The Hub Power Company Ltd.

PKR68.2 - BUY

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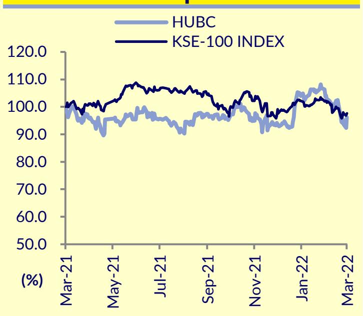
Pakistan

Power Generation & Distribution

Reuters	**HPWR.PSX**
Bloomberg	**HUBC PA**
Priced on 15 March 2022	
KSE100 @ 43,719.8	
12M hi/lo	PKR76.8/63.6
Dec-22 price target	PKR136.0
±% potential	+99.4%
Shares in issue	1,297.2m
Free float	75.0%
Mkt. cap	USD493.7m
3M ADV	USD0.6m

HUBC vs KSE100 performance



Source: PSX, Bloomberg

Regular pay-outs likely to resume

Shifting power sector dynamics to unlock valuations

Liquidity challenges in the power sector emanating from unrelenting circular debt accretion had curtailed HUBC's pay-out capacity and kept its price performance muted in the past year (underperformed KSE-100 by ~3%). However, tides seem to finally move in favour of the company, given the upward base tariff adjustments (up to PKR3.63/kWh in CY21) and renegotiation of power contracts. Hence, we re-initiate our coverage on the stock with a BUY rating and a Dec-22 DDM based TP of PKR136.0/sh (capital gain of 99%). We believe HUBC is at a good entry point to play its long-term promise of growth, with dividend pay-outs now becoming a reality (FY22/23E D/Y of 17/18%).

Our investment thesis is hinged upon the following factors

- Presently, the country's annual capacity charges amount to ~PKR0.86trn, and we project the payments to swell to PKR1.21trn in FY23 as over 7,600MW new power projects are scheduled to come online. The government has already increased base tariff by up to PKR3.63/KWh in CY21, which has helped trim the gap between revenue required and collected by Discos. This year, another base tariff hike of PKR2.17/KWh is on the cards to contain the additional capacity charges burden. Note that the recent announcement by the PM to not pass on the FCA component of electricity tariff to consumers till June'22 will be temporary and has an estimated financial impact of ~PKR98bn.

- The government has struck tariff renegotiation deals with as many as 47 IPPs under pre-1994, 1994, and 2002 power policy, which entails discontinuation of USD indexation on the ROE component. This was in exchange for partial clearance of older dues in two tranches to ease the cash flow crunch. The government has also approved a subsidy of PKR100bn for CPEC-based power plants, out of which PKR50bn was disbursed in early Jan'22. HUBC has received a cumulative PKR73.3bn (PKR56.5/sh) as of yet under these schemes.

- HUBC offers a strong USD-based IRR of 21%. The company's investment in CPEC-based local coal projects (USD ROE of 30.6%) will diversify its fuel mix and augment its capacity to a sizeable 3,581MW by CY22. We project earnings to grow at a 3-Yr CAGR of 17% (Consolidated FY22/23E EPS PKR23.2/30.9), with dividends from new ventures supporting HUBC's pay-out capacity going ahead.

- A brief analysis of equity price performance in the last 6 months shows that high dividend-paying companies have fared better. Five out of ten top-performing stocks in the KSE-100 index were the ones offering double-digit dividend yields. Hence, HUBC with its strong FY23E D/Y of 18%, appears to be a better bet.

Financial Snapshot (Consolidated)

Key metrics	FY20A	FY21A	FY22E	FY23E	FY24E
EPS	19.31	25.97	23.21	30.86	34.59
DPS	-	12.00	11.50	12.00	11.00
P/E	3.5	2.6	2.9	2.2	2.0
D/Y	0.0%	17.6%	16.9%	17.6%	16.1%
P/Bv	1.2	0.9	0.8	0.6	0.5
ROA	10.3%	12.5%	10.6%	13.4%	13.7%
ROE	39.4%	38.0%	27.7%	30.7%	27.7%

Source: Company Accounts, Alfalah CLSA Research

Inefficiencies and poor governance lead to unabated circular debt accumalation

Recent reforms to bring power sector to the fore

Pakistan's power sector has long been bedevilled by structural inefficiencies and myopic energy policies. Expensive power capacity, excess transmission and distribution (T&D) losses, lower tariff collection, and persistent energy theft hamper payments to generation companies and escalate the circular debt accumulation. The circular debt stock has reached a staggering PKR2.4trn as of Jan'22, out of which PKR1.4trn is related to power producers.

