances, ii) sponsor weakness, iii) long gestation periods of projects, iv) lack of expertise, v) security concerns and vi) regulatory hindrances have deterred a timely solution to the crisis.

### Expansion Advantage for HUBC and KAPCO

The shortfall of power supply in Pakistan has presented existing IPPs a unique opportunity to grow and improve their profitability. Being seasoned participants in the power sector, HUBC and KAPCO both possess the expertise and experience of operating in Pakistan. Together with the strength of their sponsors, these IPPs are at an advantage if they decide to setup up other power generation facilities or current plant expansion projects.



Source: NEPRA State of Industry Report 2009

HUBC has already delved into expansion with a 225MW gross capacity at Narowal, which is now expected to come online in Sep10. HUBC has also acquired a 75% stake in Laraib Energy, an 84 MW hydel power project, expected to commence its commercial operation from CY12. On KAPCO's end, an expansion in generation capacity of 280 MW was previously on the cards but was later delayed indefinitely on the grounds of liquidity constraints. However, we cannot rule out the possibility of future expansion post resolution of the circular debt issue and subsequent release of liquidity.

### Regulatory Support to Continue

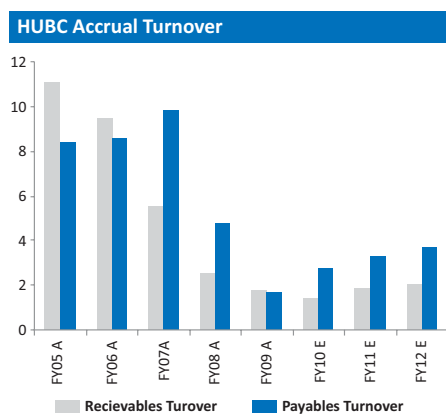
With the recent negativity surrounding the power sector, a natural question that arises is why existing IPPs would want to further invest in Pakistan's power sector. In answer to that, investment in the power sector is guided by a well crafted Power Policy which provides investors with an exuberant return hedged with inflation and exchange rate depreciation and cushioned by sovereign guarantees on its payables and receivables. Hence, we believe that if their liquidity allows, existing IPPs will not hesitate to invest further in Pakistan's power sector.

## Circular Debt Resolution; A Positive Trigger

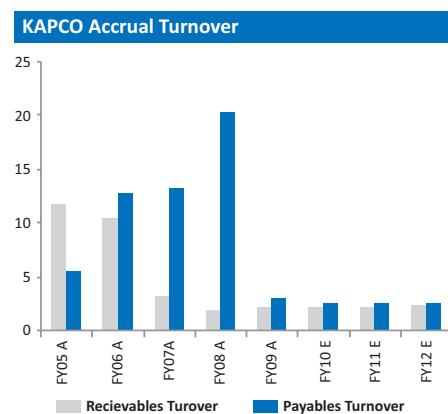
In recent times, liquidity in the energy chain has remained constrained with the circular debt issue casting a cloud over the companies' ability to pay dividends. However, for the upstream and downstream oil and gas sectors, relative attractiveness remains with a case for future growth potential and possible gains on price appreciation. On the other hand, the price of power sector scrips, historically, has been very defensive and investors have been attracted to their high dividend yields. Hence, the risk of limited ability to pay by HUBC and KAPCO has been negatively received by investors.

### Historic payout aided by periodic government payments

With a sustained gap in the average cost of power generation and consumer power tariff coupled with heavy distribution losses; PEPCO has remained unable to make timely payments to power generation entities. Although, the backlog of payments was relieved periodically with the government making bulk payments by borrowing from the banking sector, a continuous buildup ensued with the receivables and payables turnover of HUBC and KAPCO witnessing a 2-3x increase from their historical levels. Even in these times of constrained liquidity the two companies managed to maintain their payouts in excess of 95%



Source: Company Accounts, IGI Research



Source: Company Accounts, IGI Research

### Inching towards a long term solution

With a 6% power tariff increase implemented in Oct09, 12% in Jan10 and another 7% on its way in Jul10, we believe a further 13% hike would have to be necessitated to completely eliminate the tariff differential. Although the government will follow through with the removal of subsidies as per the IMF requirement, we believe, it will not come entirely on the back of increasing consumer power tariff, which has already triggered social unrest and political unpopularity with the recent increases. An alternative to plugging the differential is to reduce the average cost of generation, which can only be achieved in the long term by bringing cheaper sources of power generation, such as hydel and coal, online. In this regard, the government is coordinating with a number of international/multilateral agencies to work towards a sustainable power generation mix for the country.

### Short term operations to sustain with periodic payments

In the short term, we believe that inching consumer tariffs will look to ease liquidity for distribution companies and WAPDA, which would subsequently follow through to power generation entities and fuel suppliers. However, as previously mentioned, if social unrest continues to mount, our expectations are tagged with periodic payments made by the government to energy participants injecting liquidity into the system enabling HUBC and KAPCO to sustain their operations at current levels.

