RATING REPORT

Kot Addu Power Company Limited (KAPCO)

REPORT DATE:
December 5, 2019

RATING ANALYSTS:
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RATING DETAILS

Rating Category	Latest Rating Long-term	Latest Rating Short-term	Previous Rating Long-term	Previous Rating Short-term
Entity	AA+	A-1+	AA+	A-1+
Rating Date	*Dec 2, 2019*		*Dec 31, 2018*	
Rating Outlook	Reaffirmed		Reaffirmed	

COMPANY INFORMATION

Incorporated in 1996	**External Auditors: Deloitte Yousuf Adil, Chartered Accountants**
Public Limited Company	**Chairman: Lt. General (R) Muzammil Hussain**
Key Shareholders (with stake 5% or more):	**Chief Executive Officer: Mr. Aftab Mahmood Butt**
WAPDA- 40.3%	
Allied Bank Limited- 9.9%	
United Bank Limited- 7.9%	
KAPCO Employees Empowerment Trust- 5.5%	

APPLICABLE METHODOLOGY

VIS Entity Rating Criteria: Corporates (May 2019)
https://www.vis.com.pk/kc-meth.aspx

Kot Addu Power Company Limited (KAPCO)

OVERVIEW OF THE INSTITUTION

KAPCO owns, operates and maintains a multi-fuel fired power plant in District, Muzaffargarh, Punjab with a nameplate capacity of 1600MW and dependable capacity of 1342MW. The Company is listed on Pakistan Stock Exchange (PSX). For FY20, Deloitte Yousaf Adil – Chartered Accountants have been appointed as external auditors.

Profile of the Chairman

Lt. General Muzammil Hussain (Retd.) is a reputed ex-army person and has served army for 31 years. He has been appointed chairman of Pakistan Water & Power Development Authority (WAPDA).

Profile of the CEO

Management team is headed by Mr. Aftab Mahmood Butt who is the Chief Executive Officer. Mr Aftab is a chartered accountant by profession and previously served on the boards of Central Power Purchasing Limited & Lahore Stock Exchange Limited.

Financial Summary

Assets: 1QFY20: Rs. 153.3b, FY19: Rs. 139.3b; FY18: Rs. 138.4b

Equity: 1QFY20: Rs. 46.2b, FY19: Rs. 41.2b; FY18: Rs. 35.1b

PAT: 1QFY20: Rs. 5.0b, FY19: Rs. 13.1b; FY18: Rs. 10.6b

RATING RATIONALE

The ratings assigned to Kot Addu Power Company Limited (KAPCO) take into account its strong ownership profile being majority owned by Government of Pakistan (GoP) through its representative Water and Power Development Authority (WAPDA). The ratings draw strength from the company's strong business profile with demand risk mitigated under Power Purchase Agreement (PPA) signed with WAPDA. The ratings also draw comfort from government guaranteed cash flow stream under the agreement upon meeting certain performance benchmarks. However, the escalating inter-corporate debt is a challenge for maintaining the financial risk profile of the company. Moreover, upholding operational performance in line with agreed performance levels would remain a key rating driver. Given the expiry of PPA in June, 2021, the ratings will depend on the company's negotiation regarding operational terms and conditions with the government.

Key Rating Drivers:

Expiry of existing PPA; extension may be given at different terms: The existing PPA is set to expire in June 2021, the management is of the view that there is a strong likelihood of government extending the PPA. However, the same is expected to materialize on rather different terms that would entail a combination of take or pay and take & pay terms; leading to reduction in escalable component of tariff (ROE component). The management asserts that due to large installed capacity (1,363 MW net capacity) and the only existing tri-fuel plant in the country; relatively decent thermal efficiency level of 44%; absence of debt component in capacity that lowers the overall tariff; and vast coverage of area for regulating voltage frequency, there is a compelling probability that the existing PPA will be extended, though at different terms. Meanwhile, due to outset of some relatively newer and more efficient thermal power plants, KAPCO has been shifted downward on the merit list; sales of the company may get affected, albeit with no adverse impact on profitability, due to mismatch between electricity generation and demand caused by subdued growth environment.

