Grading Rationale
Himal Dolakha Hydropower Company Limited

Grading

Particulars	Amount (Rs. In Million)	Grading	Rating Action
Initial Public Offer	780	CARE-NP IPO Grade 4 [IPO Grade Four]	Assigned

The explanatory notes regarding the Grading symbols of CARE Ratings Nepal Limited (CRNL) are attached as Annexure 1

CRNL has assigned grading of 'CARE-NP IPO Grade 4' to the proposed Initial Public Offer (IPO) of Himal Dolakha Hydropower Company Limited (HDHCL). 'CARE-NP IPO Grade 4' indicates Below Average Fundamentals. CRNL assigns IPO grades on a scale of Grade 1 to Grade 5, with Grade 1 indicating strong fundamentals and Grade 5 indicating poor fundamentals. CRNL's IPO grading is an opinion on the fundamentals of the issuer. The grade assigned to any individual issue represents a relative assessment of the 'fundamentals' of the issuer. HDHCL proposes to issue 7.8 Mn shares of face value of Rs.100 each at par aggregating Rs. 780 Mn.

Detailed Rationale & Key Grading Drivers

The grading assigned to HDHCL is constrained by low operational plant load factor (PLF) of the projects and recent penalties levied by NEA leading to cashflow mismatches. The grading is also constrained by weak financial performance during Q1FY19 (UA, refers to quarter ended mid-October 2018), however, earned net profit during FY17 and FY18 (refers to 12 months' period ended mid-July 2018), weak debt service coverage indicators including high short term debt obligations. The grading also factored in execution risk associated with under construction project in which HDHCL has invested however, high return is expected from the project due to low cost of the project, hydrology risk associated with run-of-the river power generation, and moderate counter party risk.

The grading, however, derives strength from experienced board members and management team having experience in other hydropower project and financial support from directors. The grading also derive strength from power purchase agreement with sufficient period coverage, improvement in the PLF levels, supported by shortage of power in the country and government support for the power sector.

Detailed Description of the Key Grading Drivers

Key Grading Weaknesses

Low operational plant load factor (PLF) of both projects and penalties levied by NEA

The annual contracted PLF of the project I (4.55MW) is 69.84% and project II (8MW) is 69.00% of the installed capacity of the plant. Project I operated at relatively low PLF of 51.03% in 7MFY19 and 48.06% in FY18. Project II operated at very low PLF of 7.66% in FY18 (operational for 2 months) which improved to 26.71% in 7MFY19. The generation of the power from project II was impacted by damage of tunnel in May 2018 by landslide and technical problem in generator. However, the company was able to receive claim from insurance company for loss of revenue and for damage of assets.

The power generation as a percentage of the contracted power for project I was 68.67% in 7MFY19 and 69.65% in FY18; and Project II was low at 39.03% in 7MFY19 and 13.39% in FY18. Further, the company has started pumping in the water from Puwa Khola/river from March 2, 2019, which led to improvement in the power generation from the project II (i.e. power generation is ~ 75% of contracted energy).

Low PLF for both project resulted in significant revenue losses and short supply penalty levied by Nepal Electricity Authority (NEA). Also, NEA levied late Commercial Operation Date (COD) penalty due to delay in commercial operation of Project II which resulted in significant impact on the cashflow of the company. On the basis of generation of additional power by adding water through pumping as well as recent track record of improvement in power generation; it is expected that the revenue generation will be better in future. HDHCL revenue is dependent on revenue received from above two projects and the ability of the company to reduce the gap between operational PLF and contracted PLF will be critical for the future cashflows of the company.

