API Power Company Limited: [ICRANP] IPO 4 assigned

February 11, 2020

Summary of rated instruments

Instrument	Issue Size (NPR Million)	Grading Action
Rights Issue Grading	567	[ICRANP] IPO Grade 4; assigned
Total	**567**	

Grading action

ICRA Nepal has assigned a grading of [ICRANP] IPO Grade 4, indicating below average fundamentals, to the proposed rights issue grading of NPR 567 million of API Power Company Limited (API). ICRA Nepal assigns IPO gradings on a scale of 1 through 5, with Grade 1 indicating strong fundamentals and Grade 5 indicating poor fundamentals. For the grading categories 2, 3 and 4, the sign of + (plus) appended to the grading symbols indicates their relative positioning within the grading categories concerned. Thus, the grading of 2+, 3+ and 4+ is one notch higher than 2, 3, and 4, respectively. API is proposing to come out with a rights issue of 5,670,000 equity shares with a face value of NPR 100 each, at par. The proceeds from the proposed issue has been planned to be utilised for the development of 40MW Upper Chameliya Hydropower Project (HPP).

Rationale

The grading is constrained by the significant project execution risk and the funding risk in the 40-MW Upper Chameliya HPP amid the nascent stage of project development and the yet-to-be-achieved financial closure. Further, typical project implementation risks such as natural calamities/geological changes can result in time and cost overruns for the under-construction 40-MW Upper Chameliya HPP, exposing the project to various risks such as cost escalation, late COD penalty[1], loss of tariff escalations[2] and reduction in the project period[3]. However, the timely project completion track record of API before 9-12 months of the required commercial operation date (RCOD) in the two operational hydropower projects remain a comfort to some extent. The grading is further constrained by the subdued performance of the 8.5-MW Naugarh Gad HPP whose generation remains at ~68% of the overall contract energy in FY2019. Likewise, the cost escalation seen in API's second operational project of the 8-MW Upper Naugarh Gad HPP with an overall project cost of NPR 1,824[4] million (NPR 228/MW) is expected to impact the return indicators of the company amid the fixed tariff and escalation structures. Hydrological risks also remain high, given the fact that API's two operational hydropower projects lie in the same basin and the absence of a deemed generation clause in the power purchase agreement (PPA).

Since the revenues are directly linked to unit sales and the tariff fixed as per the power purchase agreement (PPA), any loss of generation on account of hydrology can negatively impact the project earnings and return indicators. Likewise, the grading is also constrained by the 10% reserve margin clause in the PPA of the 40-MW project, which empowers the NEA to offtake 10% energy - based on the dispatch instruction of the load dispatch centre without paying any compensation for non-offtake of the same. This can impact the revenue stream from the project to some extent. The grading is also constrained by the likely dilution in the profitability indicators over the medium term, arising from the proposed sizeable equity enhancement. Grading concerns further arise from the interest rate volatility in the market and the counterparty credit exposure of the Nepal Electricity Authority (NEA), which has a moderate financial profile (with recent improvements). This is partly mitigated by the sovereign support of the Government of Nepal (GoN) to the NEA and its past track record of timely payments to independent power producers (IPPs).

Nonetheless, the grading factors in the rich experience of the promoter group and the management team in the field of hydropower (Group has seven operational HEPs totalling 57.3 MW). The grading also considers the company's track record of timely project execution so far. However, the ability to reflect a similar performance in the proposed 40-MW project remains to be seen. The grading action also notes the low evacuation risks for the two operational projects as well as the proposed 40MW HPPs with the availability of the Nepal Electricity Authority (NEA) evacuation structures in Balanch

[1] Late COD penalty is 5% of the energy, based on contracted energy, that would have been produced during the RCOD and actual COD at the tariff rate as applicable on the actual COD

[2] Delay of 6 months beyond RCOD will lead to a tariff escalation loss; for every additional year of delay, an additional tariff escalation will be lost

[3] Project period is valid till 35 years from September 29, 2019 as per generation license or 30 years from actual COD, whichever is earlier.

[4] Budgeted total project cost was NPR 1,649 million

substation. Further, the gradings take comfort from the positive demand outlook for the energy sector owing to the supply-demand gap in the power sector as well as the increasing energy consumption in the nation. Also, firm long-term PPAs for each project with fixed tariff and fixed escalations eliminate the offtake and tariff risks for the project. This, coupled with relatively lower budgeted project cost of the 40-MW project at NPR 7,400 million (NPR 185 million/MW), the high dry energy mix of 37% under the new 6-6 months dry: wet energy modality and eight tariff escalations could support API's revenue profile going forward.