Higher proportion of capacity payments leading to improvement in profit margins: Topline was recorded lower in line with lower energy dispatch, however, gross margins showed improvement on the back of higher proportion of CPP component, coupled with lower fuel and power cost. Gas turbine overhaul expense coupled with repair and renewals was recorded lower as only one major overhaul was conducted during the year. Significant increase in provision for store obsolescence was recorded amounting Rs. 1.6b, which included provision of Rs. 1.4b based on in-house technical evaluation carried out during the year, while keeping in view their potential usage upto the expiry of current PPA (100% provision has been made for items which are not expected to be used till the expiry of PPA). Other than liquidated damages arbitration cost which stood higher at Rs. 211.3m (FY18: Rs. 28.6m), administrative expenses were largely rationalized during the review period.

Given higher quantum of availed finances under mark-up arrangements along with increased mark-up rates, finance cost was recorded higher at Rs. 8.3b (FY18: Rs. 6.2b) during FY19. Other income which stood higher at Rs. 13.8b (FY18: Rs. 9.5b), is mainly attributable to higher interest receivable on late payment from WAPDA (penal interest) coupled with true-up income realized as a result of considerable appreciation of USD against PKR and its difference with the rates used for dollar indexation of relevant CPP invoices. Bottom line of the company posted a growth of 23.5% on back of higher margins and other income despite increase in finance cost. During 1QFY20, increase in sales and higher other income reflected positively on the company's bottom line.

Change in fuel mix owing to excess supply of RLNG: During the review period, proportion of electricity generation on Gas has increased due to abundant supply of RLNG from Sui Northern Gas Pipelines Limited (SNGPL). The fuel generation mix was 71% (FY18: 57%) on gas (RLNG), 28.7% (FY18: 42%) on low Sulphur furnace oil and 0.3% (FY18: 1%) on high speed diesel. This has given rise to increase in trade payable to SNGPL amounting Rs. 24.6b (FY19: 15.1b; FY18: 4.2b), while trade payables to PSO decreased to Rs. 1.04b (FY19: Rs. 4.1b; FY18: Rs. 27.1b) by the end-1QFY20. Higher stock of furnace oil at the end-FY19 was to meet the buffer requirement as defined in PPA. As RLNG is not provided on a confirmed quota, around 21 days of furnace oil stock is kept as back-up fuel to ensure commercial availability.

Liquidity damages- Arbitration proceedings: On March 29, 2018, the company commenced arbitration proceedings in Singapore against WAPDA and Central Power Purchasing Agency (Guarantee) Limited (CPPA-G) under the arbitration rules of International Chamber of Commerce (ICC) to nullify the liquidated damages of Rs. 27.7b imposed by WAPDA/CPPA-G, and to enforce its right to claim Rs. 2.4b comprising the company's net losses not otherwise covered by penal interest. The GoP was also made a party to the arbitration proceedings pursuant to the Facilitation Agreement and it issued guarantee in favor of the company. The ICC Tribunal, in its Partial Award (received on June 10, 2019), dismissed the challenge by WAPDA to the jurisdiction of the ICC Tribunal. The ICC Tribunal further held that it has no jurisdiction over CPPA-G and GoP. The arbitration proceedings will continue between WAPDA and the company, going forward. According to the legal advice, there are sufficient grounds to defend any claim by WAPDA as these conditions were imposed on the company due to circumstances beyond its control, resultantly, no provision has been made for such liquidated damages in the financial statements.

Liquidity indicators remained intact conforming to healthy cash flows and strong debt servicing: The trade debts of the company have increased by the end-1QFY20. These include an overdue amount of Rs. 110.7b (FY19: Rs. 94.1b; FY18: Rs. 95.6b) receivable from WAPDA, resulting in increase in receivable days to 498days (FY18: 459days) by end-FY19. However, these are secured by sovereign guarantee from the GoP under the Facilitation agreement and are in normal course of business. Albeit these are interest free, a late payment surcharge of SBP discount rate plus 4% per annum is charged in case the amounts are not cleared within due dates. Further in line with increase in profitability, Funds from Operation (FFO) have improved on a timeline basis. Although debt servicing coverage ratio has decreased during the review period on account of higher interest payments, the same has remained at comfortable levels reflecting the strong ability of the company to service its debt obligations.