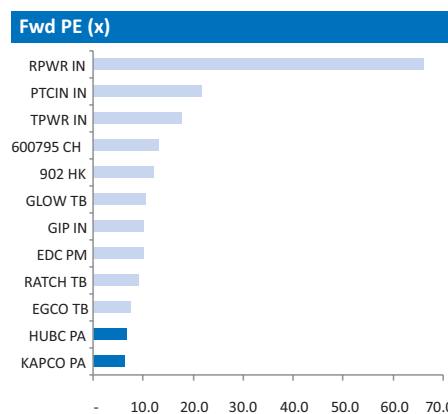
## Ahead of the Regional Curve

In comparison to its regional peers, Pakistan’s power sector continues to remain attractive for foreign investors. It stands out on the basis of favorable multiples, with forward PE, forward PB, dividend yield and ROE expected to outshine regional averages. HUBC and KAPCO, at their current prices, trade at a FY11 PE of 6.74x and 6.21x; a considerable discount of 60% compared to regional FY11 PE average of 15.88. Similarly, on a FY11 PB basis, the two companies stand at 1.26 and 1.56 against a regional average of 1.60.

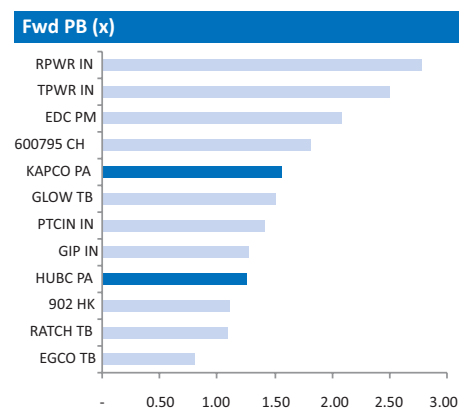
Expected dividend yields and high ROE’s further enforce the attractiveness of Pakistan’s power sector in comparison. FY11 dividend yields for HUBC and KAPCO at 14.51% and 14.28% tower over regional peers, while FY11 ROE impresses at 19% and 25%, respectively, fare well against regional peers.

Power sector regional peer analysis							
	Bloomberg code	PE (x)	Fwd PE (x)	Fwd PB (x)	Fwd PB (x)	FY11 Div Yield.	ROE
Hub Power Company	HUBC PK	6.75	6.74	1.23	1.26	14.51%	19%
Kot Addu Power Copmany	KAPCO PK	7.27	6.21	1.59	1.56	14.28%	25%
Gujarat Ind Power	GIP IN	17.68	10.29	1.39	1.27	2.90%	12%
PTC India Ltd	PTCIN IN	28.04	21.47	1.48	1.41	1.57%	7%
Tata Power India	TPWR IN	21.03	17.56	2.90	2.50	0.99%	14%
Reliance Power India	RPWR IN	81.31	65.91	2.97	2.78	0.07%	4%
Ratchaburi Electricity Generation	RATCH TB	8.93	9.08	1.15	1.09	6.08%	12%
Glow Energy Ltd	GLOW TB	11.68	10.43	1.64	1.51	5.50%	14%
Electricity Generation Company	EGCO TB	7.06	7.51	0.86	0.81	6.12%	11%
Energy Development Corporation	EDC PM	9.91	10.22	2.42	2.08	3.46%	20%
GD Power Dev Company	600795 CH	14.98	13.09	1.95	1.81	1.41%	14%
Huaneng Power International	902 HK	13.77	12.05	1.17	1.11	4.13%	9%
Average		19.03	15.88	1.73	1.60	5.08%	13.50%

