OPTIMUS CAPITAL MANAGEMENT

The Hub Power Company Limited

KATS: HUBC
Bloomberg: HUBC PA

Price: PKR 120
Fair Value: PKR 149

OUTPERFORM

Navigating between promise and obstacles

19 December 2023

- **Expanding investment horizons.** HUBC is the only IPP with 4 CPEC projects worth ~USD 4 BN, that offers a USD-hedged ROE between 27-31%. The company has a track record of stable dividends despite mounting trade debts, and with the PPA for its base plant expiring in 2027, the company's management has displayed a proactive approach in revitalizing HUBC with recent ventures in power, E&P and mining sectors.
- **New projects in power and mining to bear fruit.** The new strategic investments in power are expected to secure a high position in NEPRA's merit order, ensuring a consistent and reliable revenue stream. We expect the company to post earnings of PKR 53.7/60.6/sh in FY24/25 alongside dividends of PKR 20.5/30.5/sh during the same period.
- **However, there are challenges that linger.** Circular debt problem, tariff true-up for CPHGC/TEL/TNPTL, and pending Liquidated Damages (LDs) from the delay in COD beyond the Required Commercial Operations Date (RCOD) for TEL/TNPTL are the main challenges confronting HUBC. Nevertheless, despite these hurdles, considering HUBC's promising prospects, we maintain an outperform rating on the company.
- **Valuation.** We have a DCF based fair value of PKR 149/sh at a discount rate of 22%, yielding an upside of 25%. The largest contributor to the fair value is the base plant at PKR 50.9/sh; followed by CPHGC at PKR 44.8/sh, LEL at PKR 21.0/sh, NEL at PKR 19.2/sh, TEL at PKR 14.4/sh, TNPTL at PKR 10.7/sh, PRIME at PKR 6.0/sh, and SECMC at PKR 3.2/sh. Debt acquired for investments reduces fair value by PKR 20.7/ sh.

Y/E: Jun	FY22	FY23	FY24E	FY25E
EPS - Consol.	21.9	44.4	53.7	60.6
EPS - Stand.	16.3	23.9	27.3	41.1
DPS	6.5	30.0	20.5	30.5
BVPS	88.5	109.5	151.3	182.7
P/E	5.5	2.7	2.2	2.0
D/Y	5.4%	24.9%	17.1%	25.5%
P/B	1.4	1.1	0.8	0.7

Source: Company Financials, Optimus Research

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SOTP Valuation – Outperform

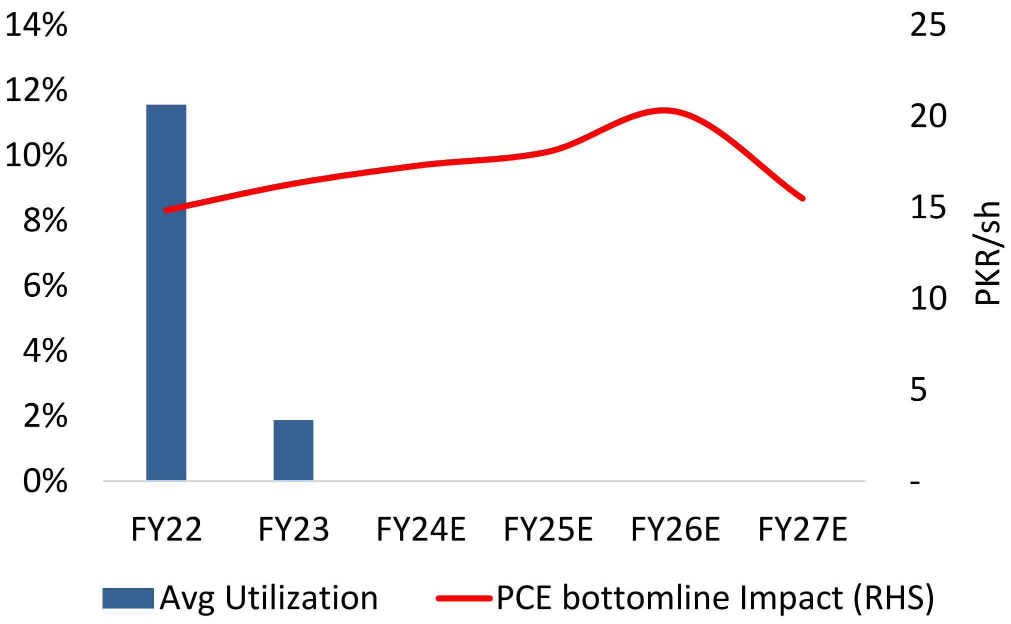
	Utilization FY23	DCF Valuation	Methodology	HUBC's Share Adjusted		
	%	PKR MN		% Shareholding	PKR MN	PKR/sh
Hub	2%	65,951	DDM	100%	65,951	50.90
CPHGC	14%	126,398	DDM	46%	58,143	44.83
LEL	47%	36,405	DDM	75%	27,286	21.04
NEL	25%	24,867	DDM	100%	24,867	19.17
TEL	53%	31,045	DDM	60%	18,627	14.36
TNPTL	71%	36,094	DDM	38%	13,824	10.66
PIOL	n.m	15,436	FCF	50%	7,718	5.95
SECMC	n.m	51,904	DDM	8%	4,152	3.20
SOTP						**170.06**
Debt				**100%**	**(26,815)**	**(20.67)**
Fair Value						**149.39**