Figure 1

Key Circular Debt Statistics

	FY17	FY18	FY19	FY20	FY21
Circular debt (PKR bn)	818	1,127	1,618	2,150	2,280
Payables to IPPs/GENCOs (PKR bn)	379	544	812	1,143	1,350
Subsidies to electricity consumers (PKR bn)					
Accrued	134	159	318	314	237
Paid	131	147	177	201	176

Source: State of Industry Report 2021, Ministry of Power, Alfalah CLSA Research

Lately, in light of the incumbent government's renewed focus on circular debt resolution under the watchful eye of IMF, the power sector appears to be on the cusp of deep structural changes. We have highlighted below the measures taken by the government, which are expected to arrest the pace of circular debt build-up in a few years.

- **Base tariff adjustments:** As per government's understanding with the IMF, it has agreed to pass on the withheld tariffs to consumers in a phased manner. A total of up to PKR3.63/KWh was increased during CY21, which has significantly trimmed the differential between revenue required and revenue collected by Discos (See Fig. 3).

  Base rate expected to increase by PKR2.0/KWh due to new capacities

  Another base tariff hike of ~PKR2.17/KWh is on the cards this year due to the addition of new capacities in the system. With slow growth in demand and over 7,600MW power projects scheduled to come online by FY23, we are projecting the country's annual capacity charges to surge to PKR1.21trn from the present level of PKR0.86trn (↑ in generation cost by PKR2.7/KWh). The increase of PKR2.17/KWh will take the base tariff from existing level of PKR16.44/kWh to PKR18.61/KWh, and will help cover the cost of additional capacity payments in FY23. There is a possibility that the government may delay the implementation of base tariff adjustment due to election-year stimulus, but overall, the reform outline certainly seems to be in the right direction.

  Note that the recent decision taken by the government to provide relief to domestic and commercial consumers by freezing the FCA component at PKR3.09/KWh till June'22 is expected to have a financial impact of ~PKR98bn for Discos (if fuel costs remain at an elevated level). The step may temporarily increase the circular debt stock in case it is not fully financed through subsidies.

- **Rolling back subsidies:** As per the IMF plan, the government has also agreed to withdraw subsidies from power consumers gradually. Under phase I of the plan, it created new tariff slabs in Oct'21 and removed 8mn power consumers from the subsidy regime, saving PKR42bn per annum.

- The second phase intends to scale back PKR20bn annual subsidy from unprotected residential consumers this year by increasing their base tariff by PKR0.95/KWh. Along with these measures, the government is also considering breaking up large power distribution companies (DISCOs) into smaller units to ensure operational efficiency and contain financial losses.

Figure 3

Power sector dynamics likely to improve going forward

	FY20	FY21	FY22E	FY23E	FY24E
Capacity Charges (PKRbn)	794	848	898	1,207	1,304
Capacity Charges (PKR/KWh)	8.56	8.53	8.77	11.45	12.01
Energy Charges (PKRbn)	677	666	852	742	673
Energy Charges (PKR/KWh)	7.30	6.70	8.32	7.04	6.20
UoSC charges and MOF (PKRbn)	43	62	64	67	70
Power Purchase price (PKRbn)	1,515	1,576	1,813	2,016	2,047
Distribution Margin (PKRbn)	189	211	218	228	240
Total R.R by Discos (PKRbn)[1]	1,703	1,787	2,031	2,244	2,287
Actual dist. losses (%)	18.9%	18.0%	18.0%	18.0%	18.0%
Actual units sold by Discos (GWh)	92,791	99,373	102,354	105,425	108,588
Actual R.R by Discos (PKR/KWh)	18.36	17.98	19.84	21.29	21.06
Total CPPA-G billing (PKRbn)	1,604	1,799	1,973	2,261	2,329
Total CPPA-G billing (PKR/KWh)	17.28	18.10	19.28	21.45	21.45
Recovery rate (%)	88.8%	97.3%	95%	95%	95%
Total CPPA-G collection (PKR bn)	1,424	1,751	1,874	2,148	2,212
Total CPPA-G collection (PKR/KWh)	15.34	17.62	18.31	20.37	20.37

