Day Break

Tuesday, 25 August 2020

IGI Securities

COMPANY UPDATE

The Hub Power Company Limited

Pow er Generation & Distribution

Recommendation		**BUY**
Target Price:	Dec-20	129.0
Last Closing:	24-Aug-20	80.4
Upside (%):		60.4
Valuation Methodology:		Discounted Cash Flow (DCF)
Time Horizon:		4M

Market Data		
Bloomberg Tkr.		HUBC PA
Shares (mn)		1,297.2
Free Float Shares (mn)		972.9
Free Float Shares (%)		75.0%
Market Cap (PKRbn | USDmn)	104.3	676.1
Exchange		KSE 100

Price Info.	90D	06M	12M
Abs. Return	15.4	(9.3)	47.9
Lo	70.3	57.4	57.4
Hi	89.8	98.9	103.2

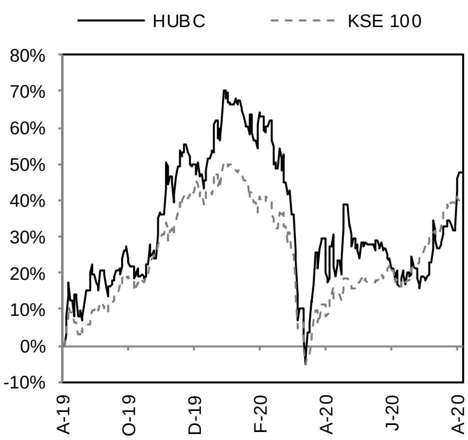
Key Company Financials

Period End: Jun

PKRbn	**2019a**	**2020e**	**2021f**	**2022f**
Total Revenue	58.1	48.3	56.6	84.5
Net Income	11.2	25.0	32.2	41.7
EPS (PKR)	8.7	19.3	24.9	32.1
DPS (PKR)	-	-	8.0	10.0
Total Assets	225.3	293.5	342.9	362.3
Total Equity	51.0	78.6	97.8	131.4

Key Financial Ratios				
ROE (%)	32.5	26.0	38.7	36.6
P/E (x)	9.3	4.2	3.2	2.5
P/B (x)	2.9	2.0	1.3	1.1
DY (%)	-	-	9.9	12.4

Relative Price Performance



Source: Bloomberg, PSX & IGI Research

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Power Generation & Distribution

HUBC: Separate MoU signed for Base plant slightly better than 1994; Final agreement contingent on recovery of receivables

- We have revised down our earnings estimate for The Hub Power Company Limited (HUBC) by 4-14% from FY21-27F leading to a downward revision of 13% in our target price to PKR 129/share. We have tweaked our estimates based on a) revised MoU for plants under Power Policy 2002 and b) separate MoU for base plant.
- The major takeaway from these MoUs is that despite deep cuts to earnings, receipt of overdue receivables amount should substantially improve cash flow position for all FO based IPPs. While we do not expect circular debt to be written off by 2023, given that structural issues within the transmission and distribution system remain, this may however slow the pace of future circular debt accumulation
- We maintain a '**Buy**' rating on HUBC, with a Dec-20 target price of PKR 129/share, offering 60% upside from last close. The Company is currently trading at FY21F P/E of 3.2x.

HUBC earnings and target price revised to reflect changes in MoUs; 'Buy' rating maintained

We have revised down our earnings estimate for The Hub Power Company Limited (HUBC) by 4-14% from FY21-27F leading to a downward revision of 13% in our target price to PKR 129/share. We have tweaked our estimates based on a) revised Memorandum of Understanding (MoU) for plants under Power Policy 2002 and b) separate MoU for base plant. We await clarity on the funding instrument for receivables as it is an integral part of the MoU.

To note, we have not incorporated 'take and pay' mechanism for Narowal (as none of the IPPs have agreed on 'take and pay' mechanism so far), nor have we built in receipt of overdue receivables which should significantly ease cash-flows for HUBC. If 'Take and Pay' is implemented 2-3 years from now, we expect HUBC's earnings to drop by 5% of our revised earnings estimate and subsequently erode 9% from our revised target price.

Exhibit: HUBC revised MOU impact

	FY21	FY22	FY23	FY24	TP
Current EPS	26.06	33.75	38.40	41.72	147.00
Narowal	(0.37)	(0.46)	(0.54)	(0.61)	(4.00)
HUB	(0.81)	(1.70)	(2.58)	(3.54)	(14.00)
Revised Estimates	24.87	31.59	35.27	37.56	129.00

Hub: Impact of separate MoU for base plant

According to the notice issued by HUBC through PSX, the Company has signed separate MOU for its base plant with the Negotiation Committee for IPPs. Seeing as HUBC does not fall under any Power Policy, this is a more negotiated agreement wherein the terms of the MoU are less severe vs. changes agreed upon under 1994 and 2002 Power Policy.

- As per the terms of the MoU, Hub plant's existing fixed O&M has been agreed to be reduced by 11% as compared to overall 11% reduction in Capacity Purchase Price (CPP) for plants falling under 1994 policy.
- Furthermore, existing indexation is to be continued on fixed O&M component of Capacity Purchase Price (CPP) with regular indexation, whereas USD /PKR and USD/CPI indexation has been discontinued on the PCE component. The USD exchange rate has been capped at NBP's selling rate prevailing as at 21st-Aug-2020 which is PKR 168.6/USD.

As a result, we expect HUBC to witness earnings attrition of PKR 0.8-7.0/share or 2-13% from FY21-27 while target price is likely to erode by PKR 12/share or 8%. To summarize, this is a less severe outcome vs. that under the 1994 MOU.

