RATING REPORT

Kot Addu Power Company Limited

REPORT DATE:
September 09, 2020

RATING ANALYSTS:
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RATING DETAILS

	Latest Rating		Previous Rating	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	AA+	A-1+	AA+	A-1+
ICP/STS	A-1+		-	
Rating Action	*Preliminary*			
Rating Outlook	*Stable*		*Stable*	
Rating Date	*Sept 09, 2020*		*Dec 02, 2019*	

COMPANY INFORMATION

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

APPLICABLE METHODOLOGY(IES)

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

Kot Addu Power Company Limited

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 Yousuf 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.

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.

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 significant improvement in profits: Revenue of the company was recorded slightly higher at Rs. 56.4b (9MFY19: Rs. 55.0b) during 9MFY20 as the impact of lower energy dispatched was more than offset by tariff indexation to inflation and currency depreciation. However, gross margins improved to 27.8% (9MFY19: 19.8%) mainly on account of higher proportion of CPP component, lower fuel & power cost and no provision for obsolesces; partially offset by higher gas turbine overhauling and repair & renewal costs owing to inspection of gas turbines and replacement of new control system. Increase in administrative expense to Rs. 670m (9MFY19: Rs. 533m) was primarily led by cost related to arbitration proceedings owing to dispute over amount of liquidated damages.

Despite some decrease in debt financing by end-9MFY20, finance cost was recorded higher at Rs. 6.9b (9MFY19: Rs. 6.5b) on account of higher average interest rates. Other income amounted to Rs. 16b (9MFY19: Rs. 10b) which mainly represented interest receivable on late payment from WAPDA (penal interest) and higher realized true-up income of Rs. 6.4b (9MFY19: Rs. 2.3b) resulting from change in USD-PKR exchange rate exceeding the threshold defined in PPA and its difference with the rates used for dollar indexation of relevant CPP invoices. Accounting for taxation, the company recorded higher net income of Rs. 17.8b (9MFY19: Rs. 10b) during 9MFY20.

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

Financial Snapshot

Tier-1 Equity: end-9MFY20: Rs. 56.3b; end-FY19: Rs. 41.2b; end-FY18: Rs. 35.1b.

Assets: end-9MFY20: Rs. 143.3b; end-FY19: Rs. 139.3b; end-FY18: Rs. 138.4b.

Profit After Tax: end-9MFY20: Rs. 17.8b; Rs. FY19: Rs. 13.1b; FY18: Rs. 10.6b.

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 accumulated further to Rs. 125.4b by the end-9MFY20 (FY19: Rs. 115.8b). These include an overdue amount of Rs. 112.3b (FY19: Rs. 94.1b) receivable from WAPDA due to delay in payments. 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. In line with the reported profits, funds from Operation (FFO) amounted higher at Rs. 21b (FY19: Rs. 18.6b) during 9MFY20. While the annualized total debt-to-FFO ratio improved to 0.56x by end-9MFY20 (FY19: 0.34x), a slight decrease in the debt servicing coverage ratio (DSCR) to 3.4x (FY19: 3.7x) was mainly due to higher interest payment during the period; nevertheless the DSCR 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 augmented to Rs. 56.3b (Rs. 41.2b) by end-9MFY20 with the partial retention of profits as the company paid cash dividend of Rs. 2.6b during the period. 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.

Total liabilities of the company decreased to Rs. 79.6b (FY19: Rs. 96.3b) by end-9MFY20 mainly owing to reduction in trade & other payables to Rs. 28.6b (FY19: Rs. 40.1b) as a result of payments to PSO and SNGPL; its impact was partially offset by increase in deferred liabilities to Rs. 7.3b (FY19: Rs. 1.8b). Outstanding balance of finances under mark-up arrangements stood at Rs. 50.2b at end-9MFY20 (FY19: Rs. 54.2b), resulting in improved gearing and debt leverage of 0.89x (FY19: 1.32x) and 1.54x (FY19: 2.38x), respectively. Subsequent to issuance of Pakistan Energy Sukuk (PES) II of Rs. 200b by Power Holding Limited (PHL), KAPCO has received Rs. 12b against overdue receivables in June'20. Resultantly, the company has reduced the utilization of short-term financing under mark-up arrangements to Rs. 44b, as of July 24, 2020.

