Nishat Chunian Power Ltd.

PKR26.4 - BUY

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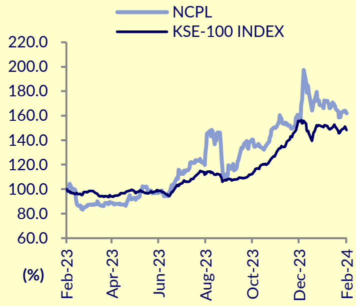
Pakistan

Power Generation & Distribution

Reuters	**NCPL.PSX**
Bloomberg	**NCPL PA**
Priced on 09 February 2024	
KSE100 @ 62,943,7	
12M hi/lo	PKR32.2/13.6
Dec-24 price target	PKR41.6
±% potential	+57.2%
Shares in issue	367.3m
Free float	60.0%
Mkt. cap	USD34.8m
3M ADV	USD0.2m

NCPL vs KSE100 performance



Source: PSX, Bloomberg

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Dividend restart imminent

Amid structural reforms, dividend payouts expected to resume

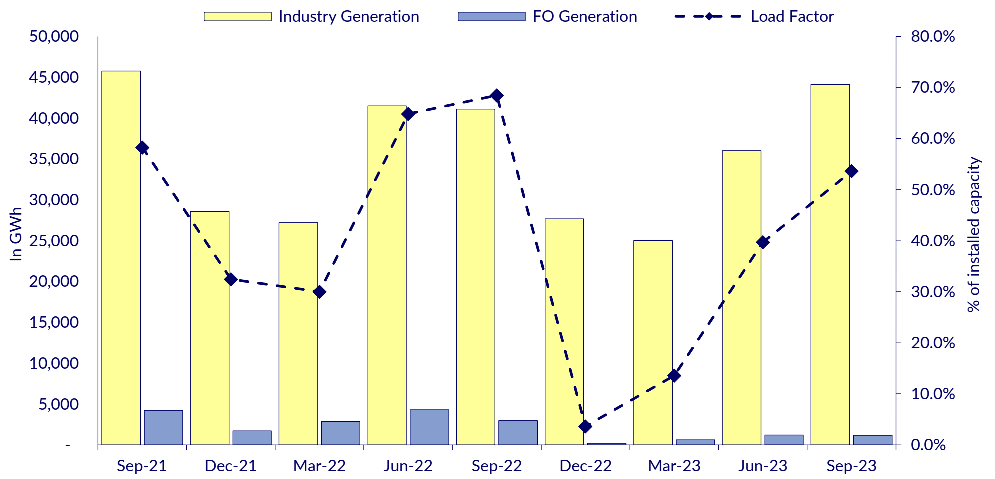
We initiate our coverage on NCPL with a BUY call and target price of PKR 41.55/sh. Our proposed investment thesis is focused on structural reforms being undertaken by the State to curb circular debt in the power sector. The government has taken prudent steps towards easing receivable accumulation through subsidies and timely pass through of quarterly adjustments to end consumers. Deacceleration of circular debt accumulation would alleviate the company's working capital and liquidity concerns and allow restart dividend payouts to investors.

Dividend payout to be reinitiated on back of fiscal support and reforms: Circular debt has been a persistent challenge permeating the energy sector. As part of the IMF program, the State has committed to limit circular debt growth through timely notification of quarterly and monthly tariff adjustments. Moreover, the State has allocated a subsidy of Rs 979 billion (0.6% of GDP) in its FY24 budget of which Rs 310 million (3.3% of target tax receipts) is earmarked for payments to IPPs and GPPs. This should help in decelerating the accumulation of circular debt giving NPCL breathing room in managing its working capital and ultimately restart its historical dividend payout. We anticipate a dividend yield of 15.1% for FY24.

Margins remain steady in face of declining utilization: In 6MFY24, NCPL generated 152GWh of electricity, a 31% decline from the corresponding period last year. This decline can be attributed to seasonal effects and subdued demand and NCPL's lower rank in the NTDC merit list (46/74 as of 16th Jan'24) Furthermore, RFO based generation continues to shrink as the generation mix shifts towards more cost-effective sources i.e. renewables and coal. Similar to its sister concern, NPCL has held its ground in terms of profitability by the virtue of its power purchase agreement (take or pay basis) which guarantees it income even if the plant is idle.

Declining fuel efficiency hedged by lower utilization levels: The plant's average utilization in FY23 was 22%. The capacity utilization of the plant has been relatively lower compared to that of its peers due to lower efficiency. Due to aging and low efficiency, the plant incurs fuel losses at higher utilization levels impacting its bottom-line. We expect the plant to continue to have a low merit order as long as demand remains muted.