Exhibit: Impact of changes on Hub Plant					
Based on separate MoU for Base plant			**EPS (PKR)**		
PKR/share	FY21	FY22	FY23	FY24	TP
Impact on Base plant	(0.81)	(1.70)	(2.58)	(3.54)	(14.00)
HUBC Consolidated EPS	26.06	33.75	38.40	41.72	147.00
After Hub adjustment	**25.24**	**32.05**	**35.81**	**38.18**	**133.00**
% Change	-3%	-5%	-7%	-8%	-10%

Narowal: Impact of changes agreed for plants under 2002 Power Policy

As Narowal falls under Power Policy 2002, we have incorporated changes made to ROE where 15% USD based ROE has been increased to 17% PKR based ROE and USD indexation has been discontinued. As a result we expect this to have a negative earnings impact of PKR 0.4-0.6/share (1% of HUBC's consolidated earnings). Considering Narowal is an inefficient plant, there is no impact of fuel and O&M savings in the future. Moreover, we have not incorporated 'Take and Pay' mechanism, which is hinged on successful deployment of overdue receivables and migration to Competitive Trading Arrangement. Furthermore, HUBC has highlighted that none of the IPPs have agreed to 'take and pay' basis so far.

Exhibit: Impact of changes on Narowal Plant						
Based on changes in Power Policy 2002				**EPS (PKR)**		
PKR/share		FY21	FY22	FY23	FY24	TP
Narowal	17% PKR based ROE	(0.37)	(0.46)	(0.54)	(0.61)	(4.00)
HUBC Consolidated EPS		26.06	33.75	38.40	41.72	147.00
After Narowal adjustment		**25.68**	**33.29**	**37.85**	**41.10**	**143.00**
% Change		-1%	-1%	-1%	-1%	-3%

Key highlights from management conference call

HUBC held an investor briefing session to discuss changes in the recently signed MoUs for the base plant and Narowal. Management also provided further details on key developments in the power sector.

- ***FO based plants with the exception of few to phase out by 2040:*** Under the Generation Capacity Action Plan 2040, the Government expects to completely phase out furnace oil based plants with the exception of 4-5 IPPs (falling under the 2002 Power Policy) which cater to the load centre in Punjab. These plants would run for 4 months per annum (3 months in summer, 1 month in winter) when Hydel generation slows down. The action plan does not project HUBC's base plant or 1994 Power Policy plants to be operational, which may potentially lead to premature voluntary termination of their PPAs.

- ***Voluntary termination of PPAs under consideration:*** While no forced termination of non-utilized furnace oil (FO) based plants can take place, a voluntary termination may lie in the offing. In the event of premature termination the formula is clearly defined in HUBC's Implementation Agreement and will be followed as such without any discounts imposed on the residual value of plant at the termination. Given that HUBC was formed under the Build Own Operate model (BOO), the plant would be transferred to the Government of Pakistan on expiry of the Generation Licence (Aug-25). That said, the Government has indicated that may not want the asset which would lead to payment of residual value (equivalent to 5-years of profits discounted under NPV).

- ***'Take and pay' basis has not been agreed yet:*** Management is of the view that it would take ~5 years for the formation of Competitive Trading Market where several issues such as wheeling arrangement, restructuring of DISCOs and T&D bottlenecks are yet to be addressed. Thus so far, none of the IPPs have agreed to 'take and pay' agreement.

- ***Competitive Power Market is a long haul:*** According to the management, there is much work to be done on Competitive Trading Arrangement. Wheeling arrangements and credit worthiness of discos will have to be assessed. According to the management it may take ~5 years for implementation, due to transmission and distribution bottlenecks.

- ***CPHGC to pay out dividend in FY21:*** CPHGCL achieved COD in Aug-19 but has been unable to pay dividends due to debt covenants attached with high borrowings for the project. Management expects the project close (lifting of debt covenants) by Dec-20 and CPHGCL can commence payouts from May-Jun-21.

- ***Chinese investors asked to provide concessions in debt repayments:*** Negotiations on are being conducted on a government-to-government basis for concessions on Chinese debt component of project costs. So far the Pakistani authorities have requested reduction in the tenor of project loans (extension from 10 to 20 years) and interest rates on repayments.

- ***Future projects under consideration:*** HUBC is currently considering two major projects for base plant which could be implemented if early termination of base plant is called for. This includes conversion of 2x300MW units of the base plant to coal and subsequent supply of power to K-Electric for which tariff is to be worked out. Currently HUBC is leveraging the experience of its co-sponsor CPHGCL for feasibility study on coal conversion. HUBC is also looking into water desalination projects for supply of clean water to Karachi.

Structural issues remain, but circular debt build-up may slowdown

The major takeaway from these MoUs is that despite deep cuts to earnings, receipt of overdue receivables amount should substantially improve cash flow position for all FO based IPPs. While we do not expect circular debt to be written off by 2023, given that structural issues within the transmission and distribution system remain, this may however slow the pace of future circular debt accumulation. We expect electricity cost recovery will continue in the form of periodic tariff adjustments particularly as these remain a key structural benchmark under the US$6bn IMF EFF Program.

Recommendation

We maintain our **'Buy'** rating on HUBC, with a Dec-20 target price of PKR 129/share, offering 60% upside from last close. The Company is currently trading at FY21F P/E of 3.2x.

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Recommendation	Rating System
Buy	If target price on aforementioned security(ies) is more than 10%, from its last closing price(s)
Hold	If target price on aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
Sell	If target price on aforementioned security(ies) is less than -10%, from its last closing price(s)

Time Horizon: Dec – 2020
Valuation Methodology: The analyst(s) has used following valuation methodology to arrive at the target price of the said security (ies):
(Discounted Cash Flow)

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