JS Research

July 19, 2010

Pakistan Market

MORNING BRIEFING

Hubco: Company update / ‘Buy’ maintained

KSE100 Index: Closing 10153.85↑ (+58.05)

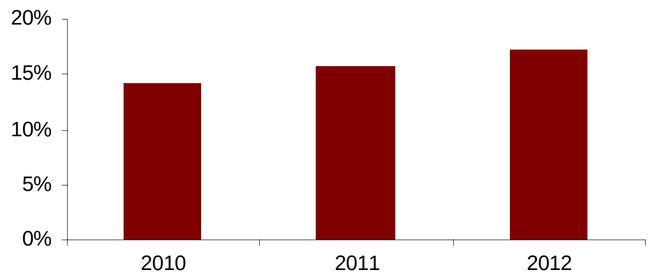
We rate Hub Power Company (Hubco) as the top defensive pick of our universe mainly on the back of consistent up-tick in its predetermined tariff profile, expected materialization of Narowal Project and attractive FY10E dividend yield of 14.2%. Hence at current levels, we maintain our ‘Buy’ call on the stock. However, the key investment risk in our opinion is the prolonged resolution of circular debt which could continue to hamper Hubco’s cash flows and as a result could limit company’s dividend paying ability in future.

Based on last closing price, the stock is currently trading at FY11F PE of 7.0x and 25% discount to our target price of 45.

Tariff now set to improve payouts

Hubco’s Power Purchase Agreement (PPA) was designed in a way that the Project Company Equity (PCE) component of the tariff would accelerate in FY10E and beyond, leading to increased returns to equity investors even in real terms (excluding indexation factors). The up-tick in tariff is already evident from the growth in company’s 9MFY10 earnings which has improved by ~44%YoY.

Hubco: Projected dividend yield



Source: JS Research

Though, the growth also includes higher production bonus on account of better load factor, we believe the rise in earnings was mainly driven by the hike in tariff profile of the company. Moreover, with company’s tariff now in acceleration phase, Hubco is well positioned to announce higher dividend to its investors. For FY10, we expect the company to declare total dividend payout of Rs4.7 per share versus Rs2.15 and Rs3.35 per share in FY08 and FY09, respectively.

Narowal Project to be commissioned in Sep10

After a delay in expected commissioning of Narowal project, the management now expects the project to be commissioned in September 2010. The company has already incurred a CAPEX of Rs20.2bn (total estimated project cost of around Rs23bn) with target Debt to Equity of 70:30, offering real IRR of 15%. Based on our estimates, the project contributes around Rs3 per share to company’s valuation (already incorporated in our Target Price of Rs45).

Circular Debt continue to hamper cash flows

Amid liquidity injection (~Rs161bn via TFC issues) earlier in FY10, Hubco along with other IPPs, witnessed some improvement in its cash flows as evident from dip in receivables which fell to Rs27bn as of September 2009 versus Rs46.6bn reported in June earlier. However, with circular debt still unsettled, the receivables have again soared to Rs57.6bn as of March 2010, which the company has managed by raising short term borrowings and delaying payments to PSO. As of March 2010 Hubco owes Rs53.2bn to PSO. With the consistent hikes in power tariff under the IMF program the accumulation of new dues have slowed down. However, the key point to watch from here is the government’s ability to retire the backlog of this inter-corporate debt which is still hovering in the range of Rs110 to Rs120bn.

Recommendation: ‘Buy’ maintained

At current levels, Hubco offers Rupee and US$ IRR of 24.0% and 21.5%, respectively with FY10E dividend yield of 14.2%. Hence, we maintain our ‘Buy’ stance on the stock.

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Also in focus

Cotton prices tumble from Rs7,300/maund

Better weather conditions owing to timely monsoon season this year and start of local cotton arrivals relieved some pressure off the cotton prices that plummeted to Rs6,000 per maund after hitting an all time high of Rs7,750 per maund. To recall, in FY09 shortage of cotton worldwide had caused cotton prices to skyrocket locally as well as globally. However, with increased usage of BT cotton seed the government is expecting a bumper cotton crop and anticipates a production of ~14mn bales for the current season. We can further see a downward movement in the local cotton prices going forward as the arrival season starts in full swing from August 2010.

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