

STOCK VALUATION: HUB POWER COMPANY*

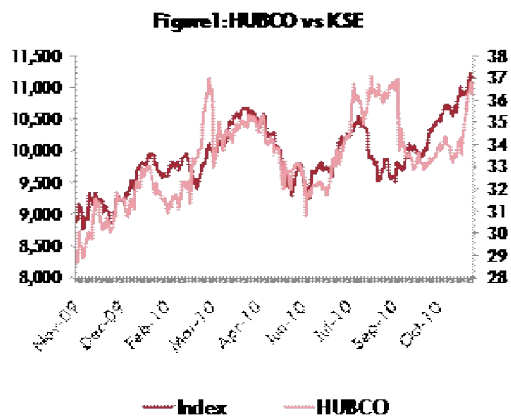
Shazia Farooq, Dileep Kumar Maheshwari
Rabbiya Ghulam Mohammad, Rafia Abdul Sattar,
Sateesh Balani
Department of Accounting and Finance
College of Business Management, Karachi

Highlights

- **Attractive Return:** We initiate coverage with a BUY rating on HUBCO on our DDM-based target price of PKR 47.13. The stock is currently trading at a P/E of 9.06x, offering a return of 41% on the price of PKR 36.72 as of 26 November 2010.
- **Best Bet among IPPs:** Unlike new IPPs, HUBCO has a U-Shaped tariff structure and its Project Company Equity (PCE) is indexed to both PKR devaluation and US CPI (while other IPPs only have exchange rate protected PCE). Furthermore, the Government of Pakistan backing for fuel supply to the company is expected to extenuate the shock of circular debt.
- **Resolution of Circular Debt to Boost Investor Buoyancy:** Complete withdrawal of the power subsidy through gradual increase in power tariff by 2.2% per month during the period November 2010 to June 2011, would ease HUBCO's counterparty risk. The move would brace expected dividend yield and payout, thereby, uplifting investor confidence in the stock's returns.
- **Expansion to Augment Dividends:** The company has entered into a growth phase with the Narowal expansion,, increasing its capacity by 20% resulting in an IRR of 15%.

*Report presented at CFA Institute Global Investment Research Challenge, Karachi in November 2010

Table 1: Market Profile	
52 Week Price Range	PKR 28.6 - PKR 37.01
Average Daily Volume	1.812 mn
Beta	0.703
Dividend Yield (Estimated)	13%
Shares Outstanding	1,157 mn
Market Capitalization	PKR 42,490 mn
Book Value Per Share	PKR 24.13
Debt to Total Capital	3.48x
Return on Equity	16%



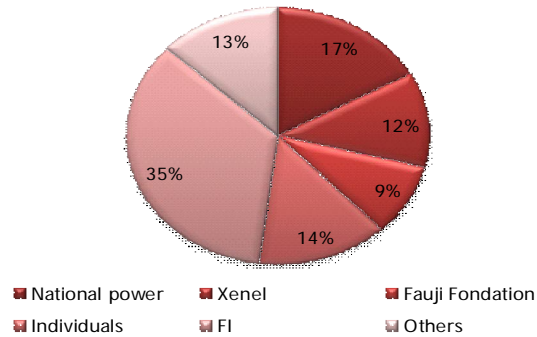
Source: Karachi Stock Exchange

Table 2: Valuation Summary

	2009	2010	2011E	2012E	2013E	2014E
Turnover (PKR mn)	82,784	99,694	101,369	123,568	126,826	129,573
Net Profit (PKR mn)	3,645	5,557	4,692	6,281	7,010	7,182
EPS (PKR)	3.15	4.8	4.05	5.43	6.06	6.21
DPS (PKR)	2.35	4.49	4.62	5.97	6.47	6.46
BVS (PKR)	24.05	23.98	24.13	23.69	23.56	23.79
ROE	12%	19%	16%	22%	25%	26%
PER (x)	11.66	7.65	9.06	6.77	6.06	5.92
ROA	4%	5%	4%	5%	5%	6%

Source: Blaze Research

Figure 2: Shareholding Structure of HUBCO



Source: Company Data

Business Description

The Hub Power Company, the first private sector infrastructure project and the second largest Independent Power Producer in Pakistan, commenced operations in 1991 as a public limited company. The sponsors include UK based International Power, Xenel of Saudi Arabia, IHI of Japan and K&M of USA. The company is listed on Karachi, Lahore and Islamabad stock exchange. Its global depository receipts are traded on Luxemburg stock exchange.

