

Grading Rationale

Mountain Energy Nepal Limited

Grading

Particulars	Amount (Rs. In Million)	Grading	Grading Action
Initial Public Offering (IPO)	393.6054	CARE-NP IPO Grade 4+ [IPO Grade Four Plus]	Assigned

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

CRNL has assigned ‘CARE-NP IPO Grade 4+ [IPO Grade Four Plus]’ grading to the proposed Initial Public Offering (IPO) of Mountain Energy Nepal Limited (MENL). ‘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 use modifier {"+" (plus)} with the grading symbols 2, 3 and 4 and the same reflect comparative standing within the category. 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. MENL is proposed to come out with IPO of 3.936054 Million equity shares having face value of Rs.100 each at par aggregating Rs.393.6054 Million.

Detailed Rationale & Key Grading Drivers

The grading assigned to MENL is constrained by project implementation risk and stabilization risk associated with the project, operational project operated at low plant load factor (PLF), hydrology risk associated with run-of-the-river power generation and exposure to volatile interest rates. The grading, however, derives strength from experienced promoters and management team, track record in operating hydro power projects, power purchase agreement with sufficient period coverage and moderate counter party risk. The grading also factors in financial closure achieved for the project under construction, relatively low cost per megawatt (MW) of the under-construction project, shortage of power in the country ensuring offtake, government support for the power sector and major developments towards power evacuation.

Detailed Description of the Key Grading Drivers

Key Grading Weaknesses

Project implementation risk and stabilization risk associated with the under-construction project

The project is still under construction with revised RCOD of August 31, 2019 which is revised from initial RCOD of May 16, 2016. The main reason for the change in RCOD is delay in construction of transmission line. The construction works are going on a satisfactory level and the project is expected to be completed within RCOD. Though the delay in the project execution has led to extended RCOD,

the project is expected to be completed within the initial envisaged project cost of Rs. 5.64 Bn. The project is still in the implementation stage and continues to remain exposed to the residual risks associated with project implementation and satisfactory operations thereafter. The risk related to construction remains crucial given that the plant is being executed in the hilly region where the uncertain geology and adverse climatic conditions of the area leads to high project implementation risks and plays a major part in the timely completion of the planned activities.

Current project operated at low PLF

The annual contracted plant load factor (PLF) of the Tadi Khola Hydroelectric Project (TKHEP) is 74.32% of the installed capacity of the plant. The project has been operating at low PLF over the period ended July 16, 2018. During FY18 (refers to 12 month period ended mid-July 2018), the PLF from the project was low at 57.36% which declined from PLF of 59.14% during FY17. The power generation from the project as a percentage of the contracted power was 77.18% in FY18 (79.57% in FY17). Operating PLF was lower than contracted energy PLF on annual basis due to hydrology issues, as a result there was short supply penalty of Rs. 4.45 Mn during FY18 as well as revenue losses.

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

Run-of-the-river power is considered to be unsteady 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. It, thus, generates much more power during times when seasonal river flows are high and much less during the drier months. MENL is generating electricity from discharge of Tadi River at TKHEP and proposed to utilize discharge from Mistri River at Mistri Khola Hydroelectric Project (MKHEP), which are snow fed streams, comprising of mountainous terrain. Hence, the project is exposed to risk associated with variation in discharge of water from the aforesaid rivers.

Exposure to volatile interest rates

Nepalese banking sector fixes interest rates on lending, based on quarterly published base rate by the banks. Due to tight liquidity in the market, the interest rate has been high and volatile during the last 12 months. Therefore, funding from Banks and Financial Institutions are exposed to volatile interest rate.