Proposed issuance of short-term instrument for working capital requirements

The company is in process of issuing a series of rated, privately placed, Islamic Commercial Paper (ICP) / Short-term Sukuk (STS) of up to Rs. 15.0b, inclusive of green-shoe option of Rs. 3.0b. The instrument will be issued in three tranches, with each tentatively amounting to Rs. 5.0b inclusive of green-shoe option of Rs. 1.0b. The proceeds of the issue will be utilized by the company to meet its working capital requirements. Tenor of each issue will be six months. Repayment structure comprises a bullet payment of face value at the end of the maturity of the respective ICP/STS issuance. Given that the issuance is of short-term tenor and will mainly replace the commercial borrowings, leverage indicators are expected to remain largely around current levels. Expected drawdown and maturity dates of each tranche are tabulated below;

Tranche (Rs. billion)	Expected Drawdown Date	Maturity Date
Issue 1 up to Rs. 5.0b	August 17, 2020	February 13, 2021
Issue 2 up to Rs. 5.0b	January 21, 2021	July 28, 2021
Issue 3 up to Rs. 5.0b	June 25, 2021*	December 22, 2021

**Subject to renewal of PPA*

Kot Addu Power Company Limited Annexure I

Financial Statement (*Amount in Million)*

BALANCE SHEET	FY17	FY18	FY19	9MFY20
Fixed Assets	11,047	8,663	6,755	5,041
Other Assets	8,424	6,908	5,897	7,122
Stock in Trade	5,914	6,718	9,466	4,903
Trade Debts	89,987	115,472	115,798	125,396
Cash & Bank Balance	629	685	1,350	788
Total Assets	116,001	138,446	139,267	143,251
Trade and Other Payables	34,169	49,755	40,139	28,649
Long-Term Debt *(Inc. current mat)*	475	54	38	30
Short-Term Borrowings	46,133	49,875	54,180	50,153
Other Liabilities	2,721	3,669	3,749	8,125
Total Equity	32,503	35,093	41,161	56,294
Paid-Up Capital	8,803	8,803	8,803	8,803
INCOME STATEMENT	FY17	FY18	FY19	9MFY20
Revenue	81,846	91,916	84,830	56,397
Gross Profit	14,180	13,379	14,205	15,676
Operating Profit	18,498	21,995	27,269	31,665
Profit Before Tax	14,073	15,808	18,963	24,727
Profit After Tax	9,447	10,617	13,111	17,774
FFO	11,439	17,014	18,608	21,002
RATIO ANALYSIS	FY17	FY18	FY19	9MFY20
Gross Margin (%)	17.3	14.6	16.8	27.8
Current Ratio (x)	1.3	1.3	1.4	1.7
FFO to Total Debt (x)	0.25	0.34	0.34	0.56*
FFO to Long-term Debt (x)	24.0	312.0	488.6	933.4*
Debt Servicing Coverage Ratio (x)	3.5	5.4	3.7	3.4
ROAA (%)	9.1	8.4	9.4	16.8*
ROAE (%)	29.8	31.4	34.4	48.6*
Gearing (x)	1.43	1.42	1.32	0.89
Debt Leverage (x)	2.57	2.95	2.38	1.54

**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
Sector	Power
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
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
RATING TYPE: CP/STS				
20/08/2020		**A-1+**	**Stable**	**Preliminary**

Instrument Structure	KAPCO is issuing a series of rated, privately placed, Islamic Commercial Paper (ICP) / Short-term Sukuk (STS) of up to Rs. 15.0b, inclusive of green-shoe option of Rs. 3.0b. The instrument will be issued in three tranches, with each tentatively amounting to Rs. 5.0b inclusive of green-shoe option of Rs. 1.0b. The proceeds of the issue will be utilized by the company to meet its working capital requirements.
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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Due Diligence Meetings Conducted

Name	Designation	Date
Mr. Zubair Aslam	Manager Treasury	July 25, 2020