Table 3. Capacity Mix of HUBCO

Plant Name	Installed Capacity (in MW)	Type of Plant
Hub	1200	Thermal
Narowal	*214	Thermal
Laraib Energy	*84	Hydel
Total	1498	

*Narowal COD expected in April 2010

*Laraib COD expected in June 2013

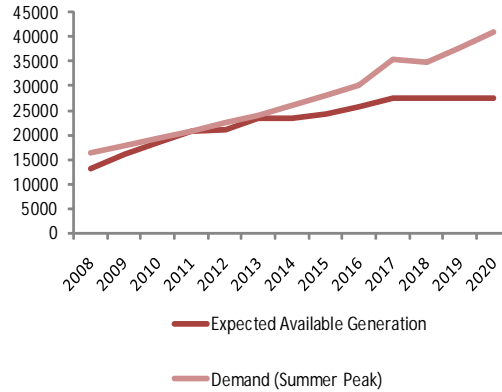
Source: Company Data

The company is mainly engaged in developing and operating power stations. It sells power to Water and Power Development Authority (WAPDA), its only customer, under a guaranteed minimum off-take contract. The company operates on the basis of four main agreements including Power Purchase Agreement (PPA) with WAPDA, Fuel Supply Agreement (FSA) with PSO, Operating and Maintenance Agreement (O&MA) with International Power and Implementation Agreement (IA) with the Government of Pakistan (GoP).

The company originated with a thermal power plant, based on residual fuel oil (RFO).

With a gross generation capacity of 1292 MW, the plant is located near Hub in the province of Baluchistan. Subsequently, it expanded power generation capacity by installing a 213 MW RFO power station at Narowal in the province of Punjab which is expected to come online by the third quarter of this fiscal year. In 2008, the company also established Laraib Energy Limited to construct an 84MW hydro power project near the New Bong Escape in Azad Jammu and Kashmir. HUBCO has a 75.5% controlling interest in Laraib which is the first private sector hydro project in Pakistan. The project is expected to come online in FY20.

Figure 3: Supply and Demand of Electricity in Pakistan (MW)



Source: PPIB

Industry Analysis

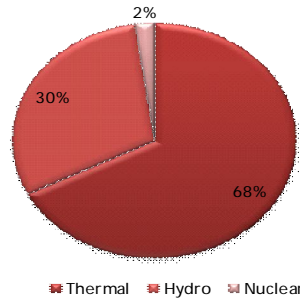
Factors Fueling Growth

Demand to Outpace Supply

The power situation in Pakistan has been critical over the past few years and is expected to aggravate in the future. Demand has grown at a CAGR of 5.2% during the past ten years whereas the supply increased by 2.2%. This gap can mainly be attributed to deficit capacity building.

Currently the electricity production per capita of Pakistan is 512 kWh which is very low when compared to the other countries in the region including Malaysia, Iran and Turkey, having a production per capita in excess of 2500 kWh. Although the government has made strenuous efforts in resolving the existing issues, the measures were adhoc and largely short-term. A long-term well thought out strategy is desperately needed for an efficient resolution of the energy crisis in the country.

Figure 4: Nominal Power Generation Capacity (MW)

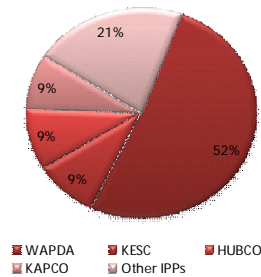


Source: SOI Report 2010

Heavy Reliance on Thermal Power

Total nominal power generation capacity of Pakistan as on 30 June 2010 was 21,593 MW of which 14,576 MW (68%) was thermal, 6,555 MW (30%) was hydroelectric and 462 MW (2%) was nuclear. With a heavy reliance on expensive thermal capacity, Pakistan has been unable to improve its energy mix over the years. Frequent water losses due to limited storage capacity and depletion of gas reserves have compelled the country to resort to thermal based power generation. Although Pakistan has sufficient potential for alternate sources of energy like coal, wind and solar, no proper measures have yet been taken to initiate such projects.

