AKD Daily

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Today's Daily

KAPCO: Acquiring HUBC is a 'Game of thrones'

Running a thorough series of scenario analyses based on multiple factors, we look at what a potential acquisition of 17.4% stake in HUBC would look like for KAPCO (pending approval by BoD & public announcement of intention/offer). Incorporating decision trees while valuing outcomes using the DCF methodology (isolating dividend streams from current operations and potential expenses from increased debt burden), our analysis aims to delineate decision making based on value creation from the benefits of specific outcomes (circular debt clearance, dividend income from HUBC). Looking at hampered liquidity and highlighting the dubious overhang from circular debt (75% of KAPCO's total assets as of 3QFY17), we believe any acquisition will involve a hefty debt load (~85% of deal size), where re-payment and handling of liquidity (possible dividend curtailment, allocation of income from extension) remains key to enhancing shareholder value. Citing vagueness on multiple fronts (additional bidders, deal price and premium, privatization) we retain our DDM based TP of PkR83.8/sh (PkR116.5/sh with 15yr extension) on KAPCO (FY18/19F D/Y of 13.1/13.1%).

KSE100 - Index

Current	43,136.06
Previous	44,186.96
Chg.	-2.38%

Mkt Cap. (PkRbn/US$bn)

Current	8,983 / 85.23
Previous	9,179 / 87.09
Chg.	-2.13%

Daily Turnover (mn)

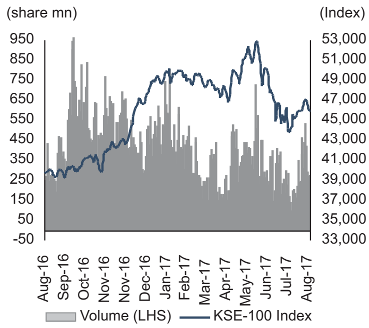
Current	167.27
Previous	187.25
Chg.	-10.7%

Value Traded (PkRmn/US$mn)

Current	8,840 / 83.87
Previous	10,326 / 97.98
Chg.	-14.4%

News and Views

- As per news reports, former PM Nawaz Sharif and his sons will not appear before 14-member NAB interrogation team today (Friday) to record statement in Azizia Steel Mills case. As per sources, Mr. Sharif has decided not to appear till the Supreme Court decides on his review petition against Panama leaks case verdict.
- The National Accountability Bureau (NAB) has written a letter under the Mutual Legal Assistance to authorities in Saudi Arabia seeking details of properties of the Sharif family by Aug'30.
- As per recent data released by SBP, country's total foreign exchange reserves continued their downward trend for the fifth consecutive week, falling US$62mn to US$19.941bn during the week ended Aug 11'17. The SBP's reserves declined by US$88mn to US$14.31bn, while reserves held by commercial banks slightly improved to US$5.631bn.



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Deal Size (PkRmn) sensitivity to fairvalue

Sensitivity to assumed premium to fairvalue	17.37%
2.5%	23,239
5.0%	23,806
7.5%	24,372
10.0%	24,939
12.5%	25,506
15.0%	26,073
17.5%	26,640

Source: Co. Reports & AKD Research

Risks & limitations: Some assumptions remain core to our analysis: tariffs and dividend incomes are incorporated with major assumptions being PkR vs. US$ depreciation of 4.0%YoY, projects and hinge on payments meet planned deadlines (FY21F end of KAPCOs tariff, FY20F start of CHPGC income). Moreover, the methodology of valuing IPPs as bonds (using DDM) has drawbacks such as it excludes cash flows from subsidiaries (HPSL an O&M provider) for tangible dividend income, leaving out potential synergies from streamlining of operational expenses. In addition to the risks of the scenarios detailed below, clarity on additional acquirers (notice of potential divestment by DAWH as of June'30th), bids and premia to current, softer price levels (HUBC is -8/+1% CY/FYTD) are essential factors in incorporating any post-acquisition scenarios to our investment case.

KAPCO vs. Peers: Leverage Ratios

Company	Receivables Turnover	Payables Turnover	D/E	Long Term D/E	Interest Coverage Ratio
EPQL	3.24	3.58	1.30	0.74	5.95
KAPCO	1.10	2.80	2.80	0.02	5.23
NPL	2.10	30.00	0.75	0.55	4.29
HUBC	1.26	1.24	3.64	0.79	4.11
SPWL	2.43	4.23	1.14	0.75	4.02
NCPL	2.21	21.80	1.83	0.95	3.26
LPL	1.95	14.58	0.80	0.09	2.39
PKGP	1.53	11.35	0.73	0.07	1.86
Mean	1.88	10.27	1.83	0.59	3.59
Median	1.95	4.23	1.30	0.74	4.02
KAPCO with Add. Loan	**1.10**	**2.80**	**3.51**	**0.74**	**2.83**

Source: Company Reports & AKD Research

What this means for KAPCO: KAPCO has expressed its interest to acquire

201mn shares (17.37%) of HUBC as notified by the largest shareholder in the company, DAWH in a bourse filing on Friday (11th August). While the company's books clearly lack the ability to finance this transaction (PkR24.9bn at a target price of PkR124/sh to be conservative), we try to analyse the potential impact under various scenarios. With cash and bank balances amounting to less than Pkr1bn, financing the acquisition through debt seems to be quite a viable option for the company. KAPCO's financials demonstrate that its long-term debt to equity ratio is the lowest in the industry, standing at 2% as of Mar'17 providing sufficient cushion in this regard. Moreover, a significantly high interest coverage ratio of 5.23x also supports the case. Additionally, the company might also plan to partially reduce its dividend outflow while we remain cognizant of the fact that the acquisition will also result in additional income through proportionate dividends from HUBC. That said, at an assumed level of PkR21.2bn of debt, long-term debt would rise to PkR21.9bn, where Long-term D/E ratio would still not go beyond 74% (vs. industry average of 59%). Further, at an annual mark-up of 7%, the interest coverage ratio would come down to 2.83x, not very far from the sector average (3.59x).