Source: NEPRA, Optimus Research
Note: Discount Rate: 22%

Hub Base Plant – Matter of Debate Come the Future

- **No utilization is prompting exploration for other options.** As significant capacity additions have been available with lower variable costs, the base plant has not been utilized since 2QFY23. Given its location in Hub, it is not considered crucial for system stability, unlike other FO power plants. Discussions have arisen regarding the early termination of its PPA for conversion to coal and supply to KE.
- **U-shaped Project Company Equity (PCE) component to arouse debate.** As outlined in the base plant's PPA, the PCE component escalates biannually and is anticipated to add PKR 17.3/18.1/sh to the company's bottom line in FY24/25, even though the plant stays unutilized and its PCE is USD de-indexed at PKR/USD of 168. This is at a time when unprecedented increase in consumer bills has already triggered nationwide protests.
- **Dividends allocated until FY30.** As the base plant's PPA is set to expire in Mar-27, our projections indicate that the base plant is poised to have an equity amounting to PKR 46 BN (PKR/sh 35.5) available for distribution. However, it's unlikely that HUBC will receive all of its receivables and clear all payables simultaneously upon expiry. Consequently, our valuation has distributed the base plant's dividends until FY30.

Chart 1: PCE Bottom line Impact vs Utilization



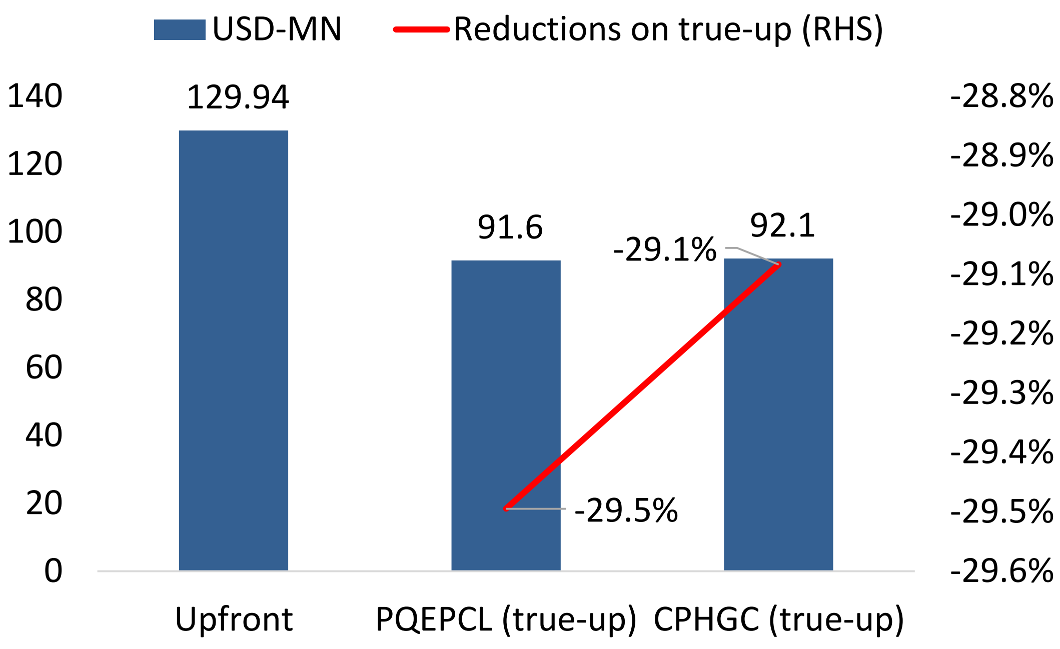
Source: NEPRA, Optimus Research

Note: Lower PCE/sh in FY27 with PPA expiring in Mar-27

CPHGC – Attractive Prospects, but COD Adjustment Remain a Concern

- **True-up tariff challenges.** At true-up, CPHGC's initial 27.2% USD indexed ROE was revised down to PKR 1.0034/KWh, resulting in a 29% reduction on true-up. The company took legal action and the true-up adjustment was suspended, subject to the final outcome of the appeal. Therefore, CPHGC continues to operate under the reference tariff and any favorable resolution will have an upside risk to our estimates.
- **Power evacuation constraints to drive low utilizations.** CPHGC's utilization has fallen from an average of 70% over the years to an average of 14% in FY23. Moreover, the plant remained unutilized in Oct-23, despite ranking relatively high on the merit order (25th/22nd in 1st/2nd fortnight of Oct-23).
- **Dividends to increase conservatively.** CPHGC achieved PCD in Feb-23, allowing it to pay dividends to shareholders, which relieved HUBC of USD 150 MN stand-by letter of credit (SBLC) in support of CPHGC which improved the company's cash position. We expect CPHGC to pay a dividend of PKR 10.0/14.0/sh in FY24/25 to HUBC.