NPL Load Factor vs Industry Generation



Source: NEPRA, Alfalah CLSA Research

Superior O&M & insurance savings lend towards bottom-line growth: After the expiry of its contract with Wartsila, operation & maintenance related activities have been moved inhouse allowing it to reap higher OEM savings. NCPL has an experienced in-house O&M team that maintain the plant's performance and operational efficiency. Compared to NPL, the O&M savings are relatively higher on account of having a lower fixed cost component. This, however has been impacted by O&M savings being shared on 50:50 basis with the power purchaser. Below is the EPS impact of OEM savings expected at different utilization levels.

Figure 1

Scenario Analysis			
Capacity Utilization	0%	35%	60%
EPS Impact/sh	0.90	2.19	3.11

Source: Company Accounts, Alfalah CLSA Research

In addition to OEM savings, the company also enjoys savings on insurance. In FY 23, the insurance component in revenue was increased over 53% with the added impact of the deteriorating USD-PKR parity, the insurance revenue surged by two-fold with savings translating to PKR1.52/sh. We expect NPCL to continue make savings in this area with impact of these savings estimated to be PKR1.7/sh in FY24.

Rate cuts to ease finance costs and make bridge financing cheaper – The management had decided not to pay dividends in FY23 citing high finance costs and focus towards balance sheet repairs. By Mar'24, we expect rate cuts to be implemented which would culminate into lower borrowing costs. This would give the company flexibility in its management of working capital and eventually resume dividend payout to investors. Furthermore, the slowing down of circular debt accumulation would allow it to use its liquidity to lower its financial obligations. This ultimately supports their ability to restart investor returns.

Favorable decision in litigation case expected: In Mar'20, NAB had highlighted that power plants established under the 2002 Policy had made unprecedented savings based on higher tariffs. Upon negotiations currently, NCPL excess payment worth Rs 8.36bn is pending with NAB and has been retained by the Arbitration Tribunal. Management strongly believes that the decision will be made in favor of NPCL and no provisions have been booked in this regard.

Shift to market model: What to expect? Going forward, the power sector is expected to shift from a single buyer model to a wholesale market model where multiple buyers and sellers can engage in bilateral contracts. NCPL has agreed that once CTBCM model is implemented, its power purchase agreement will be amended from "take or pay" to "take and pay" which would render capacity payments redundant as revenue will be incumbent on the offtakes agreed. This can go in different directions for NCPL i) it acquires license to sell to bulk power purchasers or negotiate an industrial wheeling arrangement ii) minimum annual guaranteed energy is converted to a take or pay provision with availability obligations for the company.

Delayed payment markup from overdue receivables: NCPL's net receivable position as of 1QFY24 is PKR16.8 Bn (PKR 45.80/sh). With interest rates at its highest, NCPL has been able to rake in higher delayed payment markup on its receivables, this has not only mitigated the finance costs emanating from its short-term borrowing line but also contributed positively towards bottom-line growth.

Although, we anticipate interest rate cuts from Mar'24, penal income is expected to grow due to lower base effect. (FY24E: Rs 6.54/sh vs FY23: Rs 5.8/sh)

Recommendation: With a dividend reinstatement in the horizon, NPCL is currently undervalued and trading at a forward P/E of 2.03x making it an attractive opportunity for income-focused investors. We highlight a BUY call on the scrip with Dec-24 target price of PKR41.55/sh offering a 57% upside from the previous close. Together with its dividend yield, annual return is 72%.

Figure 2

Financials Snapshot

Year till 30 Jun	FY22	FY23	FY24E	FY25E	FY26E
EPS	6.8	10.8	13.0	12.2	12.6
P/E	3.88	2.45	2.03	2.16	2.10
DPS (PKR/sh)					
Div. Yield	10.0	-	4.0	8.0	8.0
P/BV	37.8%	0.0%	15.1%	30.3%	30.3%
ROA	0.40	0.40	0.35	0.33	0.32
ROE	7.8%	7.2%	12.4%	16.5%	14.7%

Source: Company Accounts, Alfalah CLSA Research

Key methodology and triggers: NPL's Dec-24 Target price of PKR41.55/sh is based on the Dividend Discount Model.

Upside Risk

- Strong operating performance in line with NEPRA's stated benchmarks, increasing efficiency gains
- Lower exposure to circular debt due to sovereign cash injections

Downside Risk

- Unfavorable terms and conditions under the competitive trading agreement
- Acceleration of circular debt accumulation
- Increasing shift towards renewables and alternative sources of power of generation will result in the plant further sliding down the merit order
- Volatility in international crude prices, hindering capacity utilization

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