Source: State of Industry Report, Nepra, Ministry of Power, Alfalah CLSA Research
[1]R.R: Revenue Required
[2]Assuming there is no time lag; hike of PKR2.17/KWh assumed in FY23

- **Clearance of overdues and tariff renegotiations to provide solace:** The government has also renegotiated tariff agreements with 47 IPPs in exchange for partial settlement of outstanding receivables. ~PKR224bn has already been disbursed to pre-1994 and 1994 IPPS in two settlements. On the other hand, 12 IPPs under the 2002 power policy received the first tranche of over PKR60bn (40% of total overdues) in early Jan'22, and the remaining amount is expected to be disbursed in the next six months. The revised contract terms entail de-linking the ROE component from variation in PKR/USD and will help contain the increase in capacity payments to existing plants.

  A subsidy grant of PKR100bn has also been approved by ECC for CPEC-based power projects, out of which PKR50.0bn has been paid off to clear the dues, and the remainder will be disbursed in coming few months as well.

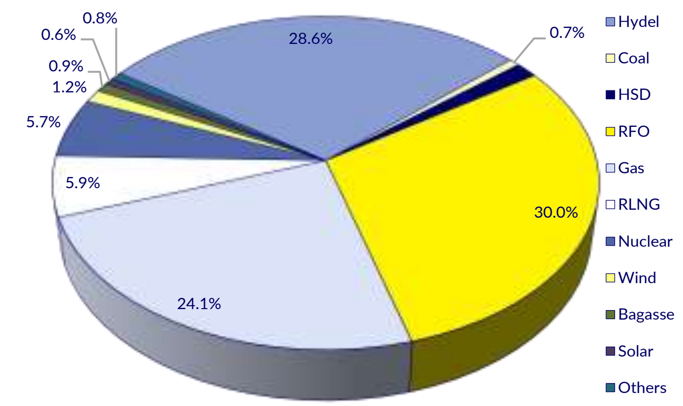
New capacity additions in the system will bring down fuel cost

- **Shift in energy mix underway:** Over the past few years, we have seen a clear shift in the country's generation mix, with dependence on expensive RFO coming down and cheaper renewable energy and coal-based generation gathering pace. In FY17, FO and coal comprised ~30% and ~1% of the country's total fuel mix, whereas, presently, they make up ~8% and ~20% (7MFY22), respectively. Around 2,600MW power projects based on local Thar coal are scheduled to commence operations this year which will bring down the overall fuel cost going ahead.

  Additionally, nuclear plants constitute 7% of the country's total installed capacity as of now and have a fuel cost near PKR 1.0/kWh. The 1100MW K-3 nuclear project is also underway and is expected to come online by Apr'22. Fuel savings resulting from low-cost power generation is expected to reduce the overall generation cost as evident from the decline in revenue requirement by Discos (on PKR/KWh basis) in FY24 (see Fig. 3).

