Day Break

Thursday, 23 July 2020

COMPANY UPDATE

The Hub Power Company Limited

Power Generation & Distribution

Recommendation		**BUY**
Target Price:	Dec/20	147.0
Last Closing:	22-Jul-20	80.0
Upside (%):		83.7
Valuation Methodology:		Discounted Cash Flow (DCF)
Time Horizon:		5M

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)	103.8	672.7
Exchange		KSE 100

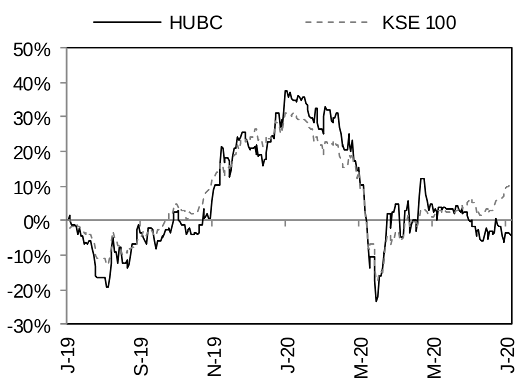
Price Info.	90D	06M	12M
Abs. Return	(0.4)	(30.5)	(4.6)
Lo	70.3	57.4	57.4
Hi	84.2	103.0	103.2

Key Company Financials

Period End: Jun

PKRbn	**2019a**	**2020e**	**2021f**	**2022f**
Total Revenue	58.1	49.2	58.6	86.5
Net Income	11.2	26.7	33.7	43.5
EPS (PKR)	8.7	20.6	26.0	33.6
DPS (PKR)	-	-	4.0	10.0
Total Assets	225.3	293.5	353.2	374.0
Total Equity	51.0	78.6	108.1	143.0
Key Financial Ratios				
ROE (%)	32.5	26.0	41.2	36.1
P/E (x)	9.2	3.9	3.1	2.4
P/B (x)	2.9	2.0	1.3	1.0
DY (%)	-	-	5.0	12.5

Relative Price Performance



Source: Bloomberg, PSX & IGI Research

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Power Generation & Distribution

HUBC: New projects to be earnings accretive but cash constraints may restrict payouts

- ✓ We have tweaked our earnings for Hub Power Generation Company Limited (HUBC) by +10% for FY20 and downwards by 7%-8% for FY21-22 after incorporating recent decline in interest rates (down by 625bps so far in CY20 to 7.0%), higher borrowing requirement for working capital and delays in project commencement of Thar Energy Limited (TEL) and Thal Nova (further ~6-month delay),
- ✓ We maintain our liking for the Company on account of healthy earnings growth from FY20-25 driven by new coal projects coming online. However, on account of cash tied up in circular debt and equity requirements for new projects, cash constraints are likely to persist leading to restrictive cash payout,
- ✓ We maintain a BUY stance on HUBC with our revised Dec-20 target price of PKR 147/share offering 84% upside from last close. The company is currently trading at FY21/22 P/E of 3.1/2.4x.

Strong earnings growth ahead – 5yr CAGR of +17% during FY20-25F…

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…this is to be primarily driven by new coal plants

We expect HUBC to post earnings growth of +2.4xYoY in FY20 on account of commencement of operations of its 47.5% owned associate – China Power Hub Generation Company Limited (CPHGCL) which achieved COD in Aug'19. To recall, HUBC entered into several different coal projects which included CPHGCL, TEL and Thal Nova Limited. CPHGCL on annual basis is estimated to contribute PKR 13-16/share to HUBC's consolidated earnings during FY21-24, while TEL and Thal Nova cumulatively are expected to contribute PKR 4-6/share to HUBC's consolidated earnings during FY22-24. On account of Covid-19 outbreak, project commencement date for Thal Nova (23% completed as of Apr-20) has been moved up by 9 months to Jan-22 whereas for TEL (55% completed as of Apr-20) it has been moved up by 3 months to Jun-21. However, on account of force majeure claimed by EPC contractor due to Covid-19 outbreak, which has been notified to PPIB by HUBC, would result in delays in COD of the plants and thus lead to a penalty of USD 2.8mn/month.