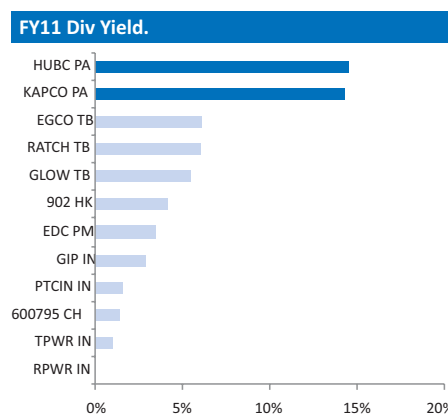
Source: Bloomberg, IGI Research



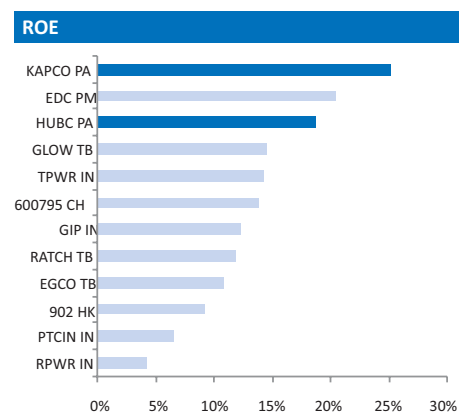
Source: Bloomberg, IGI Research



Source: Bloomberg, IGI Research



Source: Bloomberg, IGI Research



Source: Bloomberg, IGI Research

# **Stock Summary**

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Monday 19 July, 2010

Recommendation: **BUY**  
Target Price Jun11: **PKR 57.5**

## Electrifying Returns

KSE Ticker	HUBC
Bloomberg code	HUBC PA
52wk Average Price (PKR per share)	30.38
52wk Average Daily Volume (mn shares)	1.96
52wk Average Daily Turnover (PKR mn)	63.31
52wk Average Daily Turnover (USD mn)	0.75
Paid-up Capital (PKR mn)	11,572
Shares Outstanding (mn)	1,157
Index Weightage (%)	1.50
Free Float (%)	28.0

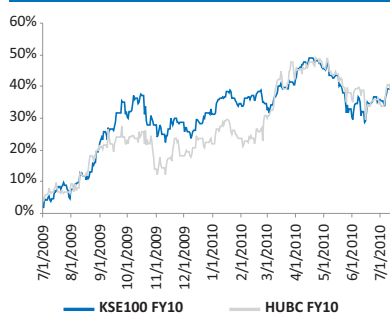
### The Bulls will be Rooting for HUBCO

Dividend yields for HUBC remain the most powerful investment case for investors. From FY05-09, it has averaged a payout ratio in excess of 100% and we assume that the company will continue to maintain its payout to the tune of 95% of its earnings, moving forward. At current levels, the company's FY11 dividend yield stands at 14.5%, which offers a spread of 197 bps over the 10yr PIB and 212 bps over the 1yr T-Bill. Furthermore, HUBC's FY11 expected dividend yield stands second only to FFBL amongst our IGI universe of listed equities. Hence, with regulatory uncertainty in the air, we reiterate our liking for HUBC as a possible safe haven in equities.

### Standalone earnings growth to peak in FY10

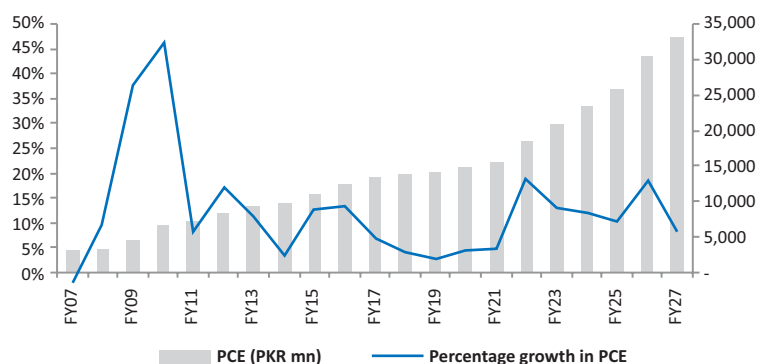
The tariff structure for HUBC, like all IPP's, is guided by a Power Purchase Agreement (PPA), which defines its revenues. While revenue generated in the tariff as a result of fuel price appreciation and plant maintenance are completely passed through as a cost, the Project Company Equity (PCE) is pocketed entirely by the company. It is predefined in the Capacity Purchase Price (CPP) component of the tariff and its percentage growth peaks in FY10. In 1H FY10, it has already improved 33% HoH and we expect further growth of 11% HoH in 2H FY10. Although, growth for the company eases, moving forward, the PCE component ensures earnings march upwards till the validity of HUBC's tariff agreement.

Relative return KSE-100 vs HUBC



Source: Bloomberg, IGI Research

PCE component of HUBC tariff



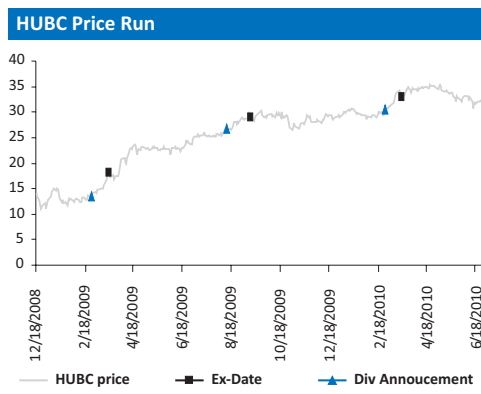
Source: IGI Research

### Expansion projects to support bottomline growth

While earnings growth on a stand alone basis is expected to peak in FY10, subsequent earnings will witness a significant push as HUBC's expansions come online. With the COD of Narowal now scheduled for Sep10, the 213MW net expansion plant will have negligible impact on FY11 earnings. However, assuming no further delays, the plant will contribute PKR 0.35 per share and PKR 0.66 per share towards the company's FY12 and FY13 earnings and PKR 6 per share towards our target price for HUBC, respectively. Furthermore, the company has also acquired a 75% stake in Laraib Energy, a 84MW hydel power plant for which the ECC has approved a levelized tariff of PKR 6.84/kWh. HUBC's move towards hydel power generation provides clear indication of the company's willingness to move into renewable energy as well. We have currently not incorporated earnings in our model from Laraib Energy as the project's PPA awaits finalization.