- **Valuation.** Our DCF valuation after accounting for ROE reduction for CPHGC works out to PKR 126.4 BN. Out of this, HUBC's 46% ownership contributes PKR 58.1 BN (PKR 44.8/sh) at a 22% discount rate to our overall valuation.

Chart 2: ROE - Upfront vs COD



Source: NEPRA, Optimus Research

Adjustments at COD – PQEPCL, CPHGC and EPTL

USD MN	PQEPCL/CPHGC	PQEPCL	CPHGC	EPTL	EPTL
	Upfront	True-up	True-up	Upfront	True-up
Capital Cost	1,536	1,460	1,332	816	769
Project Cost	1,912	1,983	1,768	995	952
Reduction in Capital Cost		**5.0%**	**13.3%**		**5.8%**
Debt	1,434	1,555	1,362	746	714
Equity	478	427	407	249	238
Debt (%)	75.00%	78.44%	77.02%	75.00%	74.99%
Equity (%)	25.00%	21.54%	23.02%	25.00%	25.04%
Net Capacity (MW)	1,213.18	1,242.95	1,249.10	600.6	602.6
Exchange Rate (PKR/USD)	97.10	105.73	119.15	97.1	114.17
ROE (PKR/KWh)	1.1872	0.8896	1.0034	1.4075	1.5302
ROE	**129.94**	**91.61**	**92.15**	**76.26**	**70.75**
Reduction on True-up (%)		**29.5%**	**29.1%**		**7.2%**

Source: NEPRA, Optimus Research

OPTIMUS CAPITAL MANAGEMENT

COD tariff for TNPTL/TEL expected to decrease ROE

- **Mechanism for capital cost indexation.** As per TEL/TNPTL's upfront tariff, the capital cost shall be indexed during the validity period with the changes in the Producers Price Index (PPI) for steel and electrical machinery.
- **Expected reduction in the reference capital cost.** The validity period lies between Jun-14 and TEL/TNPTL's date of Upfront Tariff, which was 18-Oct-2016. The PPI for steel and electrical machinery during the validity period indicates a downward revision in reference capital cost of ~10%.
- **Further adjustments.** Moreover, considering alterations in COD related to European made boiler, Sinosure Fee, Interest during Construction (IDC), Debt-to-Equity ratio, Exchange Rate, Net Capacity etc, observed in comparable plants such as CPHGC, PQEPCL, and EPTL similar adjustments can be expected for TEL/TNPTL during their true-up, resulting in a subsequent change in the overall project cost.
- **Outcome.** In summary, factoring in the respective ROE decreases for similar plants due to cost changes during their true-up, our valuations account for a 25% reduction in ROE for TEL/TNPTL, come their true-up.

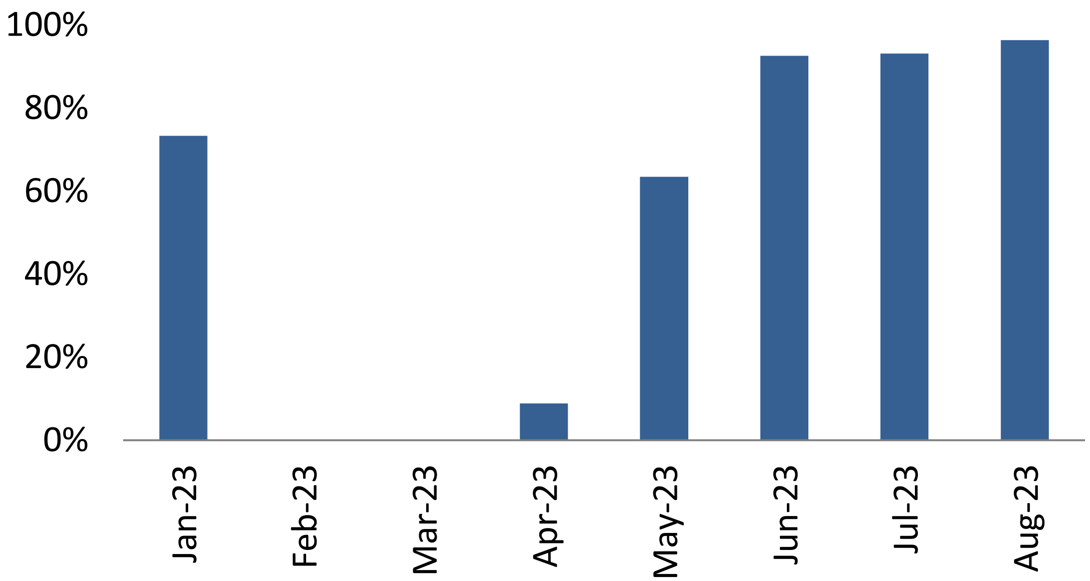
USD MN	Reference	Jun-14	Oct-16	Indexation	Indexed share
Steel (51%)	208.2	232.5	187.6	0.81	167.98
Elect Mach. (38%)	155.1	113.6	112.9	0.99	154.16
Unindexed	44.9				44.9
Allowed cost					**367.04**
Capital Cost	**408.2**				
Reduction	**10%**				