Figure 4

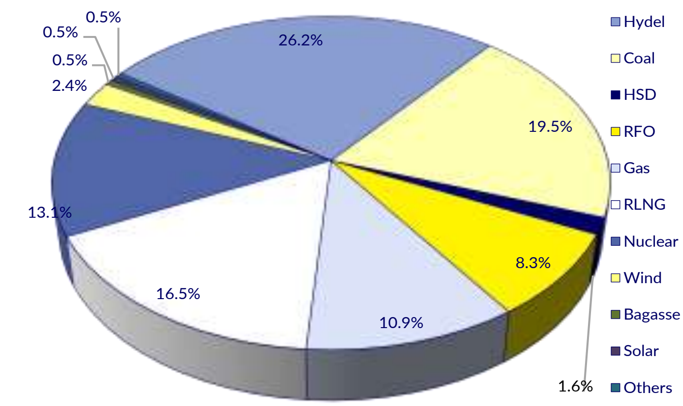
Fuel mix in FY17



Source: Nepra, Alfalah CLSA Research

Figure 5

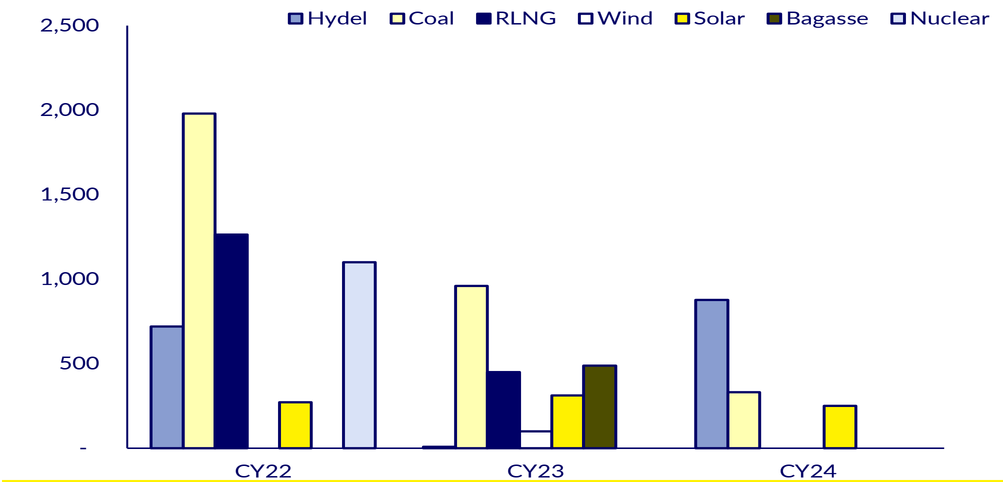
Fuel Mix in 7MFY22



Source Nepra, Alfalah CLSA Research

Figure 6

New capacity additions focused on low-cost generation (MW)



Source: State of Industry Report 2021, Alfalah CLSA Research

Note that the structural inefficiencies (including T&D losses and lower bill recovery) continue to exist on the distribution side of the power value chain. However, we look forward to the launch of the Competitive Trading Bilateral Contract Market (CTBCM) model, which plans to introduce reforms on the distribution side and bring the 'Take and Pay' contracts regime in the power space. The implementation timeline remains ambiguous, and we are also uncertain regarding its applicability on only the new PPAs or the existing ones too; nevertheless, the development will significantly contain the flow of circular debt.

The Hub Power Company Ltd – Company Profile

New projects to lend a longer life to company

Pakistan's total installed generation capacity in the NTDC system stands at 34,501MW (as of May'21), out of which HUBC contributes a sizeable 8%. Since the inception of its first plant in 1997, the company has embarked on an aggressive growth strategy and has expanded by more than two-folds. HUBC is one of the largest IPPs in the country, with gross capacity expected to reach 3,581MW by CY22 (spanning across 6 diversified power projects). It is the only power producer with four projects listed under CPEC that offer a guaranteed ROE between 27%-31% (USD-hedged), enabling the company to lock in a healthy income flow for 30 years.