Augmentation in equity base on back of profit retention and virtually long-term debt free balance sheet: Equity base is strengthened on timeline basis and registered an increase of 17.1% during the review period solely on account of profit retention. The company continued to pay cash dividend to its shareholders. KAPCO funds its working capital requirements, mainly trade debts, through short-term borrowings, trade payables and own sources. The company has to pay relatively high interest on trade payables to suppliers (SNGPL and PSO). However, funding mix of trade payables with relative low cost short-term borrowings, provides a positive arbitrage for the company vis-à-vis interest received on accumulated trade debts. Gearing and leverage indicators have improved on a timeline basis on the back of higher equity base.

Kot Addu Power Company Limited Appendix I

(Amounts in PKR Millions)

BALANCE SHEET	30-Jun-17	30-Jun-18	30-Jun-19	30-Sep-19
Fixed Assets	11,047	8,663	6,755	6,187
Other Assets	8,424	6,908	5,897	5,624
Stock in Trade	5,914	6,718	9,466	8,021
Trade Debts	89,987	115,472	115,798	132,155
Cash & Bank Balances	629	685	1,350	1,280
Total Assets	116,001	138,446	139,267	153,267
Trade and Other Payables	34,169	49,755	40,139	48,277
Long Term Debt (*incl. current maturity)	475	54	38	35
Short Term Debt	46,133	49,875	54,180	54,502
Other Liabilities	2,721	3,669	3,749	4,259
Total Equity	32,503	35,093	41,161	46,194
Paid-Up Capital	8,803	8,803	8,803	8,803
INCOME STATEMENT	30-Jun-17	30-Jun-18	30-Jun-19	30-Sep-19
Revenue	81,846	91,916	84,830	35,365
Gross Profit	14,180	13,379	14,205	5,224
Operating Profit	18,498	21,995	27,269	9,385
Profit Before Tax	14,073	15,808	18,963	7,093
Profit After Tax	9,447	10,617	13,111	5,033
FFO	11,439	17,014	18,608	6,594
RATIO ANALYSIS	30-Jun-17	30-Jun-18	30-Jun-19	30-Sep-19
Gross Margin (%)	17.3	14.6	16.8	14.8
Current Ratio (x)	1.3	1.3	1.4	1.4
FFO to Total Debt (x)	0.25	0.34	0.34	0.48*
FFO to Long Term Debt (x)	24.0	312.0	488.6	748.4*
Debt Servicing Coverage Ratio (x)	3.5	5.4	3.7	4.5
ROAA (%)	9.1	8.4	9.4	13.8*
ROAE (%)	29.8	31.4	34.4	46.1*
Gearing (x)	1.43	1.42	1.32	1.18
Debt Leverage (x)	2.57	2.95	2.38	2.32

**Annualized*

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix II

VIS **Credit Rating Company Limited**

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

REGULATORY DISCLOSURES Appendix III

Name of Rated Entity	Kot Addu Power Company Limited (KAPCO)				
Sector	Power				
Type of Relationship	Solicited				
Purpose of Rating	Entity Rating				
Rating History	**Rating Date**	**Medium to Long Term**	**Short Term**	**Rating Outlook**	**Rating Action**
	12/02/2019	AA+	A-1+	Stable	Reaffirmed
	12/31/2018	AA+	A-1+	Stable	Reaffirmed
	12/18/2017	AA+	A-1+	Stable	Reaffirmed
	11/28/2016	AA+	A-1+	Stable	Reaffirmed
	11/20/2015	AA+	A-1+	Stable	Reaffirmed
	12/29/2014	AA+	A-1+	Stable	Reaffirmed
	9/20/2013	AA+	A-1+	Stable	Reaffirmed
	5/03/2012	AA+	A-1+	Stable	Reaffirmed
	2/21/2011	AA+	A-1+	Stable	Reaffirmed
Instrument Structure	N/A				
Statement by the Rating Team	VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.				
Probability of Default	VIS' ratings opinions express ordinal ranking of risk, from strongest to weakest, within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.				
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