The worst is seemingly priced in, HUBC is worth a re-look

While dividend payouts are likely to remain restricted until cash-flow issues resolve – over the next few years – we believe the negatives appear to be largely priced in. HUBC has shed 15%CYTD, significantly underperforming the KSE-

100 (which has shed c. 7.6%CYTD) to trade at a FY21f P/E of 3.1x. This is 63% below its average forward P/E of 8.4x, leaving significant room for valuation re-rating, in our view.

Exhibit: Earnings contribution of existing and new projects (PKRbn)

Coal projects to contribute major portion in earnings growth going forward, 5yr CAGR of 17% FY20-25f

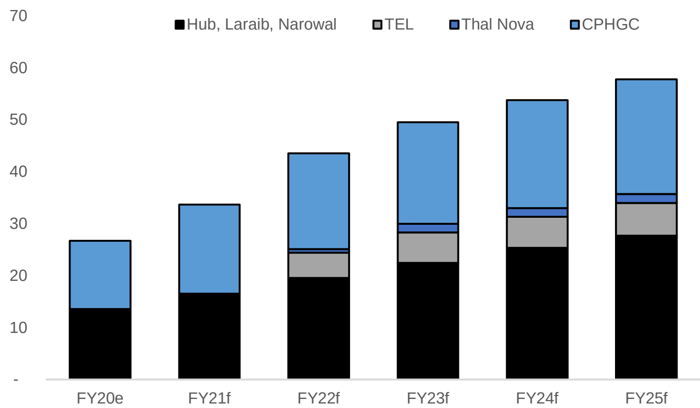
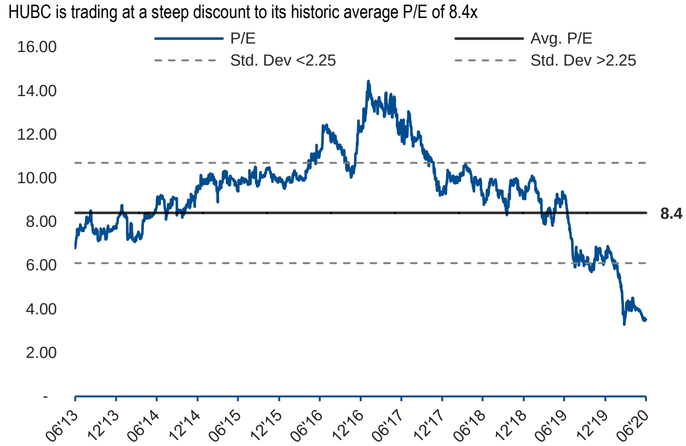


Exhibit: HUBC historic average P/E

HUBC is trading at a steep discount to its historic average P/E of 8.4x



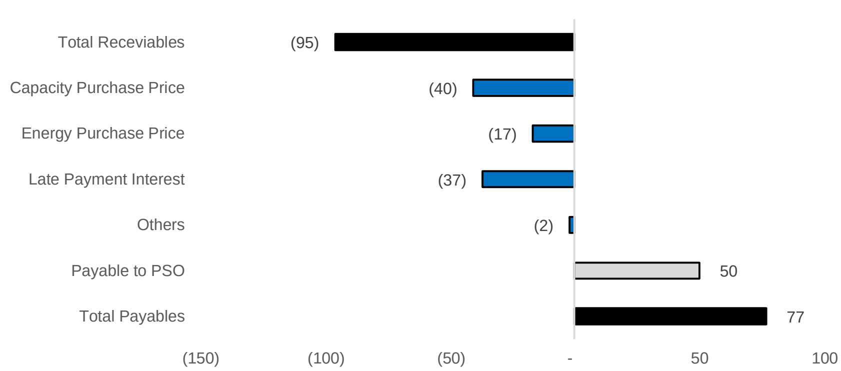
Build up in CPP and EPP payments weighing on cash flows