Figure 7

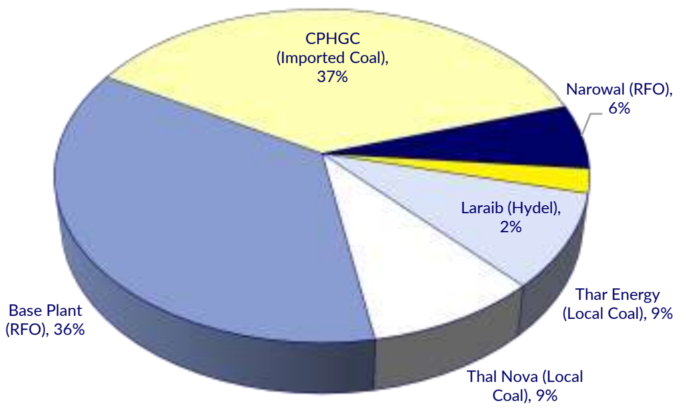
Power projects under HUBC's belt

	Gross Capacity	Fuel Type	Holding	Benchmark Efficiency	COD	PPA Term	Cost (USD bn)
Existing Power Projects							
Hub Power Plant	1,292MW	RFO	100%	39%	Mar-97	30 Years	1.6
Narowal Power Plant	225MW	RFO	100%	45%	Apr-11	25 Years	0.3
Laraib Energy	84MW	Hydel	75%	90%	Mar-13	25 Years	0.2
CPHGC	1,320MW	Imported Coal	46%	39%	Aug-19	30 Years	2.0
Upcoming Power Projects							
Thar Energy Ltd.	330MW	Local Coal	60%	37%	Jul-22E	30 Years	0.5
Thal Nova Power Plant	330MW	Local Coal	38%	37%	Oct-22E	30 Years	0.5

Source: Company website, PPIB, Alfalah CLSA Research

Figure 8

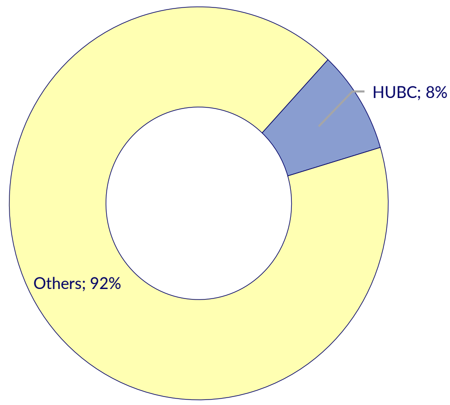
HUBC – Exposure to a diversified fuel mix (Gross Capacity)



Source: Company Accounts, Alfalah CLSA Research

Figure 9

Market share based on country's total capacity



Source: Nepra, Company Accounts, Alfalah CLSA Research

Hub Base Plant – Alternative plans under consideration

HUBC's oil-fired base plant has been operational since 1997 and has a remaining PPA tenor of 5 years. With extensive low-cost capacity additions in the NTDC system, the base plant's generation levels have fallen below 10% in recent years (excluding 1QFY22). The company's dividend payment capacity has also remained restricted in the past few years (skipped payouts from FY19-FY20) owing to CAPEX commitments for new projects and unabated accretion in circular debt.

Under the recently amended PPA contract, Hub received a total inflow of PKR58bn (PKR45/sh), which slightly eased the cash flow squeeze and unlocked dividend payout capacity (announced a special dividend of PKR6.5/sh in Jan' 22). Note that the base plant also enjoys a unique U-shaped tariff profile, which incorporates a relatively steep ascent in Project Company Equity (PCE) component beginning in FY22 and peaking in FY27 (PPA expiry). Hence, this supports an organic growth in earnings going forward despite the removal of USD indexation on PCE component and creates room for dividend payments. We project the company to announce a total dividend of PKR11.5/12.0 per sh. in FY22/FY23.

Evaluating new projects to stretch the life of base plant beyond FY27

Our DDM based valuation for the plant stands at ~PKR60.6/sh at a 17.5% K_e. With the PPA term nearing its expiry and lower utilization levels, the company is mulling over the government's proposal to buy the base plant for PKR65bn (PKR50/sh) in exchange for conversion of 2/4 turbines on Thar coal and establishment of a water desalination plant in Karachi. The proposal is still at its initial stages, and no conclusive decision has been reached.

China Power Hub Generation Company (CPHGC) to provide dividend income support

Offers a guaranteed USD and inflation hedged ROE of 27.2%

CPHGC, which marked HUBC's entry in coal power generation, came online in late CY19 and increased the company's gross capacity to a sizeable 2921MW. The project primarily depends on imported coal for fuel and offers an attractive ROE of 27.2% (USD and inflation hedged).

CPHGC is relatively ranked higher in the NTDC's merit order list due to its lower cost generation, ensuring better plant utilization levels. However, it has recently fallen in the list (from 15th rank in early Dec '21 to 37th rank presently) owing to a rise in imported coal cost (PKR15.1/kWh). Although the IPPs enjoy a cost pass-through structure, the increased generation cost will weigh on the company's working capital requirements and may push it further down the pecking order.