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Source: IGI Research

**Higher load factor deems rewards**

In 1H FY10, HUBC received PKR 195mn as a production bonus from WAPDA after their plant operated at 79% through CY09, which is higher than the required load factor. Although, we have not incorporated any production bonuses to our earnings expectations moving forward, we cannot rule out the possibility of an earnings surprise from production bonuses in the future.

**Earnings Season Dynamo**

In the recent past, HUBC’s share price has exhibited a peculiar trend. As the company announces its dividend for the period, its share price appreciates significantly moving towards the ex-dividend date. Since the market had bottomed out in Dec08, the stock price has appreciated 17%, on average, between each dividend announcement and ex-date period. Hence, with the result season approaching, we believe another price run in HUBC may well be on the cards for investors to capitalize.

HUBC - Financial Highlights						(PKR mn)
	FY08 A	FY09 A	FY10 E	FY11 E	FY12 E	FY13 E
EPS	2.25	3.27	4.90	4.91	6.18	7.32
EPS growth	-2%	45%	50%	0%	26%	18%
DPS	2.15	3.35	4.50	4.80	5.75	6.81
BVPS	24.61	25.52	25.93	26.04	26.47	26.98
PE (x)	14.72	10.13	6.75	6.74	5.35	4.52
PB (x)	1.34	1.30	1.28	1.27	1.25	1.23
Div. Yield	6%	10%	14%	15%	17%	21%
TIE (x)	2.27	2.74	4.50	2.74	3.18	4.00
ROE	9%	13%	19%	19%	23%	27%
ROA	4%	4%	5%	5%	6%	8%

Source: Company Reports, IGI Research

## Key Risks

**Circular Debt Build up**

As previously mentioned in our sector analysis, the circular debt has adversely affected the energy chains liquidity and, consequently, cast a doubt over the companies’ ability to payout timely dividends. Investor interest in HUBC has also stifled recently due to similar concerns. Although, HUBC charges interest on WAPDA’s delayed payments, which it later passes on to PSO, cash conversion cycle for the company has considerably slowed down. However, we maintain that leveraging PSO’s plea; HUBC will be able to demand periodic payments from the regulators, which will enable it to sustain its operations. We reject the idea of a provisioning of HUBC’s receivables from WAPDA, which implies the inability to pay on part of the Government of Pakistan.

**Penalties on any delay in Narowal**

HUBC has acquired debt to finance the equity portion of the Narowal Project. Any further delays in the commissioning of the project could see the company unable to meet its loan repayment schedule. Furthermore, any delay beyond Sep10 would also be penalized with the company liable to pay USD 17,800 per day as Liquidated Damaged (LD) to WAPDA. However, this risk is partly mitigated with the company passing on the same penalty to its EPC contractor, MAN Diesel, as per industry convention, making them liable for the eventual payment.

## Valuation

HUBC - Base Assumptions	
Rf	12.5%
Market risk premium	6%
Beta	0.83
Re	17.5%

Source: IGI Research

We deem the Dividend Discount Model (DDM) most feasible for valuing HUBC. We have come up with a rate of return on equity of 17.5% using a risk free rate of 12.5%, a market risk premium of 6% and a beta of 0.83. At the given rate of return on equity, we value the stock at PKR 57.5 per share for Jun11.

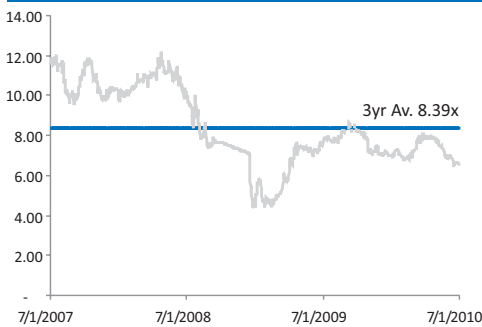
		PKR/USD Depreciation								
		2.00%	2.25%	2.50%	2.75%	3.00%	3.25%	3.50%	3.75%	4.00%
US CPI Inflation	1.50%	49.0	49.9	50.8	51.8	52.7	53.7	54.7	55.7	56.7
	1.75%	50.1	51.0	51.9	52.9	53.9	54.9	55.9	56.9	58.0
	2.00%	51.2	52.1	53.1	54.1	55.1	56.1	57.1	58.2	59.2
	2.25%	52.3	53.3	54.2	55.3	56.3	57.3	58.4	59.5	60.5
	2.50%	53.4	54.4	55.4	56.5	57.5	58.6	59.7	60.8	61.9
	2.75%	54.6	55.6	56.7	57.7	58.8	59.9	61.0	62.1	63.3
	3.00%	55.8	56.9	57.9	59.0	60.1	61.2	62.4	63.5	64.7
	3.25%	57.1	58.2	59.2	60.3	61.5	62.6	63.8	64.9	66.1
	3.50%	58.4	59.5	60.6	61.7	62.9	64.0	65.2	66.4	67.6