Figure 5: Electricity Generation by Company 2008-2009



Source: Pakistan Energy Yearbook 2009

Stakeholders

Electricity production in Pakistan is mainly contributed by Water and Power Development Authority (WAPDA), Karachi Electricity Supply Company (KESC) and Pakistan Atomic Energy Commission (PAEC). The development of IPPs since 1994 has significantly contributed to power production capacity. WAPDA and KESC are integrated public sector utilities which are responsible for the supply of electricity to the country through 220 kV double circuit transmission lines.

National Electric Power Regulatory Authority (NEPRA) is the power sector regulator managing the issuance of licenses for generation, transmission and distribution of electric power and determining of the tariff rates. PEPCO was the public sector distributor which, after 18 years of operation, was dissolved by the government in October 2010 on account of huge losses and management inefficiencies. Post closure of PEPCO, its nine distribution companies were made independent.

Independent Power Producers

Most of the IPPs are thermal based since set up costs of such plants are lower compared to hydel power units. Currently 19 IPPs with an installed capacity of 6,600 MW are operating in Pakistan, providing more than one third of total energy generation.

Corporate Structure

IPPs are established through public-private ownership for generating electricity and supplying to the sole buyer i.e. WAPDA. IPPs are operating under various project agreements with the government in addition to the power policies of 1994 and 2002.

Capital Structure

The minimum equity required for financing IPP in Pakistan is 20% of project capital cost with at least 51% equity

held by founder shareholders for up to 6 years from commercial operation date. The government has also allowed 100% foreign shareholding.

Tariff Structure

The tariff structure of IPPs has two components namely; Energy Purchase Price (EPP) and Capacity Purchase Price (CPP). Both these components are measured in per kWh. The EPP deals with actual power generation and comprises of fuel and variable operating and maintenance (O&M) costs that are indexed to inflation and exchange rate variation. The CPP component is independent of the power generated and is based on base capacity utilization. It is subdivided into escalable and non-escalable charges where the former includes return on equity, fixed O&M and insurance costs (all indexed of inflation and exchange rate movements) and the latter accounts for debt servicing charges including both principal and interest payments.

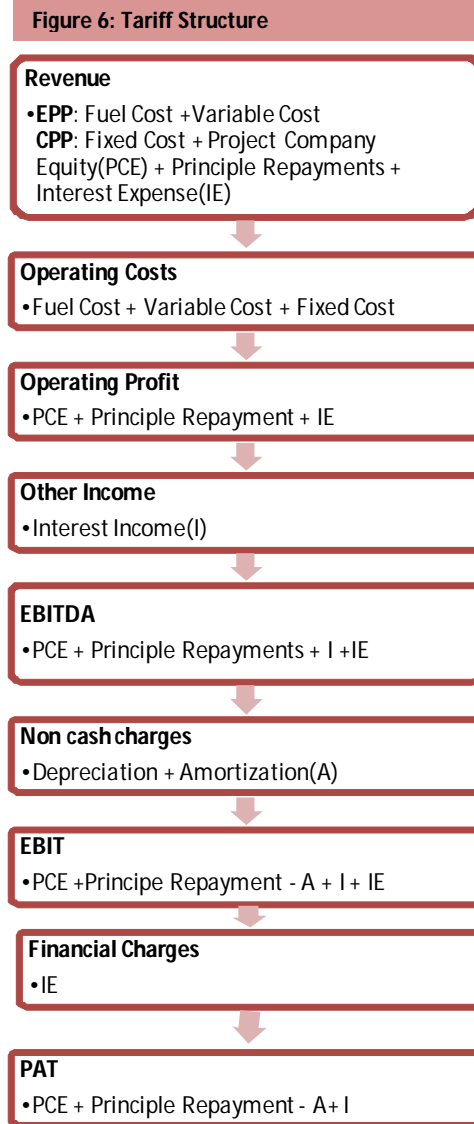
Lucrative Return Structure

IPPs have a very well defined return structure shielded from rising energy prices, interest and operation costs backed by international and sovereign guarantees for fuel and energy & capacity (E&C) payments. The returns of IPPs are denominated in US dollars based on a negotiated ROE with the government and assured cash flows over the project life.

Government Support to Stimulate Foreign Investment

The private sector has always received tremendous support from government in the form of various incentives for the development of power. This is one major reason why Pakistan's power sector has always been eyed by foreign investors. Investors are guaranteed lucrative returns through the power policy, hedged against inflation and exchange rate movements, in addition to the government backing on trade debts.