Safe from tariff renegotiations

The CPEC based power plants have so far remained safe from the government’s ire over excess profits and have managed to dodge the bullet of tariff renegotiations, likely due to Chinese equity and debt interests. The recently concluded visit of the Prime Minister to China has provided significant impetus to CPEC-based companies. The government is planning to establish a revolving account for projects to finance their working capital needs and has also approved release of PKR100bn, out of which PKR50bn has already been disbursed in Jan'22. The remaining amount is likely to be paid off in a few months. Reportedly, CPHGC has received a total of PKR9.0bn (PKR6.9/sh) from the total PKR50.0Bn disbursed. The company's overdue balance stood at PKR37.2bn (PKR28.6/sh) as of Feb 25th, 2022.

Due to the lender covenants and delays in tariff true-up, the company has not commenced dividend payments as of yet. The tariff true-up is expected in the first half of CY22, and the start of dividends from the plant will ramp up HUBC's payout capacity. So far, CPHGC has contributed a cumulative PKR29bn (~PKR22/sh) towards HUBC's operating profit. The decline in the share of profits (loss of PKR1.5bn or PKR1.1/sh) in 2QFY22 was due to transformer damage, which is now back in service since Jan '22. The company has already filed insurance claims and is expecting to recover an amount in the range of USD50-55mn in lieu of plant downtime.

Note that the revenue calculation for CPHGC is based upon the upfront tariff as of now. Any change in the ROE component post revision in allowed project cost in COD tariff may change our earnings projections. The two similar 1320MW imported coal-based plants in Sahiwal and Port Qasim witnessed an average decline of 23% in their ROE component in COD tariff. Hence, we present a sensitivity analysis of change in CPHGC's contribution to revision in the ROE component in the COD tariff.

Tariff revision pose a risk to our estimates

Figure 10

Sensitivity of earnings and value contribution to CPHGC's tariff revision (PKR/sh)

	↓25%	↓20%	↓15%	0%	↑15%	↑20%	↑25%
FY23E EPS	9.5	9.9	10.2	11.4	12.5	12.9	13.3
FY24E EPS	10.1	10.5	10.9	12.2	13.5	13.9	14.3
Valuation Share (46% stake)	20.5	23.1	25.8	34.5	43.7	46.8	49.8

Source: Company Accounts, Alfalah CLSA Research

Another risk facing the dividend commencement is the increased withholding tax rate of 25% on dividends under the Finance Act, 2020. The management is optimistic that the decision will be reversed very soon (back to 7.5%) as it was done for bagasse-based power plants under the Finance Act, 2021. We have assumed dividend commencement from the plant in FY23 and have used tax rate of 25% in our projections on prudent basis. Downward revision in tax rate to 7.5% will raise our consolidated earnings estimates by PKR2.2/2.5 per sh. and dividend expectation by PKR0.5/0.0 per sh. in FY23/FY24E.

CPHGC (46% holding) is expected to add PKR34.5/sh towards HUBC's total valuation. As per the latest news flow, the government is considering prolonging the debt tenor of Chinese IPPs by 5 years to 15 years and has also proposed purchasing 1200MW electricity from Pakistan for onward supply to Afghanistan. Although the Chinese investors have refused to revise the contract terms, extension in the debt tenor will have a slightly positive impact on the valuation contribution of CPHGC.

Narowal Energy – Receipt of overdues to provide short-term respite

Similar to the base plant, the 225MW RFO-fired power plant also falls lower on the NTDC's merit order list (63rd rank) due to its expensive fuel generation cost. However, in terms of utilization levels (44% vs. base plant's 14% in 1HFY22), it fares slightly better due to its location advantage and higher efficiency levels. Going forward, given the new low-cost capacity additions in the system, we expect the generation levels to stay on the lower side for the remaining tenor of the PPA term.

Resumption of NEL's dividends to support HUBC's payout

NEL suspended dividend payments to HUBC post FY19 due to a cash flow crunch. However, the company was amongst the 12 IPPs falling under power policy 2002 that renegotiated tariff agreements with the government to release outstanding circular debt-related dues. The revised contract terms entailed a change in ROE rate from 15% (dollar terms) to 17% (PKR-based) with no further USD indexation. The overdue receivables for NEL roughly amounted to PKR18bn, for which it recently received the first payment tranche of ~PKR6.4bn (40% of receivables). The remaining amount is likely to arrive after six months.