Source: NEPRA, BLS, Optimus Research

Thar Energy Limited – Tackling Challenges Amidst Appealing Opportunities

- **Thar projects investments.** TEL and TNPTL are identical mine-mouth plants with attractive returns. These projects offer attractive prospects with a 30.65% USD indexed ROE component.
- **Dividends to begin in the second half of FY25.** The time required for true-up for some power plants varied from three months to three years, and so, we've projected dividend income starting from the latter half of FY25, expecting dividends of PKR 4.0/sh to be paid to HUBC.
- **Pending LD's to dampen returns.** The RCOD was revised from Mar-21 to Nov-21, due to COVID-19, subject to payment of HVDC charges up to USD 1.9 MN/month (USD 15 MN in total). The company has sought clarifications from CPPA(G), including provision of evidence of COD of the HVDC line. Till such time, there is no exposure on TEL. Additionally, TEL achieved COD on 01-Oct-22, and as per PPA, a delay in RCOD attracts USD 0.75 MN/month. They have already been invoiced USD 7.7 MN for the period from Nov-21 to Sep-22. TEL has recorded the payable for the said amount.
- **Valuation.** Our DCF valuation for TEL accounting for ROE/LD's reduction works out to PKR 31.0 BN, at a 22% discount rate. HUBC contributes PKR 18.6 BN (PKR 14.4 /sh).

Chart 3: Plant Usage Levels



Source: NEPRA, Optimus Research

Note: Transmission constraints from Jan-23 to Apr-23 led to lower usage

ThalNova Power Thar Ltd - Promising Prospects, Pending Challenges

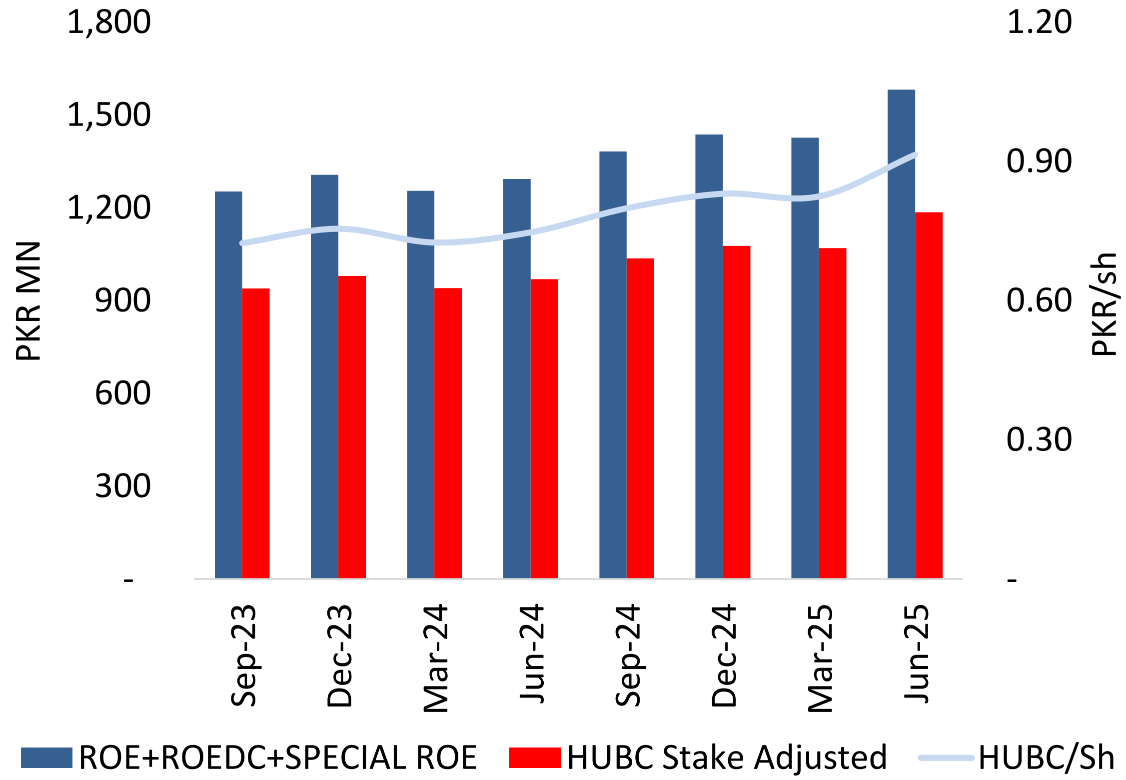
- **Dividends to commence from 2HFY25.** As explained on the previous page, we have estimated dividend income to commence from 2HFY25, anticipating dividends of PKR 2.5/sh to be disbursed to HUBC.
- **Outstanding LDs anticipated to dampen returns.** The RCOD was revised from Mar-21 to Jun-22, due to COVID-19, subject to payment of HVDC charges up to USD 1.9 MN/month (USD 29 MN in total). The company has sought clarifications from CPPA(G), including the provision of evidence of COD of the HVDC line. Till such time, there is no exposure on TNPTL as well. Moreover, the company requested CPPA(G) for further extension of RCOD by 232 days and achieved COD on 17-Feb-23, hence, there is no exposure of PPA LDs as of Jun-23, which is dependent on the final decision of the appeal.
- **Valuation.** Our DCF valuation for TNPTL accounting for ROE/LD's reduction works out to PKR 36.0 BN, at a 22% discount rate. HUBC contributes PKR 13.8 BN (PKR 10.7/sh).