Figure 6: Tariff Structure



Source: Blaze Research

Favorable Agreements and Tariff

Power Purchase Agreement (PPA)

PPA represents a contract between the IPPs and WAPDA whereby both the parties agree upon conditions related to plant operation and tariff charges. So far there have been two different PPAs signed in Pakistan with various IPPs under power policies of 1994 and 2002 respectively

Implementation Agreement (IA)

The IPPs sign IA with the government which guarantees the performance of WAPDA in terms of the conditions stipulated in the PPA.

Fuel Supply Agreement (FSA)

This agreement is signed between the IPPs and fuel contractors to ensure that fuel requirements of the IPPs will be met. Unlike the first generation PPA, the second generation PPA does not provide the guarantee of the government for fuel contract obligations. However, this does not affect the financial health of the IPPs as the risk is entirely passed on to the fuel supplier.

Operation and Maintenance Agreement (O&MA)

The O&M Agreement between the IPPs and their respective contractors ensures that the latter efficiently adhere to the operations and performance standards of the IPPs plants.

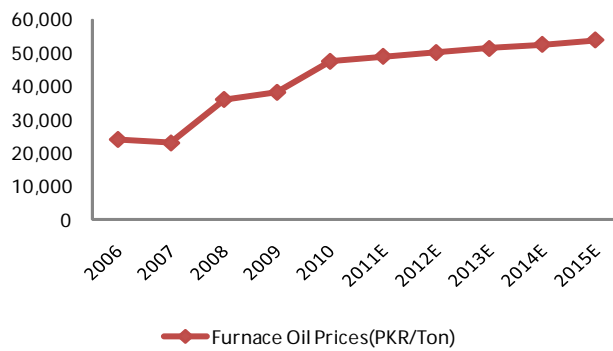
Industry Threats

Energy Price Hike

Pakistan's energy bill has surged due to escalating international oil prices coupled with rupee devaluation. Over the last five years, furnace oil prices rose by a CAGR of 29% from PKR 24,263/ton in 2006 to PKR 47,500/ton triggering an increase

in electricity prices. Against this backdrop, the rising inclination of private sector towards the RFO based plants is not suitable for Pakistan's economy in the long run. The cost of thermal energy has risen sharply due to which subsidy is provided by the government. The major threat facing the industry is the IMF's conditionality stipulating subsidy withdrawal.

Figure 7: Furnace Oil Prices



Source: PSO, Blaze Research

Table 4: Trade Debt Position of PEPCO

	(bn PKR)		(bn PKR)
PEPCO Receivable	181	PEPCO Payable	211
Private	93	IPPs	111
KESC	38	Oil Companies (PSO+APL)	27
Sindh Government	20	Wapda Hydel	45
Fed Government Tube well	5	Rental Projects	9
Others	26	Gas Companies	20

Source: SOI 2010

Circular Debt

Pakistan faces severe internal liquidity crisis especially in the energy sector with almost every other company indebted to the government or consumer/supplier. Theft of electricity in the country is major cause of circular debt with likes of KESC having 57% collection ratio.

Out of the 9 electric distribution companies in the country, 5 have high transmission and distribution losses. Transmission losses result in load shedding leading to low revenues for these companies which aggravates the issue of circular debt. One of the main causes for the inefficiency is the deteriorating distribution system which results in overload and tripping of main power grids.

Net circular debt position has decreased by 16.9% in June 2010 from PKR 216bn in the corresponding period last year. This was mainly possible through issuance of TFCs worth PKR 80bn and PKR 82bn in March and September 2010 respectively. However, this proved to be a short term measure as the level rose to PKR 235bn in October 2010.

Power Price Hike to Reduce Circular Debt

Recently, the government has announced a gradual phase out of subsidies through power price hike of 17.6% during November 2010-June 2011 to reduce the disparity between average cost of power generation and power tariff. We believe that this step will considerably alleviate the circular debt levels of IPPs.

Healthy Payout despite Circular Debt

Circular debt significantly raised receivable and payable levels of IPPs. Nonetheless, companies particularly HUBCO and KAPCO seem to be indifferent, maintaining healthy payout ratio in excess of 95%.