Source: IGI Research

\* HUBC has a semi-annual model thus USD depreciation assumption are for 6mo period, our base case assumption is 3% depreciation in PKR against the USD in 6mo translating into 6% for 1yr

## Price Performance

HUBC - Trailing PE vs. 3 yr. Av PE



Source: Bloomberg, IGI Research

HUBC's share price witnessed significant movement in the last fiscal year gaining 30% in FY10. The scrip traded below its 3yr average PE for most of FY10, both on a leading and trailing basis. The stock's 52 week high was recorded at PKR 35.29 per share and, since, it has receded slightly inline with the broad based correction in the market. At its price of PKR 33.09 per share, on Jul15'10, HUBC was trading at a leading PE of 6.54x.

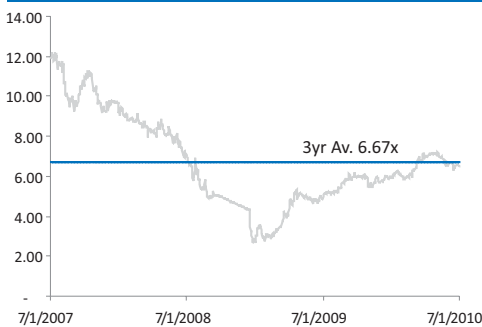
HUBC - Jun11 Relative Valuation (PKR per share)

	12mo Trailing PE					
	4	5	6.54	8.39	10	12
12mo Trailing EPS (Jun30'11)	4.60	18.40	23.00	30.08	38.59	55.20
	4.70	18.80	23.50	30.74	39.43	56.40
	4.80	19.20	24.00	31.39	40.27	57.60
	4.91*	19.64	24.55	32.11	41.19	58.92
	5.00	20.00	25.00	32.70	41.95	60.00
	5.10	20.40	25.50	33.35	42.79	61.20

\* IGI Estimate

Source: IGI Research

HUBC - Leading PE vs. 3 yr. Av PE



Source: Bloomberg, IGI Research

HUBC - Jun11 Relative Valuation (PKR per share)

	12mo Leading PE				
	4	5	6.52	6.67	10
12mo Leading EPS (Jun30'12)	5.50	22.00	27.50	35.97	66.00
	5.75	23.00	28.75	37.61	69.00
	6.00	24.00	30.00	39.24	72.00
	6.18*	24.72	30.90	40.42	74.16
	6.25	25.00	31.25	40.88	75.00
	6.50	26.00	32.50	42.51	78.00

\* IGI Estimate

Source: IGI Research

## Recommendation

At current levels, we reiterate our BUY stance on the scrip with a Jun11 target price of PKR 57.5 per share. We justify the 74% upside based on easing liquidity upon resolution of the circular debt freeing dividends, contribution of Narowal expansion towards earnings and possible surprises on part of production bonuses for maintaining higher than expected load factor.