Going forward, the company's ability to achieve timely financial closure for the 40-MW project and collect the rights issue within the project development period of 40MW HPP through different tranches, complete the proposed 40-MW project within the expected cost/time, and achieve design operating parameters, would all have a major bearing on the overall return indicators for the company.

Key grading drivers

Credit strengths

Rich experience of promoters and management team in hydropower sector: The company's board and senior management have prior experience and technical expertise in the hydropower sector. The Group has seven operational HPP totalling 57.3 MW. The prior experience of the Group is expected to aid the constructional, operational and maintenance aspects of the current operational and constructional project under the company.

No evacuation risks, given the available evacuation structures: The power generated from the two operational projects totalling to 16.5MW and the under-construction project would be evacuated to the NEA's Balanch 132kV substation. For, the under-construction 40-MW project, the company would be constructing a 16-km long 132kV ACSR Wolf transmission line from the switchyard of the project to NEA's Balanch 132kV substation.

Low tariff risk, given long-term PPA at predetermined tariffs and escalations: The tariff and tariff escalation risk for the operational project is low as the company already has a 30-year PPA for the project with the NEA (the sole purchaser and distributor of electricity in Nepal) for its entire project capacity of 16.5MW. Amid completion of both the operational projects ahead of the RCOD, both the projects are eligible for maximum escalations as provided in the PPAs and are not subjected to any late COD penalty, which remains good for the company. The tariff and tariff escalation risk for the 40-MW Upper Chameliya HPP also remains on the lower side since a firm PPA with fixed tariff and fixed number of escalations has already been entered with the NEA. However, the project's ability to get completed within or after the RCOD of the project that lies in February 25, 2023 will be determining the number of tariff escalations and/or the late COD penalty to be applicable to the project.

The return metrics of 40-MW Upper Chameliya HPP to remain pivotal for overall return metrics of the company: The overall project return indicators should remain supported by the project that has been proposed to be developed at a relatively lower per MW cost of NPR 185 million, which could help the company achieve an economy of scale. This along with the high dry energy mix of ~37% and eight tariff escalations would be supporting the return indicators of the 40-MW project and would remain pivotal in defining the average return indicators for the company.

Credit challenges

Low generation of the operational hydropower projects: The net energy generation trend of the first operational 8.5-MW project remains subdued at ~68% (FY2019) and ~75% (6M FY2020) of the contract energy. This is mainly on account of the fluctuations in river hydrology and also disturbances in the project operation due to frequent repair and maintenance of project machineries. The net generation trend for the second operational 8MW project is yet to be seen since the project is in operation since October 30, 2019 only (~62% generation in 71 days since operation). Going forward, the ability of the operational as well as the under-construction project to operate with good generation trend would remain critical in determining the revenue flow and return indicators for the company.

High funding risk for the 40-MW project: The financial closure for the 40-MW project is yet to be achieved. The project has been planned to be developed at a cost of NPR 7,400 million (NPR 185 million per MW) at an estimated debt-equity ratio of ~70:30. The debt component (NPR 5,180 million) is yet to be tied and the loan agreement is pending. Also, the equity portion that has been planned to be raised over a few tranches with the beginning of the project development, also reflects some uncertainty in timely collection and infusion of equity for the project development. Nonetheless, the Group strength should bridge any gaps if such a scenario was to arise.

Inherent risk of project execution: The 40-MW project is at a nascent stage of development, which exposes the project to inherent project execution risks. The risk could remain further accentuated by any geological surprises that may prevail while carrying the project execution going forward. However, the track record of the company in carrying out the project execution remains good so far and remains to be tested for the bigger project of this size. The project has an RCOD of February 25, 2023.

Penalty to be invoked if API fails to meet 30% of dry energy supply target: The PPA for the 40 MW additional capacity has been made under the 6-6 months dry energy (~37%) and wet energy modality with the supply of at least 30% dry contract energy. API has to meet 30% of the dry energy supply, failing which it would be subjected to a penalty based on the total energy supplied in a year, **less** than the total annual estimated energy based on 30% dry season energy and **a product of** the power purchase rate in the wet season of the relevant year.