We expect the liquidity boost will enable NEL to resume dividends and ramp up the dividend pay-out capacity of HUBC. The project adds PKR14.6/sh to HUBC's total valuation based on our estimates.

Laraib Energy – Steady income generation to continue

Sustainable income stream; adds PKR12.7/sh to HUBC's value

The hydel-based IPP accounts for nearly 10% of HUBC's consolidated earnings. Unlike other power plants in HUBC's portfolio, the company has relatively maintained its payout frequency as it requires negligible fuel expenses and remains virtually immune to the swelling circular debt problem. Laraib's outstanding dues roughly amount to PKR5.5bn (or PKR4.2 per sh.) At 17.5% cost of equity, our DDM based valuation for Laraib works out to be ~PKR22.0 bn. HUBC owns a 74.95% stake in this project, which adds PKR12.7/sh to our SoTP based target price of PKR136.0/sh.

New projects in the offing

Growth projects to amp up valuations!

HUBC's investment in the CPEC based 2x330MW coal-fired power plants is finally expected to reap benefits as the projects are scheduled to come online in 2HCY22. Thar Energy Limited (TEL) and ThalNova Power (TNPTL) together entail an investment of over USD 1.0 bn and enjoy an attractive USD-based ROE of 30.65% for 30 years. Both these plants intend to utilize indigenous coal supplies from SECMC, which is also undergoing Phase II of expansion (production capacity to double to 7.6MTPA) and is likely to commission in the current year. Given the shift in government's focus towards cheaper indigenous resources for power generation, these coal power plants are likely to be ranked higher in the merit order list, thereby ensuring regular power dispatch. In case of delays in the commencement of Phase II of SECMC, these projects may have to temporarily depend on imported coal for fuel.

TEL and ThalNova have completed 86% and 65% of project work, respectively

With HUBC's ownership stake of 60% in TEL, 38% in TNTPL and 8% in SECMC, expected annual earnings and valuation contribution cumulate to PKR3.8/sh and PKR13.7/sh, respectively. Note that the previous RCOD of TEL and TNPTL was in Mar'21 but COVID-driven supply disruptions delayed the COD to 2HCY22. HUBC has managed to get an extension in RCOD from CPPA-G for both the projects, hence, saving themselves from PPA damages. However, it may have to incur liquidity damages as the plant hold-up also delayed the COD of Matiari to Lahore Transmission Line project (commenced in Sep'21). The expected monthly penalty is around USD2mn and the charges will be capitalized.

Diversifying exposure to E&Ps

HUBCO is also foraying into upstream exploration through a 50:50 joint venture (Prime Oil International Oil & Gas) with ENI's local employees to take over ENI Pakistan's assets. The NOC from FBR and clearance from DGPC is expected to be received shortly after which the results of ENI's operations will be incorporated into the company's structure. Presently, ENI has major permits in Bhit/Bhadra (40% working interest) and Kadanwari (18.4% working interest) field and shared permits in Latif (33.3% interest), Zamzama (7.8%), and Sawan (23.7% interest) fields. The management has not disclosed the full details of the new venture; nevertheless, completion of the transaction provides further upside risk to our valuations.