	CPHGC	PQEPCL	EPTL	TEL	TNPTL
Upfront Tariff	Feb-16	Feb-15	Mar-15	Oct-16	Oct-16
COD	Aug-19	Apr-18	Dec-19	Oct-22	Feb-23
COD Tariff	Jun-22	Sep-19	Jun-22	Pending	Pending
COD to True up	**2.87 Yrs**	**1.43 Yrs**	**2.51 Yrs**		

Source: NEPRA, Optimus Research

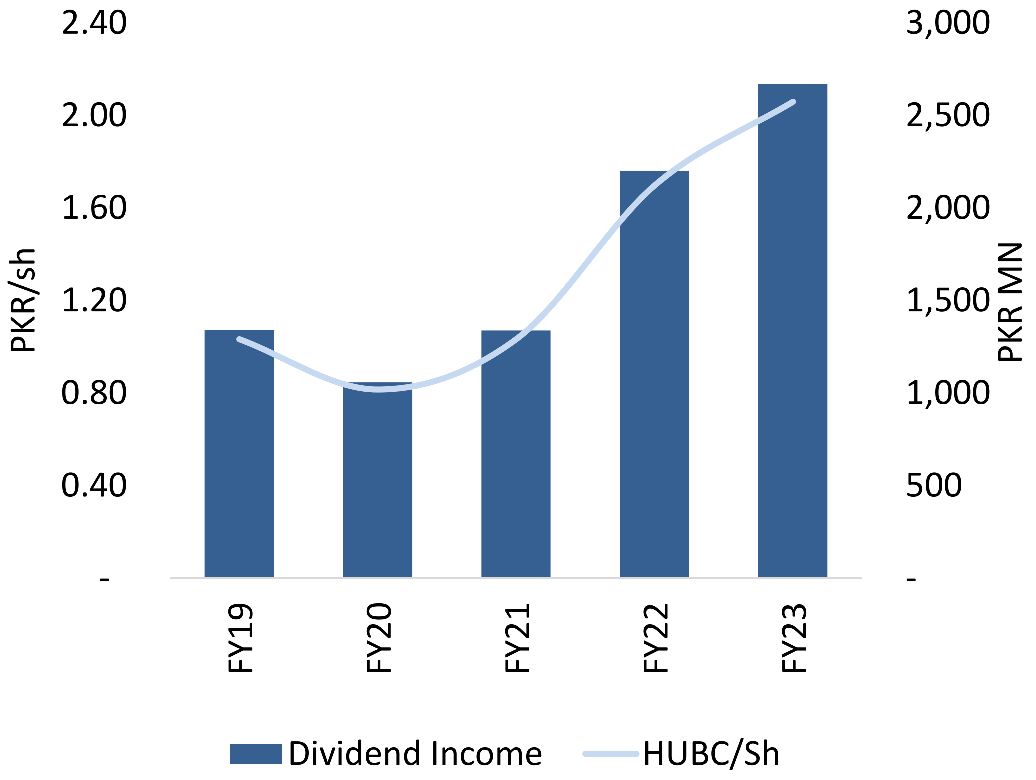
Laraib Energy Limited – Payout Tradition to Continue

Chart 4: LEL still receives full indexation on its ROE components, leading to the company's tradition of paying healthy dividends to HUBC (PKR 3.0/2.5/sh in FY24/25 to HUBC).



