Kot Addu Power Company Limited

OVERVIEW (January 01, 2013) : The country's largest independent power producer, Kot Addu Power Company Limited (Kapco) is principally involved in the ownership, operation and maintenance of a 1,600 MW nameplate capacity gas, furnace oil and diesel fired power station at Kot Addu in the province of Punjab, and to sell the electrical energy produced from there to its single customer, the Pakistan Water and Power Development Authority (Wapda). The company holds immense significance as its shares are listed on all the three stock exchanges and is also a KSE-30 Index company. Kapco is a significant contributor to the national exchequer, being the only IPP in the country that pays income tax at the corporate level, amounting to Rs 2,564 million in FY12. The company's social action programme includes a rich portfolio of projects in the health and education sectors. **Industry Overview** The electric power sector in Pakistan is primarily state-owned. It is governed under a regulatory regime which requires IPPs to sell electricity under long-term agreements to Wapda and NTDC. The tariff agreement is the key financial instrument determining a IPPs income and profitability, and this tariff is determined by the regulatory authority Nepra. The combination of these two factors implies that the IPPs ability to convert fuel to energy at an efficiency level equal to or below the stipulated level is the sole controllable determinant of profitability for a company. Since 1997, Pakistan's generation capacity has exceeded demand. However, the achievement of equilibrium in demand and supply has come due to production deficits. In this regard, the issues of circular debt (which amounts to Rs 400 billion in the energy industry, according to Foundation Securities Limited) and shortages in the fuel supply have curtailed IPPs' abilities to produce sufficiently. Simultaneously, demand has grown at faster rates than was anticipated in 1997, thus antagonising the existing shortage. Expansion into alternate energy sources has presented itself as a key opportunity for IPPs.

Performance Snapshot FY12

The two key challenges for Kapco remained the same as for the entire IPP sector - shortages in the supply of fuel along with defaulting overdue payments from Wapda. The risk-profile of IPPs remains high in spite of high profitability of the sector as a whole, and bullish expectations by most investors. Return on equity (ROE) decreased from 27.24 percent in FY11 to 25.67 percent in FY12. From the perspective of a DuPont Analysis, the reduction came despite an increase in financial leverage from 3.98 (FY11) to 4.20 (FY12). These results are explained by a reduction in operating profitability (operating margins in FY11 were 25.03 percent, and reduced to 18.33 percent in FY12) and an increase in finance costs by 12.39 percent. The decreasing ROE in FY12 stands testament to the susceptibility of the IPP to exogenous economic and political factors. Operating profitability was expected to increase since gas turbines were upgraded; three major overhauls were conducted; nine combustion inspections took place; and all supervision, monitoring and improvement activities were conducted in line with the recommendations of the original equipment manufacturer, benchmarked against international best practices. Despite these measures, the rise in fuel prices, shortages in fuel, and the issue of circular debt translated into a load factor of a mere 51.9 percent where availability increased to 89 percent. Costs associated with that excess capacity hindered the company's profitability which saw a reduction in the gross profit and operating profit margins. The net profit margin was further dampened due to the increasing finance cost associated with the increasing financial leverage - the margin fell from 8.78 percent to 6.04 percent. Price-to-Earnings ratio increased, primarily fuelled by a reduction in the Basic EPS by 6.88 percent from Rs 7.41 to Rs 6.90. In terms of the risk profile of the company, the six percent increase in financial leverage translated into a reduction in the interest cover ratio from 2.14 times in FY11 to 1.88 times in FY12. The ratio's reduction below two times for the first time in five years (down from the high point of 4.65 times in FY08) is reason for concern. The cash flow coverage ratio (which measures the net operating cash flow over finance costs) was positive for the first time in three years, but was still low at 0.74 Managing liquidity is a concern for the company with the current ratio slipping down to 1.2 times. Wapda's overdue receivables amount to a total of Rs 58,109 million which amounts to 84 percent of total trade debts. The interesting point to note here is that trade debtors represent 69.79 percent of total assets and are nearly three times the size of total shareholder equity. The Wapda owing is secured by sovereign guarantee from the Government of Pakistan; however, repeated delays have caused Kapco to be tentative about expansion due to liquidity issues, and constrained the working capital position such that capacities could not be fully utilised in the pursuit of efficiency and profitability. Despite these conditions, market expectations remain bullish for the IPP sector. Kapco temporarily became Elixir's top pick in the IPP space (before being replaced by Hubco, due to Hubco's reduction in risk profile associated with the circular debt), and market prices drove upwards from Rs 42.61 at the close of FY11 to Rs 45.00 at the close of FY12. Kapco responded with a sturdy dividend yield of 15.33 percent.

Performance over the years

In the five year period from FY08 to FY12, the key challenge to Kapco has been the diminishing load factor which has reduced from 75.2 percent to 51.5 percent. Thermal efficiency has only varied by 60 basis points over the period, and availability has also remained consistent. The only exception to this was FY10 when the Great Floods severely affected the areas surrounding Kot Addu. Sales have increased by a robust annual average of 22.07 percent over the relevant period. However, with cost of sales increasing by an annual average of 25.79 percent, gross profits have only increased by an annual average of 5.17 percent and net profit has increased by an annual average of four percent. In terms of margins, profitability has shown a general downward trend. To illustrate this, ROE has decreased from 37.35 percent in FY08 to 25.67 percent in FY12, while net profit margins have decreased from 14.24 percent in FY08 to 6.04 percent in FY12. On the positive side for shareholders, the dividend yield has remained stable at an average of 15.28 percent, with the exception of FY10, which presents an anomaly explained justifiably by the Great Floods. The price-to-earnings ratio has increased from 5.19 to 6.52, while the price-to-book ratio has decreased from 1.94 to 1.675 over the five-year period from FY08 to FY12. The cash flow position over the period has been reason for concern. The operating cash flow as a ratio to short-term debt of the company increased from almost 0.00 in FY11 to 0.18 in FY12, a modest and unimpressive improvement when compared with peers. Operating Cash Flows as a percentage of net sales have been negative for three out of the five years in the period and currently stand at 11.83 percent, up from -0.05 percent in FY11. With a steadily declining interest cover ratio (falling from 4.65 times to 1.88 times in the five years), and an annual average growth rate in current liabilities of 26 percent, this liquidity trap is anticipatory of problems. Load factors must increase in the interest of profitability and this is constrained by the limited working capital position; this being additional to the liquidity risk already sustained.

Future Outlook

The key challenges to the sector remain the same - circular debt, rising fuel prices and fuel shortages. The persistence of these issues will cause the current energy crisis to continue indefinitely thus harming economic development of the nation as a whole, and causing massive inconvenience to households that often face 8-10 hours' worth of loadshedding or more. If the current rate of expansion of IPPs does not continue, then the gap between demand and supply will likely widen. The recent drop by Elixir Securities of Kapco from its top pick in the IPP space is indicative of how important it is for the company to hedge against the risk of exogenous variables in the political and economic environment as other companies in the sector have done.