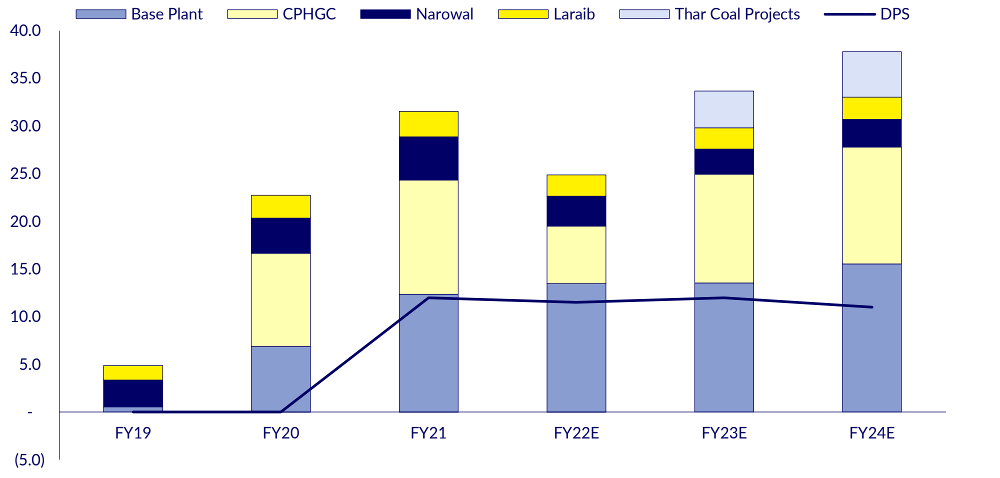
Valuation Methodology and Recommendation

HUBC offers a strong USD-based IRR of 21%. We have used SoTP based methodology to value the company. At 17.5% K_e, we assign a BUY rating on the stock with Dec'22 DDM-based target price of PKR136.0/sh, implying a massive capital upside of 99% and FY22/FY23 dividend yield of 17/18%, respectively. The largest contribution to the fair value is from the base plant at PKR60.6/sh, followed by CPHGC at PKR34.5/sh and Narowal at PKR14.6/sh.

Base plant and CPHGC contribute the largest to fair value

Figure 12

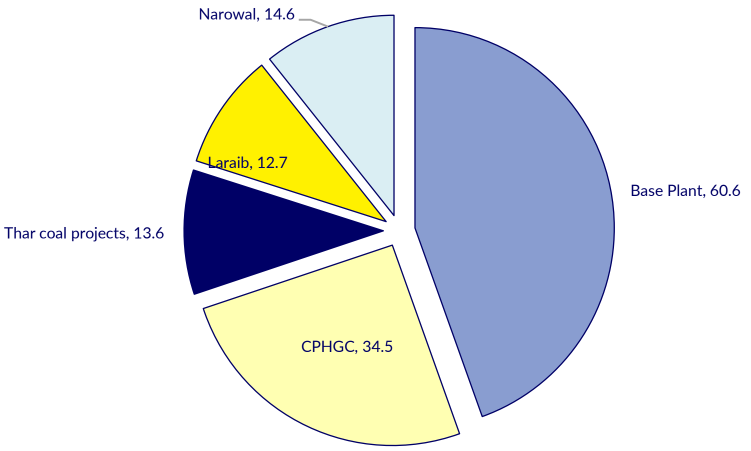
Earnings contribution from subsidiaries (PKR/sh)



Source: Company Accounts, Alfalah CLSA Research
*Consolidated earnings

Figure 13

Valuation break-ups (PKR/sh)



Source: Company Accounts, Alfalah CLSA Research

High yielding dividend plays appear as safer bets

A brief analysis of equity price performance in the last 6 months shows that while the benchmark KSE-100 index has fallen by 5.2%, 5 out of 10 stocks that outperformed the market included companies which offer double-digit dividend yields (see Fig.14). Hence, HUBC with its strong FY23E D/Y of 18%, appears to be a better bet.

5/10 top performers offer double digit dividend yields

Figure 14

KSE-100 index top gainers (Sep'21 to Mar'22)

Top Performers	Outperformance to KSE-100index	D/Y (TTM)
PSEL	65%	0%
UBL	34%	12%
ABL	32%	9%
EFERT	31%	19%
MARI	31%	11%
FATIMA	31%	4%
DCR	30%	10%
FABL	29%	6%
BAFL	21%	11%
MTL	21%	9%

Source: PSX, Alfalah CLSA Research

Upside risks

Decline in PKR/USD value

Earlier than expected dividend income from CPHGC

Downward revision in WHT rate on dividends

Downside risks

Interest rate risk and PKR appreciation

Delays in receipt of second tranche for Narowal and CPHGC

Tariff renegotiation of CPEC-based plants

Delays in commissioning of new projects

Delays in implementation of QTAs and FCAs will escalate the circular debt problem.

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