## Financial Summary

HUBC	(PKR mn)					
	FY08 A	FY09 A	FY10 E	FY11 E	FY12 E	FY13 E
<b>Income Statement</b>						
Net Sales	62,435	82,784	89,071	104,384	118,556	115,604
Cost of sales	56,029	56,029	81,542	94,831	107,326	103,427
Gross Profit	6,406	26,755	7,529	9,553	11,230	12,177
EBITDA	6,117	7,429	8,802	10,833	12,733	13,613
EBIT	4,461	5,737	7,120	8,742	10,243	11,119
Finance Cost	1,966	2,095	1,584	3,186	3,224	2,782
Profit After Tax	2,601	3,781	5,671	5,682	7,152	8,468
<b>Balance Sheet</b>						
Current Assets	28,124	50,990	90,882	65,600	65,483	59,646
Non current Assets	34,573	39,196	29,202	50,454	48,107	45,772
Total Assets	62,697	90,186	120,085	116,054	113,590	105,418
Current liabilities	26,919	49,297	62,612	60,944	60,588	54,569
Long term liabilities	7,307	11,356	27,477	24,987	22,377	19,631
Shareholder's equity	28,471	29,532	29,996	30,124	30,625	31,217
Total equity and liabilities	62,697	90,186	120,085	116,054	113,590	105,418
<b>Cashflow Statement</b>						
Cashflow from Operating Activities	7,832	5,357	(117)	12,329	6,727	11,517
Cashflow from Investing Activities	(3,747)	(6,315)	8,311	(23,343)	(142)	(159)
Cashflow from Financing Activities	(4,165)	1,330	12,426	(7,925)	(9,126)	(10,067)
Beginning cash balance	743	662	1,034	21,654	2,715	173
Net change in cash	(81)	372	20,620	(18,939)	(2,542)	1,291
Ending cash balance	662	1,034	21,654	2,715	173	1,463
<b>Key Ratios</b>						
ROE	9%	13%	19%	19%	23%	27%
ROA	4%	4%	5%	5%	6%	8%
EPS	2.25	3.27	4.90	4.91	6.18	7.32
DPS	2.15	3.35	4.50	4.80	5.75	6.81
BVPS	24.61	25.52	25.93	26.04	26.47	26.98
PE (x)	14.72	10.13	6.75	6.74	5.35	4.52
PB (x)	1.34	1.30	1.28	1.27	1.25	1.23
Dividend Yield	6%	10%	14%	15%	17%	21%
Net Sales growth	41%	33%	8%	17%	14%	-2%
EPS growth	-2%	45%	50%	0%	26%	18%
Gross Profit Margin	10%	32%	8%	9%	9%	11%
Net Profit Margin	4%	5%	6%	5%	6%	7%
Asset Turnover	1.00	0.92	0.74	0.90	1.04	1.10
Current Ratio	1.04	1.03	1.45	1.08	1.08	1.09
TIE (x)	2.27	2.74	4.50	2.74	3.18	4.00
Receivables Turnover	2.51	1.78	1.39	1.82	1.99	2.25
Payables Turnover	4.79	1.71	2.79	3.25	3.70	4.02

Source: Company Accounts, IGI Research

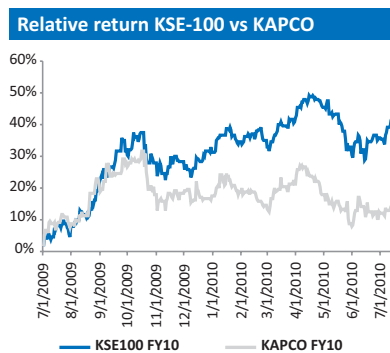
Recommendation: **BUY**  
Target Price Jun11: **PKR 55.3**

## The Next Best Bet

KSE Ticker	KAPCO
Bloomberg code	KAPCO PA
52wk Average Price (PKR per share)	43.90
52wk Average Daily Volume (mn shares)	0.39
52wk Average Daily Turnover (PKR mn)	18.26
52wk Average Daily Turnover (USD mn)	0.21
Paid-up Capital (PKR mn)	8,803
Shares Outstanding (mn)	880
Index Weightage (%)	1.55
Free Float (%)	18.0

### The Other 'Super Power'

For KAPCO, dividend yields provide investors an exciting investment opportunity. Historically, from FY05-09, the company has distributed an average 98% of its earnings to shareholders and we estimate a conservative payout of 95%, moving forward. At current levels, KAPCO offers an FY11 dividend yield of 14.3%, which offers a spread of 175 bps over a 10yr PIB and a spread of 190 bps over the 1yr T-Bill. Furthermore, KAPCO's FY11 expected dividend yield stands in the top tier amongst our IGI universe of listed equities. Finally, although we believe that the scrip's relative attractiveness is superseded by HUBC; at its current prices, it offers as an attractive alternative for investors looking to diversify amongst the power sector in Pakistan.



Source: Bloomberg, IGI Research

### Expansion Blues will not last

The company had been in the initial stages of planning an expansion project, which would have enhanced the company's generation capacity by 280MW. However, KAPCO had previously delayed the expansion plan and very recently dropped the project citing liquidity constraints. Following a resolution to the circular debt issue, post consumer tariff hike, we believe easing liquidity could lead KAPCO to resume its plans of bringing the addition online. The expansion was planned to come up in KAPCO's current facility, which would save the company significant infrastructure development cost. Although we have not incorporated any contribution of the project towards the company's earnings, we estimate its value to be in the vicinity of PKR 8 per share given there is eventual resumption.

### Circular debt impact on KAPCO more severe

As the government moves towards a resolution of the circular debt, we expect KAPCO to gain significantly. As previously mentioned, easing liquidity would enable KAPCO to pursue its expansion plans, consequently resulting in improved cash flow and a higher payout. Also, unlike HUBC, KAPCO has a higher interest payable on delayed payments to PSO compared to interest receivable on payments from PEPCO. Although KAPCO bridges this gap with short term borrowing, it dents the company's bottomline with a significant jump in financial charges. An eventual resolution of the circular debt would also result in timely payments in the energy chain reducing KAPCO's reliance on short term borrowing.