HUBC's base plant has been nearly non-operational in the last year or so owing to lower demand by power purchaser from FO based power plants. This has led to a slowdown of accumulation in the overall receivables which currently stand at PKR 95bn as of Mar-20. The EPP receivables have actually declined since Jun-19 from PKR 19bn to PKR 16.5bn as of Mar-20. However, CPP receivables have piled up by a whopping PKR ~10bn to PKR 40bn as of Mar-20 compared to PKR 31bn as at Jun-19. Out of this PKR 40bn, nearly PKR 30bn is overdue CPP payments of Hub plant. Thus cash stuck against CPP payments has weighed on cash flows leading to lower payouts amid increased requirement for WC financing and cash required for equity stake financing in new projects.

With the burden of CPP payments on Government touching PKR ~1.0trn, CPP payments are likely to be further delayed in our view whereas payments relating to coal plants would be prioritized. The situation has also worsened post Covid-19 outbreak as Government had announced stimulus package and provided relief through Federal Budget 2021, thus putting further pressure on fiscal side.

Exhibit: Break-up of receivables as at Mar-20 (PKR bn)

HUBC's receivables majorly comprise of CPP over dues as base plant remained non operational



HUBC's cash constraints to ease once all projects achieve COD

Cash constraints due to circular debt persist. However, this should be largely resolved once (a) equity requirements for new projects are met, and (b) upcoming coal projects achieve COD (Thal Nova COD: Jan-22). As of Mar-20 a total of USD 23mn and USD 10-15mn was left for TEL and Thal Nova respectively. Furthermore, recent 625bps cumulative decline in interest rates (to 7.0% from Mar-20-to- date), should translate into positive earnings impacts of PKR 4-5/share which should help ease debt burden entering in to FY21.

Agreement with KEL for base plant's coal conversion should add to savings

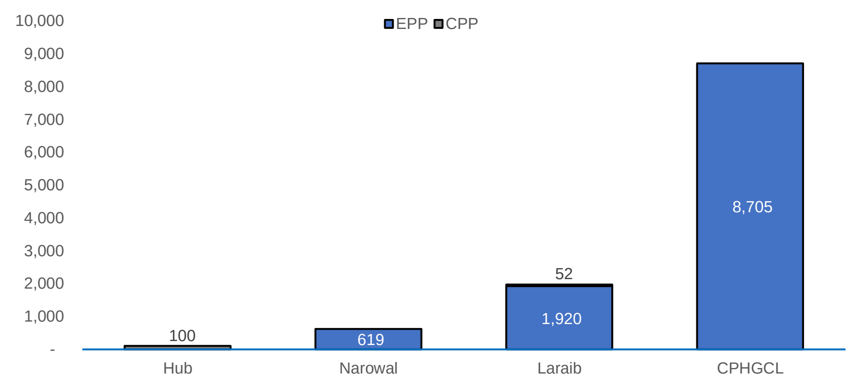
As part of ongoing negotiations with committee formed by the Government and lower demand by for FO based generation, HUBC is considering to convert two units of its base plant in to coal (likely to cost around USD 500-600mn) with a separate Power Purchase Agreement with KEL. It is pertinent to mention that Hub plant remains low on NEPRA's overall merit order list. This would save the Government from having to pay capacity payments during non-operational months around the year while lower tariff would allow further savings when offtake is needed.

FO based plants largely ignored in Sukuk-II cash disbursements

The Energy Sukuk-II was issued and disbursed during Jun-20 after significant delay with negligible disbursements towards FO based power plants. Total EPP and CPP payments accounted for only 4% of the total PKR 200bn payment. HUBC's base plant received only PKR 100mn in CPP payments (out of overdue receivables of PKR 30bn), while Narowal received PKR 619mn in EPP payments. However, Laraib (Hydel) received a much larger share of PKR 1.92bn and PKR 0.05bn under EPP and CPP payments respectively. Total CPP payments overdue for Narowal and Laraib stood at PKR ~8bn as of Mar-20. CPHGCL being a coal plants received a major chunk of its overdue EPP payments to the tune of PKR 8.71bn.