Table 5: Risk Profile

RISKS	RISK MITIGANTS
Delayed payment by WAPDA causing financial constraints	Company continues with running finance facility to meet working capital requirement
Minimal exposure to credit risk	GOP guarantee for recovery of company's trade debts and other receivables
Volatility in exchange rates hinder ability to meet off-shore lender debt obligations	PPA provides tariff indexation for currency depreciation on foreign debt
Volatility in interest rates to result in higher debt servicing charges and reduced net cash flow	Overcome with fixed lending rates and hedging arrangements
Poor performance of plant resulting in payment of penalties to WAPDA	O&M agreement with International Power Plc
Delay in supply of fuel by PSO leading to penalty charges to WAPDA	Liquidation damages paid to WAPDA can later be flipped by liquidation damages paid by PSO
Management inefficiency to affect cash flows	Competent management with a proven track record
Change In IPP's taxation policy	Change in Taxation policy secured under the implementation Agreement
Delay in COD of Narowal causing payment of liquidation damages to WAPDA	These charges to be passed to EPC contractor, MAN diesel

Source: Blaze Research

Risks

Possible Difficulty in Meeting Obligations Related To Financial Liabilities

The CPP and EPP charges of the company are passed on to WAPDA. Therefore, any delay by WAPDA in this regard affects company's payment obligations, mainly fuel and debt servicing charges. The company manages its liquidity risk through running finance facilities which cover short term funding needs triggered by delayed payments from WAPDA. Payments to PSO are also delayed in case WAPDA does not pay on time.

Possible HUBCO Default on Numerous Obligations

The guarantee of GoP on the performance of WAPDA ensures the recovery of trade debts and other receivables which minimizes the company's credit risk to a great extent.

Exchange Rate Risk on FX Loans

Volatility in exchanges rates and unavailability of foreign exchange hamper the company's ability to cope with its debt obligations particularly towards off-shore lenders. The PPA provides the company with the advantage of tariff indexation for any currency depreciation on the foreign debt element (along with other factors), thereby mitigating the exchange rate risk. The government provides guarantee for the accessibility and the hedging of total foreign currency liability.

Interest Rate Risk

Fluctuations in market interest rates may require the company to pay higher debt servicing charges, thus reducing its net cash flow. This risk is mostly dealt with given the fixed lending rates on company's debt or alternatively through hedging arrangement at the preference of the lenders.

Poor Performance of Plant

Revenues are highly dependent on plant performance which is determined by various factors including heat rates, plant availability, dependable capacity and emissions. A deficiency in any of these factors may lead to payment of penalties to WAPDA or PSO. The risk of loss in revenues owing to poor plant performance is, however, low as the company's O&M contractor, International Power, is a well-reputed equipment supplier which is also a shareholder in the project. International Power is accountable as per O&M Agreement for penalties in case of non-performance and bonuses for efficiency.

Delays in Fuel Supply

HUBCO's fuel input remains contingent to timely delivery of supplies by PSO. Hence, any potential supply delays or bottlenecks will assume the added risk of paying penalty charges to WAPDA as per PPA. These penalty charges can later be recovered through payment of liquidated damages from PSO.

Inadequate Management Control by the Company

Any inefficiency on the part of company's management can lead to improper monitoring of the operator's performance, affecting operating cash flows. This risk is mainly addressed by the current management structure consisting of highly skilled and experienced staff. Moreover, guarantees and liquidated damages can be called from O&M contractors on account of their poor performance.

Political Risk

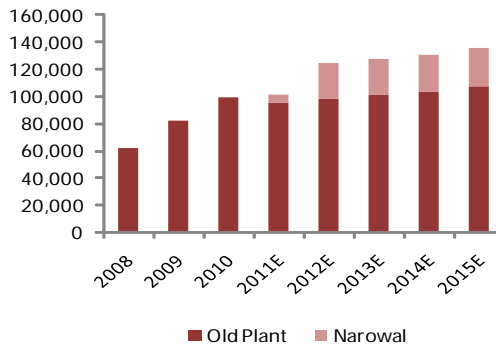
Tax Rate Changes

The company is exempt from all taxes and duties. Any change in this policy in future may reduce profitability. This contingency is also taken into account in the Implementation

Penalty on Delay in Narowal

The company is liable for the payment of liquated damages to WAPDA on a daily basis by delaying the commercial operation date for Narowal project beyond September 2010. The risk is offset by passing these charges to the EPC contractor, MAN diesel.