KAPCO - Financial Highlights						(PKR mn)
	FY08 A	FY09 A	FY10 E	FY11 E	FY12 E	FY13 E
EPS	9.05	6.45	5.78	6.77	8.03	9.06
EPS growth	60%	-29%	-10%	17%	19%	13%
DPS	5.45	6.45	5.49	6.00	7.63	8.61
BVPS	24.24	26.23	26.52	27.29	27.69	28.14
PE (x)	4.64	6.52	7.27	6.21	5.23	4.64
PB (x)	1.73	1.60	1.58	1.54	1.52	1.49
Div. Yield	13%	15%	13%	14%	18%	20%
TIE (x)	4.65	2.36	2.62	2.99	3.89	5.12
ROE	37%	25%	22%	25%	29%	32%
ROA	14%	9%	8%	9%	11%	13%

Source: Company Reports, IGI Research

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## Key Risks

### **Plant depreciation and maintenance costs**

KAPCO's aging plant recently incurred a non recurring repair and maintenance charge of PKR 800mn. With its plant deviating significantly from its historical fuel mix and relying largely on FO, further repair and maintenance charges pose a possible risk that could impede future earnings. Moreover, shortfall in supply of electricity could also make KAPCO liable to pay WAPDA liquidated damages (LD) denting its profitability.

### **Short Term financing constraints**

As mentioned previously, KAPCO is liable to pay higher interest on delayed payments to PSO compared to its interest receipts on delayed payments from WAPDA. Although, the company manages this gap with short term borrowing, subsequent delays in the circular debt resolution may exhaust the company's short term borrowing facility implying a higher cost of borrowing moving forward.

## Valuation

APL - Base Assumptions	
Rf	12.5%
Market risk premium	6%
Beta	0.56
Re	16%

Source: IGI Research

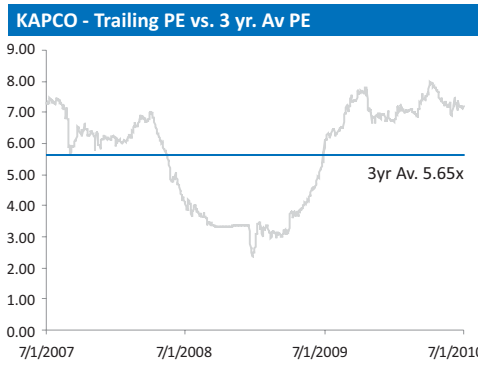
Similar to HUBC, we find the Dividend Discount Model (DDM) most feasible to value KAPCO. Arriving at a rate of return on equity of 16% using a risk free rate of 12.5%, market premium of 6% and a beta of 0.56, we value the scrip at PKR 55.3 per share for Jun11.

KAPCO - Target Price Sensitivity		PKR/USD Depreciation								
		4.00%	4.50%	5.00%	5.50%	6.00%	6.50%	7.00%	7.50%	8.00%
US CPI Inflation	1.50%	47.87	49.36	50.89	52.46	54.08	55.75	57.47	59.24	61.07
	1.75%	48.12	49.62	51.16	52.74	54.38	56.06	57.79	59.57	61.40
	2.00%	48.38	49.89	51.44	53.03	54.67	56.36	58.10	59.89	61.74
	2.25%	48.65	50.16	51.72	53.32	54.98	56.68	58.43	60.23	62.08
	2.50%	48.92	50.44	52.01	53.62	55.28	56.99	58.75	60.57	62.44
	2.75%	49.19	50.72	52.30	53.92	55.60	57.32	59.09	60.91	62.79
	3.00%	49.47	51.01	52.60	54.23	55.91	57.65	59.43	61.27	63.16
	3.25%	49.75	51.30	52.90	54.54	56.24	57.98	59.78	61.62	63.53
	3.50%	50.04	51.60	53.21	54.86	56.57	58.32	60.13	61.99	63.90

Source: IGI Research

## Price Performance

In FY10, KAPCO's price appreciated 10% underperforming the KSE100 returns by 24%. At its 52 week peak of PKR 48.9 per share, the scrip's leading PE touched 8x; considerably higher compared to its 3yr average PE of 5.50x. Since, KAPCO's share price has declined 15% to settle at PKR 41.61 per share, as of Jul15'10. At this price, the scrip is trading at a leading PE of 6.15x.

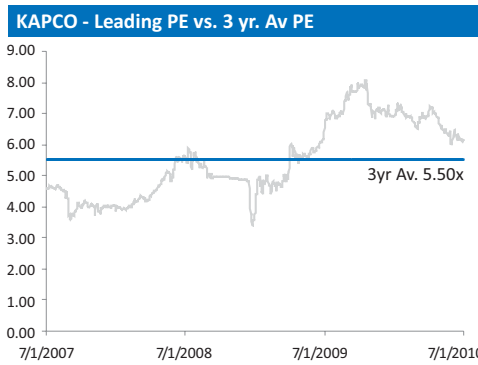


Source: Bloomberg, IGI Research

KAPCO - Jun11 Relative Valuation		(PKR per share)					
		12mo Trailing PE					
		3yr Av.		Current			
		4	5	5.65	7.2	8	10
12mo Trailing EPS (Jun30'11)	6.40	25.60	32.00	36.16	46.08	51.20	64.00
	6.50	26.00	32.50	36.73	46.80	52.00	65.00
	6.60	26.40	33.00	37.29	47.52	52.80	66.00
	6.77*	27.08	33.85	38.25	48.74	54.16	67.70
	6.90	27.60	34.50	38.99	49.68	55.20	69.00
	7.00	28.00	35.00	39.55	50.40	56.00	70.00