Source: NEPRA, Optimus Research

Chart 5: Unlike other plants in HUBC's portfolio, whose payout was constraint due to circular debt, LEL has continued to pay dividends.

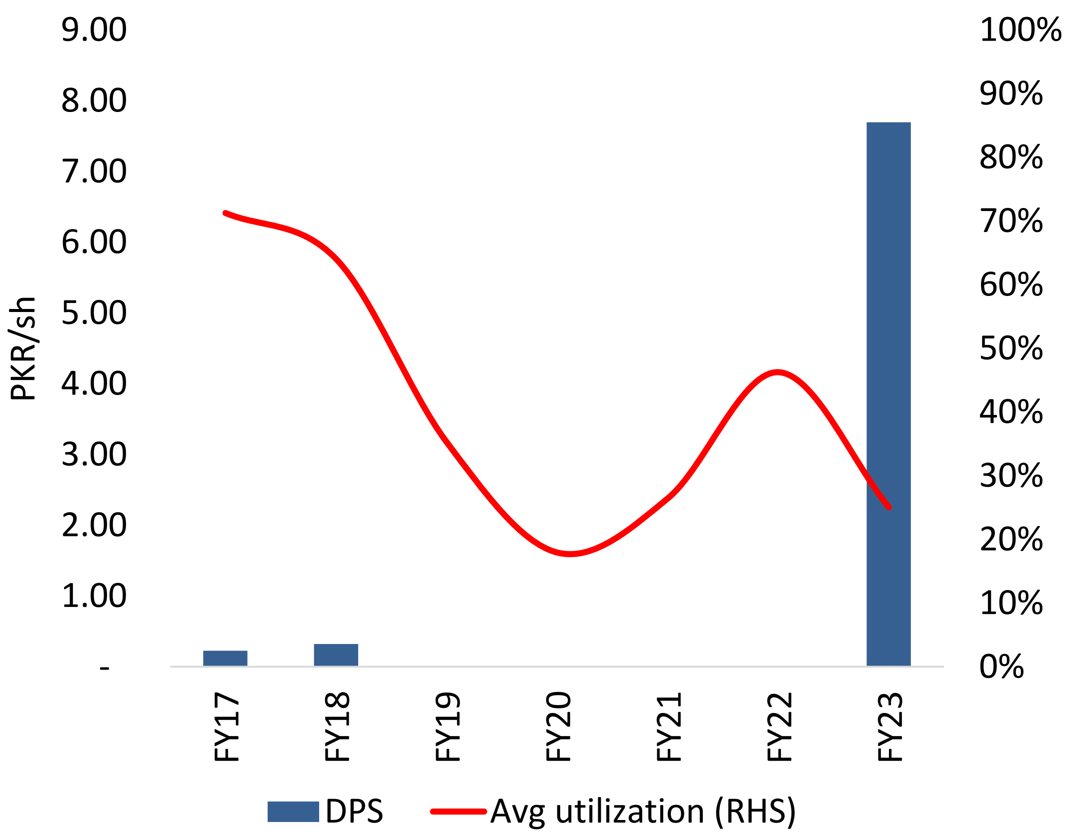


Source: Company Financials, Optimus Research

Narowal Energy Limited – Payout to Stay Healthy Post Circular Debt Resolution

- **Need for system stability to derive utilization.** Its relatively lower position on the merit order because of its RFO fuel base and with the availability of capacity additions with reduced variable costs in the NTDC system, NEL is expected to stay inactive. However, its significance for system stability necessitates its utilization, particularly during the summer months. Still, the plant's utilization rate fell to an average of 25% in FY23 from an average of 64% in FY18 and we expect it to remain in the 20% range for most of the remaining of its PPA terms.
- **Payout Stability post circular debt resolution.** Circular debt settlement plan enabled NEL to resume its dividends (PKR 7,844/2,138 MN in Dec-22/Jun-23) to HUBC. To recall, NEL received the first and second installments of PKR 6,400 MN (40%) and PKR 9,600 MN (60%) of the overdue receivables in Jan-22 and Jun-22, respectively. We expect NEL to pay a dividend of (PKR 2.0/3.0/sh in FY24/FY25) to HUBC after addressing the circular debt issue.
- **Valuation.** Our DCF valuation for NEL plant accounting for the impact of the renegotiated tariff as per the MOU works out to PKR 24.9 BN (PKR 19.2/sh) at a 22% discount rate.