Weak financial performance during Q1FY19, although net profit earned during FY17 and FY18

The revenue of the company increased to Rs. 122 Mn during FY18 as compared to Rs. 89 Mn during FY17 mainly due to income in the form of insurance claim and also due to Project II coming into operation from April 2018; however, revenue from project I declined to Rs 82 Mn from Rs 89 Mn during FY17. On back of the increase in income, HDHCL’s PAT increased to

Rs. 15 Mn during FY18 from Rs. 9 Mn in FY17 and also leads to improved gross cash accruals. Further, HDHCL revenue from power sales was Rs 46 Mn with PBILDT of Rs 37 Mn during Q1FY19 (UA). However, HDHCL has incurred cash losses of Rs 8 Mn during Q1FY19 mainly due to substantial increase in interest expenses from project II, which has been capitalized till FY18. It has negative reserve and surplus of Rs 164 Mn at the end of Q1FY19 due to accumulated losses in the past. Company's return on net worth was low in FY18 and FY17 and negative for Q1FY19.

High overall gearing with weak debt service coverage indicators

Overall gearing ratio of the company marginally improved to 2.39x as on July 16, 2018 (PY 2.41x), however remained high. Interest coverage ratio of the company which was 2.01x during FY18 deteriorated substantially to less than unity (i.e.0.83x) in Q1FY19 (UA) mainly due to sharp increase in interest expenses. The total debt to gross cash accruals (GCA) was high at 32.29x during FY18. The insufficient cashflows due to negative GCA and delay in the payments from NEA and penalties levied by NEA lead to cashflow mismatches for the loan principal payment for Q1FY19. Further, the company has high short term debt obligations to be repaid in near future which is proposed to be repaid through the proceeds of proposed IPO.

Execution risk of under construction project in which HDHCL invested however, high return potential

HDHCL has proposed to invest Rs.570 Mn in KBNR Isuwa Power Ltd. (KIPL, 97.20 MW Isuwa Khola Hydropower Project) from the initial public offer (IPO) proceeds. The company already invested Rs 445 Mn through a bridge loan till mid Jan 2019. The bridge loan is proposed to be repaid through proceeds of proposed IPO issue. The project of KIPL is in initial stage of construction leading to significant project execution risk. Further, HDHCL will not get any return on investment till the project come into operation. However, due to low estimated cost per MW, it is expected that KIPL will provide high return once the project is completed within time and cost estimates. Estimated cost of project is Rs 9,964 Mn which is proposed to be funded in debt equity ratio of 80:20 with RCOD of July 17, 2023. KIPL has entered into pre-consortium agreement for the proposed debt.

Hydrology risk associated with run-of-the-river power generation

Run-of-the-river (ROR) power is considered an uneven source of power, as a run-of-the-river project has little or no capacity for water storage and therefore is dependent on the flow of river water for power generation. ROR, therefore, generates much more power during times when seasonal river flows are high (Mid-April to Mid-December) and much less during the drier months (Mid-Dec to Mid-April). Hence, the project is exposed to risk associated with variation in discharge of water from the aforesaid river. HDHCL Project I utilize discharge from Mai Khola/river located at Ilam District and Project II utilize discharge from Mai Khola/river as well as Puwa Khola/river.

Moderate counter party payment risk

HDHCL is exposed to counter party payment risk pertaining to NEA, which has been making consecutive losses in past till FY 2016 and carry huge accumulated loss in its book. As per the annual report published by NEA, during FY18 (provisional), NEA earned profit of Rs 1,010 Mn. Further, during FY18, NEA achieved gross cash accrual of Rs 5,142 Mn. The counter party payment risk is moderated by the fact that, NEA is fully owned by government of Nepal and NEA is generating positive gross cash accruals and further, NEA has been making timely payment to independent power producer (IPPs) in past. During FY18 and H1FY19, the company has received payment for project I generally within 45 days. However, the company is not able to receive payments for project II due to pending calculation for late COD penalty and power short supply penalty charged by NEA. HDHCL received payments from NEA during Jan 2019 towards the bills submitted for Project II from April 2018 to November, 2018 leading to stressed liquidity. However, HDHCL is getting timely payment from NEA for both the projects for the bills raised from Mid- December 2018.