\* IGI Estimate

Source: IGI Research



Source: Bloomberg, IGI Research

KAPCO - Jun11 Relative Valuation		(PKR per share)					
		12mo Leading PE					
		3yr Av.		Current			
		4	5	5.5	6.15	8	10
12mo Leading EPS (Jun30'12)	7.25	29.00	36.25	39.88	44.59	58.00	72.50
	7.50	30.00	37.50	41.25	46.13	60.00	75.00
	7.75	31.00	38.75	42.63	47.66	62.00	77.50
	8.03	32.12	40.15	44.17	49.38	64.24	80.30
	8.25	33.00	41.25	45.38	50.74	66.00	82.50
	8.50	34.00	42.50	46.75	52.28	68.00	85.00

\* IGI Estimate

Source: IGI Research

## Recommendation

KAPCO's stock prices witnessed a significant correction since our last update on the power sector in Apr10. At current levels, we believe that the negatives discussed are priced in and we upgrade our recommendation from NEUTRAL to BUY with a target price of PKR 55.3 per share, which presents an upside of 32%.

## Financial Summary

KAPCO	(PKR mn)					
	FY08 A	FY09 A	FY10 E	FY11 E	FY12 E	FY13 E
<b>Income Statement</b>						
Net Sales	55,947	69,364	76,873	82,977	89,563	96,671
Cost of sales	46,600	58,373	66,535	71,674	77,449	83,647
Gross Profit	9,347	10,991	10,338	11,303	12,115	13,024
EBIT	10,268	15,133	12,684	13,824	14,569	15,192
Finance Cost	2,208	6,410	4,850	4,629	3,750	2,969
Profit After Tax	7,966	5,672	5,090	5,955	7,070	7,976
<b>Balance Sheet</b>						
Current Assets	37,083	41,163	49,145	51,176	50,064	48,963
Non current Assets	19,881	18,796	17,329	15,966	14,628	13,222
Total Assets	56,964	59,959	66,474	67,143	64,691	62,185
Current liabilities	35,636	36,876	43,136	43,131	40,326	37,421
Long term liabilities	8,808	8,137	7,091	6,025	5,344	4,677
Shareholder's equity	21,328	23,083	23,338	24,011	24,365	24,764
Total equity and liabilities	56,964	59,959	66,474	67,143	64,691	62,185
<b>Cashflow Statement</b>						
Cashflow from Operating Activities	6,489	5,445	12,312	5,225	5,183	7,360
Cashflow from Investing Activities	(152)	(424)	(85)	(196)	(227)	(168)
Cashflow from Financing Activities	(6,366)	(4,799)	(5,910)	(6,301)	(7,618)	(8,321)
Beginning cash balance	209	179	400	6,718	5,446	2,784
Net change in cash	(30)	221	6,317	(1,272)	(2,662)	(1,129)
Ending cash balance	179	400	6,718	5,446	2,784	1,655
<b>Key Ratios</b>						
ROE	37%	25%	22%	25%	29%	32%
ROA	14%	9%	8%	9%	11%	13%
EPS	9.05	6.45	5.78	6.77	8.03	9.06
DPS	5.45	6.45	5.49	6.00	7.63	8.61
BVPS	24.24	26.23	26.52	27.29	27.69	28.14
PE (x)	4.64	6.52	7.27	6.21	5.23	4.64
PB (x)	1.73	1.60	1.58	1.54	1.52	1.49
Dividend Yield	13%	15%	13%	14%	18%	20%
Net Sales growth	51%	24%	11%	8%	8%	8%
EPS growth	60%	-29%	-10%	17%	19%	13%
Gross Profit Margin	17%	16%	13%	14%	14%	13%
Net Profit Margin	14%	8%	7%	7%	8%	8%
Asset Turnover	0.98	1.16	1.16	1.24	1.38	1.55
Current Ratio	1.04	1.12	1.14	1.19	1.24	1.31
TIE (x)	4.65	2.36	2.62	2.99	3.89	5.12
Receivables Turnover	1.91	2.12	2.20	2.20	2.30	2.50
Payables Turnover	20.39	3.04	2.60	2.50	2.50	2.80

Source: Company Accounts, IGI Research

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I, Ahmed Mumtaz, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject, securities and issuers. I also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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