Chart 6: Dividend Income to resume from NEL

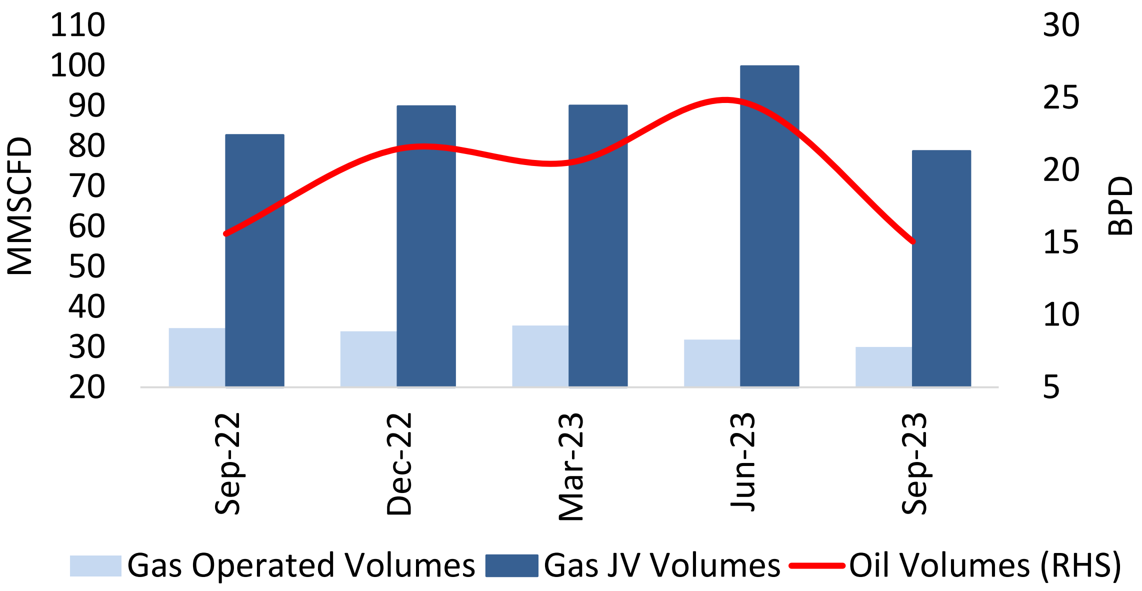


Source: Company Financials, Optimus Research

PRIME - Venturing into Alternative Energy Pathways

- **Robust profitability.** Following its acquisition, the company reported a profit of PKR 1,691 MN in 1QFY24, which is ~41% net profit margin as per our estimated revenues.
- **Reserves concentrated in few fields.** Based on estimates derived from PPIS data, PRIME possesses gas reserves of ~134 BCF as of Jun-23. The company has a reserve life of ~9.2 years, and a production rate of 79 MMSCFD in Sep-23.
- **Projected revenue and profit.** Based on the volumes, we project that the company will generate annual revenue of ~PKR 16.6 BN in FY24. Assuming an NPM of 40% (against other listed E&P companies range of 35-40%), the expected profit for FY24 is ~PKR 6,682 MN.
- **Valuation.** Based on estimated free cash flow (FCF) and a discount rate of 22%, yields a value of approximately PKR 15.4 BN. At the 50% stake held by HUBC, this translates to a fair value of PKR 7.7 BN, representing 3% of the total fair value of HUBC.

Chart 7: Gas/Oil Volumes



Source: PPIS, Optimus Research

SECMC - Security Through Low-Cost Energy

- **Expansion of coal mining capacity.** Subsequent to phase II COD in Sep-22, Thar Coal Energy Board (TCEB) approved a tariff of Block II. Furthermore, the company plans to expand the mine capacity to 11.2 MTPA and has signed a Coal Supply Agreement (CSA) with Lucky Electric Power Company Limited (LEPCL) for its 1 X 660 MW Power Plant.
- **Cheap energy source to lead to timely payments.** SECMC's low-cost coal enables competitive power generation, making the associated plants (TEL/TNPTL) reliable. This ensures steady demand (92%/87% for TEL/TNPTL in 1QFY24), and therefore timely payments from CPPA-G.
- **Estimated profit impact.** HUBC's estimated profit share is PKR 654 MN (PKR 0.50/sh) for FY24. As the capacity increases, profit share is expected to grow, albeit at a lower rate/ton due to decreasing ROE/ROEDC payments. Moreover, SECMC is expected to reinvest its profits for investments.
- **Valuation.** Using DDM and assuming full payment from the ROE/ROEDC component, the fair value of SECMC is estimated to be PKR 51.9 BN. With 8% stake, this translates to approximately PKR 3.2/sh, representing around 2% of HUBC's fair value.