Key Grading Strengths

Board members and management team having experience in other hydropower project and financial support from directors

HDHCL has two board of directors. Mr. Birendra Bahadur Neupane, is Chairman of the company, has ~38 years of experience in construction and hydropower business. Mr. Neupane also hold chairmanship in various hydropower, hotels and agriculture companies. The management team is led by Mr. Rupmani Raj Bhandari who is the managing director of the company along with directorship in other various operational and under construction hydropower companies. HDHCL has been obtaining financial support in form of advance from directors. The advances from the directors was Rs 101 Mn in Q1FY19 (which was Rs 53 Mn in FY18) mainly to support the operations of the company.

Power purchase agreement with sufficient period coverage

HDHCL had entered into a PPA with NEA for both the projects. The period of the PPA for Project I is 30 years from July 2010 and for project II 30 years from the date of COD or till validity of Generation License (received on July 30, 2013 for 35 years), whichever is earlier. The contracted energy for the Project -I is 27.53 million units (MU) at PLF of 69.84% and the contracted energy for the Project -II is 48.35 MU at PLF of 69.00%.

For the Project -I, tariff for initial 2.4MW for wet season (i.e. Mid-April to Mid-December) is Rs 3.90 per kWh and for dry season (i.e. Mid-December to Mid-April) is Rs 5.52 per kWh and tariff rate for additional 2.15 MW is Rs 4 per kWh for wet season and Rs 7 per kWh for dry season with 3% escalation on base tariff for 9 years. For the Project -II, the tariff for wet season is Rs 4.80 per kWh and for dry season is Rs 8.40 per kWh with 3% escalation for 5 years.

Shortage of power in the country

As per the statistics presented in report published by Ministry of Energy Nepal on July 2018, the current peak electricity demand is about 1300MW. The total domestic installed capacity stands 1073 MW which includes 562 MW generated by NEA and 511 MW generated and supplied by private sector IPPs. To meet the current demand, NEA is importing upto 450 MW power from beside domestic generation.

Government support for the power sector

GoN considers hydropower generation as priority sector and tries to involve private sector participation in power generation by offering different incentives. The sector is exempted from income tax for first 10 years and 50 percent for additional 5 years to those which generate electricity within Mid-April 2024. Income tax will be levied only 20% despite that normal tax rate for entity in Nepal is 25%.

About the Company

HDHCL is Public Company, incorporated on July 03, 2008 as Himal Dolakha Hydropower Company Private Limited; later on it was changed to public limited company on November 13, 2017. HDHCL has two run of the river hydropower project under operation, which are 4.55 MW Mai Khola Small Hydropower Project (Project I) and 8MW Mai Small Cascade Hydropower Project (Project II), both are located at Ilam district of Nepal. The projects are constructed under BOOT (Build, Own, Operate and Transfer) mechanism. The COD of Project -I was achieved during February 2011. The power was connected to the National Grid at the NEA substation at Tilkeni, Ilam Bazar through 3.5 km long 33kV transmission line. Project- I was completed with total cost of Rs 725 Mn (Rs 161 Mn per MW) which was funded through Debt: Equity of 75.13: 24.87. Project –II achieved COD during April 2018. The power was connected to the NEA substation located at Godak (Ilam) through 3.5 km long 33kV transmission line. Project-II was completed with total cost of Rs 1425 Mn (Rs 178 Mn per MW) which was funded through Debt: Equity of 62.82: 37.18.

HDHCL has Rs 450 Mn paid up share capital and Rs 370 Mn advance share capital as on July 16, 2018. Mr. Birendra Bahadur Neupane (41.93%), Mr. Rupemani Raj Bhandari (28.46%) and Ms. Bhagawati Chaudhari (12.67%) are major shareholders of the company. Promoters and public holding will be 51.25:49.75 after issue of proposed initial public share.

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Annexure 1

CARE Ratings Nepal – IPO Grading Scale

CARE IPO grade	**Definition**
CARE-NP IPO Grade 1	Strong fundamentals
CARE-NP IPO Grade 2	Above average fundamentals
CARE-NP IPO Grade 3	Average fundamentals
CARE-NP IPO Grade 4	Below average fundamentals
CARE-NP IPO Grade 5	Poor fundamentals

Note:
Modifiers {"+" (plus)} can be used with the grading symbols 2, 3 and 4. The modifiers reflect the comparative standing within the category.