Exhibit: HUBC's share in Energy Sukuk-II payments

Hub plant and Narowal received the least share whereas Laraib and CPHGCL received a major chunk



Cumulatively EPP and CPP payments relating to FO plants accounted for only 3% of HUBCs receivables as at Mar-20 (12% including CPHGC) and has had limited impact on cash flows for HUBC. The Company's receivables are estimated to come down by PKR 11.4bn to PKR 84bn excluding additional pile up of dues in 4QFY20.

Government formed committee in negotiation with IPPs under Power Policy 1994/2002 to re-draft PPAs

The newly formed committee by the Government is in talks with IPPs falling under Power Policy 1994/2002 which is reported to have different points under discussion. As per the news reports (*Link*), the committee is working towards negotiating changes in PPA of IPPs. As PPAs of IPPs are 'signed and sealed', we believe these discussion points are unlikely to materialize and could only be amended on mutual agreement.

Exhibit: Points under discussion with IPPs under Power Policy 1994/2002

Points under discussion	Analyst Comments
IPPs to shift from take or pay to take and pay contract terms	Currently all the PPAs are on take or pay basis which guarantees return to IPPs regardless of offtake from power purchaser. IPPs may agree to this as they could enter in to contract with bulk consumer when there is no demand from power purchaser however transmission cost could be a burden for the IPPs if cost is shared.
Remove Indexation from USD to PKR (for return on equity to IPPs)	Under the current return structure for IPPs, PPAs are indexed with USD and any depreciation of PKR translates in to higher PKR returns for the IPPs. As USD to PKR indexation directly impacts IPPs profitability, there is a low possibility that IPPs would agree on changes within USD PKR indexation such as capping the USD rate.
IPPs to return the "excess" payments they received as pointed out in the report of committee headed by Muhammad Ali	The committee is negotiating on a claw back mechanism for sharing efficiency and other gains and savings in the future between power purchaser and IPPs which would be subject to verification of various cost, heat rate efficiency, etc. We believe IPPs may agree on these terms however, this is unlikely to affect HUBC's base plant and Narowal due to limited room for efficiency gains. This may impact other plants operating under Power Policy 2002 (namely Nishat IPPs, PKGP and AES)
Reduction of interest rate and payments on debt and other components, extension of debt tenor	As most of these IPPs have already paid of their debt and ones that remain will pay it off in the next few years, this will have little to no impact on IPPs falling under 1994/2002 power policy if agreed upon.

IPPs have responded to their points under discussion by stating that the main problems lies with new plants and DISCOs and that's where the committee should focus in bringing down the tariff. IPPs are of the view that by working towards (i) improving bottlenecks at the transmission/distribution level and (ii) reducing capacity payments of new plants (RLNG, coal), would substantially bring down the tariff by PKR 3-4/unit. Furthermore reducing Libor plus spread by 50% and increasing tenor of debt to 25yrs for new plants could provide a relief of PKR 1.5-2/unit whereas old plants can only contribute PKR 0.1/unit under this proposal.

Recommendation

We maintain a BUY stance on HUBC with our revised Dec-20 target price of PKR 147/share offering 84% upside from last close. The company is currently trading at FY21/22 P/E of 3.1/2.4x. Although cash payout has remains a key concern, we believe cash constraints are likely to ease off once financing for new projects are completed. Even after incorporating discount to P/E for high debt levels, HUBC is trading at a steep discount. We prefer HUBC as a Long term play where short term risks of cash constraints and dividend payout should be overcome by healthy cash generation from coal plants over the next 2-3 years.

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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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