Phase Wise Customers

Phase I (0 - 3.8 MTPA)	Phase II (3.8 - 7.6MTPA)	Phase III (7.6 - 11.2MTPA)
EPTL	**TEL/TNPTL**	**LEPCL**
660 MW	330 MW+330 MW	660 MW
Power Plant Facilitated	Two Power Plants Facilitated	CSA signed with LEPCL

Source: Thar Coal Energy Board, Optimus Research

Plant Wise Details

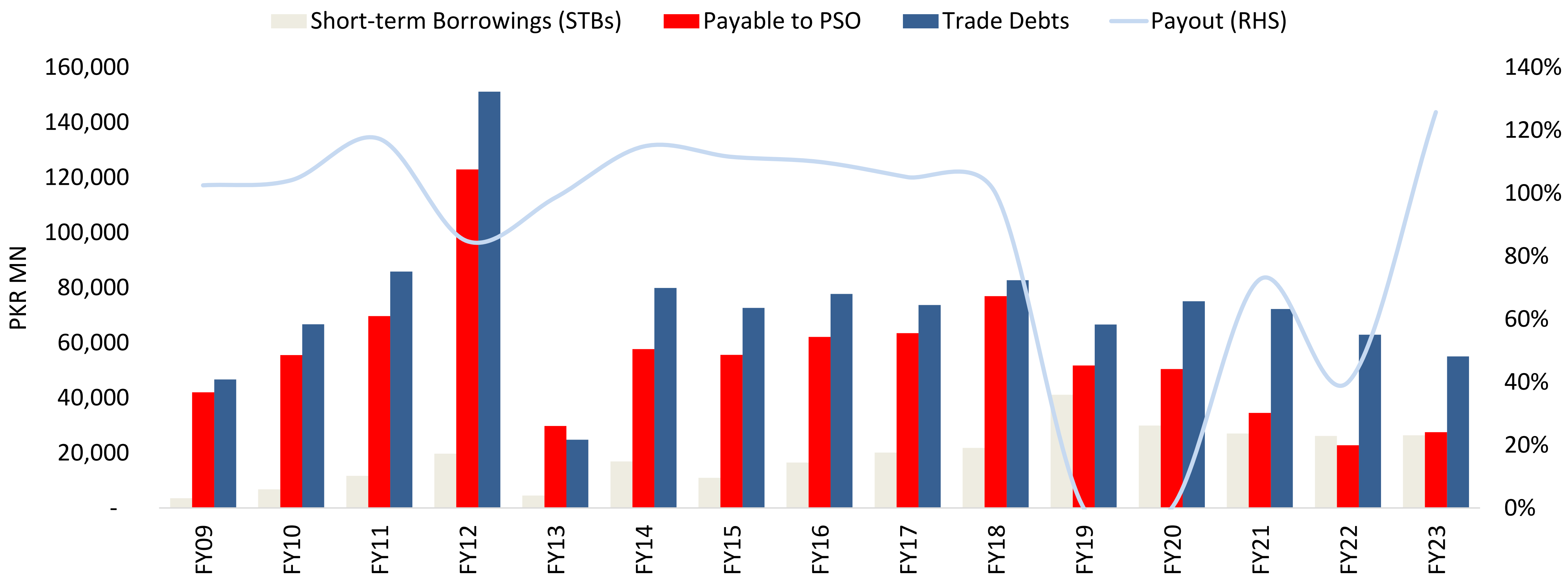
	HUB-Base Plant	CPHGC	TEL	TNPTL	LEL	NEL
COD	31-Mar-97	17-Aug-19	01-Oct-22	17-Feb-23	23-Mar-13	08-Jun-12
Power Policy	No Policy	2015	2015	2015	Hydel Policy 1995	2002
Plant type	Simple Cycle	Boiler/Steam Turbine	Boiler/Steam Turbine	Boiler/Steam Turbine	Run of the River	Combined Cycle
Net Capacity	1200 MW	1213 MW	300 MW	300 MW	84 MW	214 MW
PPA terms	30 Years	30 Years	30 Years	30 Years	25 Years	25 Years
Fuel Type	RFO	Imported Coal	Thar Coal	Thar Coal	Hydel	RFO
Debt to Equity	76:24	75:25	75:25	75:25	75:25	70:30
Agreement	Take or Pay	Take or Pay	Take or Pay	Take or Pay	Take or Pay	Take or Pay
ROE Benchmark	12.00%	27.20%	30.65%	30.65%	17.00%	15.00%

Source: NEPRA, Optimus Research

Note: All details are as per Upfront Tariff

Dividends Financed by Delayed Payments to PSO and STBs, due to Contract Nature

Over the years, HUBC has had a track record of maintaining a stable dividend distribution. Although, this is expected to remain the same, there will be challenges ahead as highlighted. Moreover, there could be periods of low payouts with further diversifications planned by the company.



Source: Company Financials, Optimus Research

Analyst Certification

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