Deal sizing & debt load: Analysing the fair value of HUBC's current operations (PkR112.67/sh excluding upcoming projects: CHPGC and TEL) and running a sensitivity with premiums to fair value (7.5-10.0% likely) on the complete stake purchased (17.37% including 2.46% stake held by directors of DAWH), we arrive at a deal size of PkR24.9bn. Incorporating the 6-9 month period for closing the transaction and accumulating required funds (debt and equity) we believe KAPCO may be able to raise PkR3.5-4.0bn through internal cash flows (curtailing PkR4.5/sh DPS for 1HFY18in this scenario) reducing the additional debt load to PkR21.2bn (~85% of expected deal size).

Sensitivity Analysis of Fair value addition to debt/interest rate levels

		Debt load for HUBC stake purchase in (PkRmn)				
		19,951	21,198	22,445	23,692	24,939
Annual interest rate on LT loan for HUBC stake acquisition	6.0%	12.86	11.80	10.73	9.67	8.61
	7.0%	12.26	11.16	10.06	8.96	7.86
	8.0%	11.65	10.51	9.37	8.23	7.09
	9.0%	11.51	9.85	8.67	7.49	6.31
	10.0%	10.39	9.17	7.96	6.74	5.52

Source: Company Reports & AKD Research

Scenario 1; Acquisition with no extension no receivable clearance: Our estimates incorporate potential long-term loan of PkR21.2bn for financing the acquisition of 17.37% stake in HUBC at 7% annual rate. With the following assumptions, the acquisition of HUBC's stake (ex 7.5% tax on dividend income) adds PkR11.16/sh to KAPCO's DDM base fair value, where we show a sensitivity of incremental value addition with potential debt load and annual interest rate of the loan as variables.

Scenario 2; Acquisition with partial receivable clearance: KAPCO's receivable level for FY19F from WAPDA is expected at PkR89.9bn, which the power purchaser is liable to clear before termination of the current PPA (expiring FY21F). Net of payables (FY19F payables are forecasted at PkR24.98bn), a 60% clearance of the receivable in tranches from FY19-21F (40%,40% and 20% payment in final year) is expected to result in additional cash inflow significantly enhancing payouts, raising the value of the post-acquisition KAPCO by PkR34.36/sh. Moreover, for every 10% increase in net-receivable payment results in value accretion of PkR5.7/sh for the combined IPP.

Scenario 3; Acquisition with extension and partial receivable clearance: We remain sanguine on the outlook for KAPCO's current tariff to be extended by 15yrs (at 16%IRR) concluding in FY36F (a case we put forward in AKD Daily of 17th Aug'16 titled "Extension news begs an upgrade"). The case for this is made by: 1) extendable plant life till FY36 by virtue of later phase wise additions to the original complex and a major portion of it (904MW out of the total 1,345MW in total dependable capacity) going through extensive maintenance in 2011 (US$14mn contract), 2) its gas units securing a high place in NTDC's merit order list where it gets priority in offtake based on cost effectiveness and efficiency and 3) its central location for supply of electricity to load centres of Multan, DG Khan and Faisalabad. Based on these underpinnings we include the impact of a tariff extension and by adding the extended payout stream arriving at incremental DDM based fair value addition of PkR35.51/sh.

Liquidity remains a sticking point: KAPCO's financials demonstrate that its long-term debt to equity ratio is the lowest in the industry, standing at 2% as of Mar'17. With sufficient cushion in this regard, the company can go for debt based financing option to acquire the stake in HUBCO. Moreover, a significantly high interest coverage ratio of 5.23x also supports the case. That said, at an assumed level of PkR21.2bn of debt, long-term debt would rise to PkR21.9bn, where Long-term D/E ratio would still not go beyond 74% (vs. industry average of 59%). Further, at an annual mark-up of 7%, the interest coverage ratio would come down to 2.83x, still not very far from the sector average (3.59x).

Investment Perspective: Risk reward outcomes of this aggressive acquisition become apparent from an increased debt load. Sensitivity of the value addition to our base case shows a PkR~1.0/sh reduction in the fair value addition from the acquisition for every 1% increase in the annual interest rate applicable on the long-term loan or PkR1.0bn in additional debt load. Adding to the mix is the delayed privatization of the GoP's 42.5% stake in KAPCO (slated to have concluded by CY16) with expected additional incentives (receivable clearance, extension), now likely post the May'18 polls. From a broader horizon, the receding interest of active (planned CAPEX, Narowal and Laraib extensions added during shareholding tenure) majority shareholders, DAWH in HUBC presents broader question marks to the possible detriments of Pakistan's IPP landscape, in our view. Sticking to our investment case we have a PkR83.8/sh DDM based TP (PkR116.5/sh with 15yr extension) on KAPCO implying FY18/19F D/Y of 13.1/13.1%.

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