Figure 8: Revenue Breakup (PKR mn)

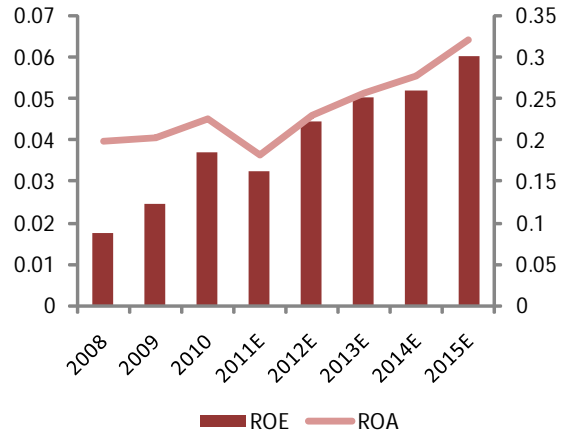


Source: Company Data, Blaze Research

Risk to the valuation

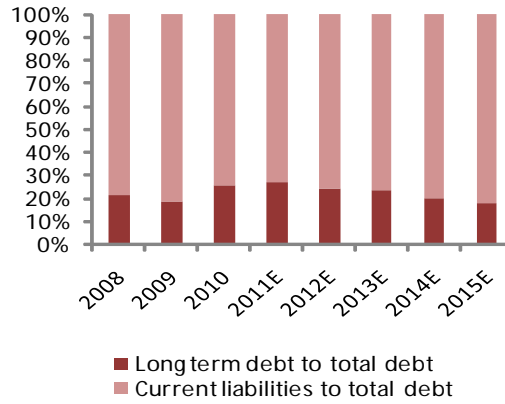
EPC contractor MAN diesel Germany was unable to meet the contractual COD of Narowal and it was delayed twice initially. According to company sources, the project is now expected to come online in April 2011. HUBCO is bound to pay the penalty of delay to the WAPDA under the PPA, although it is almost offset by the liquidity claims made to the MAN diesel. Our calculations estimate that a further delay of three months in COD would reduce target price by PKR1.08/share.

Figure 9: Return on Asset and Equity



Source: Company Data, Blaze Research

Figure 10: Debt Mix



Source: Company Data, Blaze Research

Financial Analysis

Buoyant Revenues

With increased operational efficiency, HUBCO has become successful in reaching a revenue level of PKR 99bn (EPS: PKR 3.15) for FY10 in comparison to a turnover of PKR 82bn for FY09, a YOY increase of 20%. We expect the revenue to maintain an increasing trend through FY15, despite a conservative assumption for load factor of 75% for the existing plant. Expected growth in revenue is primarily attributed to Narowal project and indexation against rupee depreciation as well as inflation. Generation bonus that company receives due to operational efficiency and load factor improvement will also contribute to revenue. We have not incorporated this source of revenue in our projections due to a conservative approach.

Strong Earnings Stream

HUBCO reported a net profit of PKR 5.5bn for FY10, an increase of 52.5% over the preceding year. ROE has shown significant growth over the past 3 years, hovering in the range of 9%-19%. We expect a slight slump in the earnings for FY11 mainly due to increased finance cost on amplified short term borrowings. Going forward, earnings are projected to increase at a CAGR of 16% during FY12-15. A u-shaped PCE structure will contribute to earnings growth in future.

Capacity Building to Enhance Balance Sheet Size

HUBCO has so far incurred a capital expenditure of PKR 21bn in setting up Narowal plant and an additional PKR 2.7bn will be invested in this project during FY11. Furthermore, the company has invested PKR 2.6bn in Laraib Energy which will require another US\$23.7mn in the next 2 years. We expect asset utilization to maintain an encouraging trend, increasing from 0.81x in FY10 to 1.04x in FY15.

Liquidity

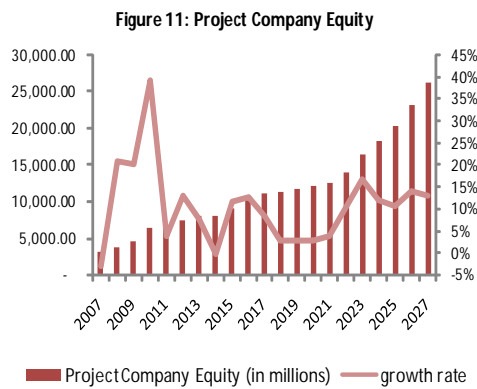
The company has managed to maintain a satisfactory current ratio since the delay in accounts receivable due to circular debt has been offset to a large extent by increasing days payable. We expect similar trends to continue through FY15.