Low offtake risk: however, provision of 10% reserve margin for 40MW project can impact revenue profile: The offtake risk for the project is low, given the presence of the take-or-pay PPA for the entire energy from the two operational projects as well as the 40MW under-constructional project. However, for the 40MW project, there is a provision of a 10% reserve margin clause in the PPA, which empowers the NEA to offtake 10% of the energy based on the dispatch instruction of the load dispatch centre. If the NEA does not offtake this reserve margin, it is not bound to pay any compensation to API, which could impact its revenue if such a scenario prevails. Nonetheless, the risk is reduced to some extent, given the present demand-supply gap in the energy sector as well as the increasing energy demand in the country.

High hydrology risk, given lack of deemed generation clause in PPA: The lack of a deemed generation clause in the PPA exposes the project to hydrological risk in case of adverse river flow scenarios without receiving any compensation for such losses. The risk is further accentuated by the fact that both of its operational projects lie in the same river which could result in a severe impact if such a scenario exist.

Analytical approach: For arriving at the grading, ICRA Nepal has applied its grading methodology as indicated below.

Links to applicable criteria:
IPO Grading Methodology

About the company

Established in June 2003 as a private limited company, API began as a subsidiary of South Asia Engineering Private Limited. In July 2013, the company was converted into a public limited company with major restructuring in its shareholding pattern. It was established by the promoters of Arun Valley Hydropower Group, one of the leading private sector hydropower groups of Nepal. The first project of the Group has been operational from 2003. The chairman of API, Mr. Guru Prasad Neupane, and his family have controlling interests across the Group companies. As of mid-January 2020, promoters held 60% stake in API while 40% was held by the general public. API plans to utilise the proposed issue proceeds in constructing the 40-MW Upper Chameliya HPP.

API's first project, an 8.5-MW run of the river HEP at Naugarh river (Naugarh Gad HEP) in Darchula district, has been operational since August 2015. The project was commissioned at a cost of NPR 1,454 million, funded in a debt-to-equity ratio of ~53:47. The electricity generated from this project is being evacuated through the 132-kVA Balanch-Syaule-Attariya transmission line. The Syaule sub-station was recently added (in July 2018) to the long stretch of the transmission line (~131 km), which has helped lower the transmission losses for the project. Prior to this development, the project supplied only ~50-55% of the contract energy, which has since improved to ~68% in FY2019 and 75% of contract energy in 6M FY2020. As per the PPA, the agreed tariff for the wet season (corresponding to 79% of annual contract energy) is NPR 4 per kWh and for the dry season, it is NPR 7 per kWh with 3% annual escalation on the base tariff for nine years

The second operational 8-MW Upper Naugarh Gad HEP lies upstream of the current operational project. The project has been recently completed and is operational since October 30, 2019 as against the RCOD of July 2020. It was completed at a cost of NPR 1,824 million (~11% cost overrun over initial estimates), mainly due to floods, the sweeping away of electromechanical equipment and damages in the structures for which extra protection work was carried on. As per the PPA, the agreed tariff for the wet season (corresponding to 77% of annual contract energy) is NPR 4.8 per kWh and for the dry season, it is NPR 8.4 per kWh with 3% annual escalation on the base tariff for five years. Power generated by the project is being evacuated through a 7-km long, 33-kV transmission line to the NEA Balanch sub-station at Darchula.

The under-construction 40-MW Upper Chameliya HPP is the third project that API is developing at a cost of NPR 7,400 million at a D:E ratio of 70:30. The financial closure for the project is yet to be achieved and the project is at a nascent stage of development. It is a run-of-the-river project and is being developed under the Q42 probability of exceedance model. The contract PLF of the project is around 75% and the PPA has been done under the 6-6 month dry:wet energy model with a high dry energy mix of ~37%. The base tariff for the wet energy is 4.8 per kWh while the same for the dry energy is 8.4 per kWh with tariff escalations of eight times over the base tariff. The RCOD of the project has been fixed at February 25, 2023. The power would be evacuated through a 16-km long, 132-kV transmission line to the NEA Balanch sub-station at Darchula.

API posted net profit of NPR 71 million over gross sales of NPR 179 million during FY2019 as against a net profit of NPR 59 million over gross sales of NPR 128 million during FY2018. The reported profits are, however, benefitted by the ballooning depreciation method adopted by the company (auditors qualified their opinion on financial statements of FY2018 over this matter). The company had NPR 1,925 million of outstanding term loans payable to the consortium banks as on mid-July 2019 and the gearing ratio of the company stood at 1.52 times for the same date

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About ICRA Nepal Limited

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