Leverage

Total debt to assets ratio of the company is expected to remain in the range of 78-80% during FY11-15. Short term liabilities will comprise 8 to 10% of total debt resulting from sharp increase in accrued accounts payable triggered by circular debt issues. We expect the issue to be resolved post FY15 based on a conservative approach. The company is compensated for any mark-up on accrued payables by WAPDA, hence nullifying the effect of such liabilities on interest cost. Furthermore, the debt position reflects the fact that despite aggressive expansion the company has managed to restrain the share of long term debt in total debt.

Investment Summary

We recommend a BUY on HUBCO based on strong revenue growth, healthy payout and attractive dividend yield. A U-shaped PCE and protection against US CPI inflation in addition to PKR devaluation will feature as key investment considerations. Ongoing capacity expansions will add further value to the stock.



Source: Company Data

Inflation and Devaluation Cover: An Added Advantage

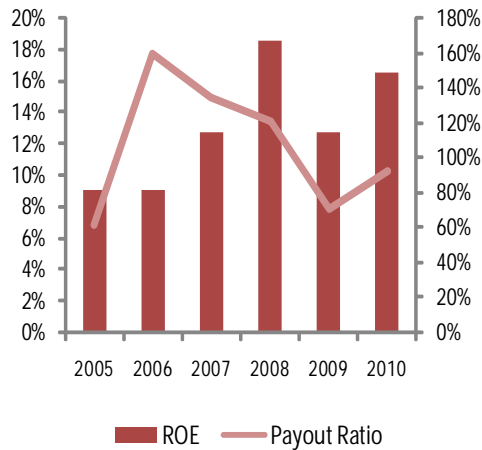
HUBCO’s tariff profile insulates its earnings against inflation and exchange rate devaluation. We have assumed an annual PKR/\$ devaluation of 2.8% and US CPI at 2.4% as forecasted in the Labor Bureau of Statistics for FY11-20.

Change in US CPI inflation and PKR devaluation will have a significant impact on our fair valuation for HUBCO’s stock. A change of 50 basis points in our assumption of PKR devaluation and US CPI inflation will result in an approximately 2% and 1.5% change in the fair value respectively.

PCE in Growing Phase

Besides a hedge against inflation and exchange rates, earnings of shareholders are also supported by the in-built growth in PCE. The U-shaped PCE is currently in a growth phase and this upward trend will continue to support HUBCO’s earnings over the entire life of the project. PCE will grow in real terms at a CAGR of 2.2% during FY11-FY15.

Figure 12: ROE and Payout



Source: Company Data, Blaze Research

Robust Payout

The company has maintained strong payout ratio in excess of 70% over the past, (in some years in excess of 100%). According to our estimates, the company will maintain an average payout ratio in excess of 100% through FY15.

Expansion Endeavors to Fuel Growth

The company has entered a growth phase with the Narowal project, increasing its capacity by 20%. Acquisition of 75% stake in Laraib Energy will add value to the company, although we have not incorporated it in our calculations.

Surety of Payments from WAPDA

HUBCO's cash flow streams are deteriorating due to delay in payments by WAPDA, which is a key consideration for investors eyeing for a dividend yielding stock. Payments from WAPDA are guaranteed by Government of Pakistan, thus easing the company's cash flow position and ensuring future consistency of dividend yields.

Generation Bonus

The PPA rewards the company with a generation bonus on a higher load factor (in excess of 60% base utilization). However, we have not incorporated the values of generation bonus in our earnings expectations. Given the growing trend of the load factor over the recent year, returns from production bonus are inevitable.

Valuation

We have valued HUBCO by using Dividend Discount Model on account of high payout ratio of IPPs. We discounted all the dividends of the company throughout the life of the project. The cost of equity is assumed at 17%, by taking 5-year PIB return of 13.75% as risk-free rate, a market risk premium of 5% and a beta of 0.703. Based on this discount rate, we have valued HUBCO at a fair price of PKR 44 per share showing an upside potential of 23% on the share price of PKR36.72 as of 24 November 2010.

Laraib will further add value to the price as Hydel project is providing an IRR of 17%. However, we have not incorporated this revenue in our valuation.

Valuation of HUBCO is sensitive to discount rate, with every change in 50 basis point change in discount rate there is an approximately 3% change in the target price.