Key Grading Strengths

Experienced promoter and management team

MENL has 5 Board of Directors, chaired by Mr. Suhrid Raj Ghimire, a leading Nepali businessman heading Continental Group with business interest in automobile trading, capital goods, energy and construction, with over 30 years of experience in running business entities. Mr. Shyam Sundar Khetan is the managing director of the company, who hold 4.84% of the total share capital, he is the chairman of Suryodaya Polymers Pvt. Ltd. and is engaged in business of real estate development. Mr. Min

Bahadur Gurung with 5.21% shares is the largest shareholder of MENL, is the Chairman/ Managing Director of Bhat-Bhateni Group, the largest retail chain of supermarkets in Nepal. The other Directors of the company are Mr. Chandra Prasad Dhakal (Chairman of Global IME Bank Ltd., Executive Chairman of IME Group of Companies), Mr. Dol Raj Sharma (chairman of City Express Investment Fund and vice chairman of City Express Money Transfer Private Limited) and Mr. Manohar Das Mool (chairman of Lumbini General Insurance Company Limited and Alliance Pharmaceuticals Pvt. Ltd.). Mr. Damodar Shrestha is the Senior Executive Engineer of the company having more than 2 decades of experience at Nepal Electricity Authority and involved in the study of more than 50 Hydropower Projects in Nepal.

Track record in operating hydro power project- TKHEP

MENL is already operating a 5 MW TKHEP located at Nuwakot district of Nepal. The project is in operation since March 2013. TKHEP had generated Rs.152 Mn revenues through sales of energy and reported Rs.44 Mn PAT and Rs.64 Mn gross cash accruals during FY18.

Power purchase agreement with sufficient period coverage

The company (through former Aadhi Shakti Bidhyut Bikash Company Limited (ASBL) and Robust Energy Limited (REL)) had entered into PPA with NEA as on March 28, 2005 and February 3, 2011 for the sale of power generated from TKHEP and MKHEP respectively. PPAs are signed for a period of 30 years from the date of COD or till validity of Generation License (obtained on November 22, 2011 for TKHEP and on November 6, 2011 for MKHEP for 35 years), whichever is earlier. TKHEP has two set of tariff rate. Tariff rate for initial annual contracted energy (i.e. 7.86 GWh) is Rs. 3.90 per kWh and Rs. 5.52 per kWh for wet and dry seasons respectively with no escalation. Similarly, tariff rate for additional annual contracted energy (i.e. 24.78 GWh) is Rs. 4.80 per kWh and Rs. 8.40 per kWh for wet and dry season respectively with 3% annual escalation on base tariff rate for 5 years. As per government's initiative of promoting private sector hydropower developers, TKHEP has been availing promotional tariff rates of Rs. 4.80 per kWh and Rs. 8.40 per kWh in wet and dry seasons respectively for initial contracted energy, upto 7 years from Commercial operation date (COD) with 3% annual escalation till mid April 2020. Tariff for MKHEP is Rs. 5.40 per kWh (from the original RCOD) with 3% escalation on base tariff for next 10 years at the contracted PLF of 65.20%.

Moderate counter party risk and prompt bills realization from the NEA

The company is exposed to counter party payment risk pertaining to NEA, which has been making losses in past till FY 2016 and carry huge accumulated loss in its book. However, during FY18, NEA earned profit of Rs 1,010.21 Mn and achieved gross cash accrual of Rs 5,141.8 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. The company has been issuing separate bill for PPA based revenue and promotional tariff based revenue. During FY18 and Q1FY19, the company received payments for PPA based revenue from NEA within 45 days. However, the company is not receiving payment for promotional tariff based revenue on time due to technical issues.

Financial closure achieved for the project cost and relatively low cost per MW

MKHEP was appraised by consortium of banks and the financial closure of the project was achieved on May 19, 2013. The envisaged cost of the project was Rs.5.64 Bn, which is to be financed in a debt-equity mix of 75:25. MKHEP is proposed to be completed within Rs. 134 Mn per MW, which is relatively low as compared to other operational and under-construction HEP. The company has incurred an amount of Rs.2,801 Mn till December 15, 2018 with an equity component of Rs.1,079 Mn and debt component of Rs.1624 Mn towards MKHEP, which shows financial progress of ~50% of total project cost. The promoters had already infused their portion of 80% of the total equity towards the project cost and the balance equity of Rs.393.61 Mn will be infused through the proposed IPO.

Shortage of power in the country

As per the statistics presented in report published by Ministry of Energy Nepal on May 2018, the current peak electricity demand is about 1300 MW. 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 India beside domestic generation.

Government support for the power sector

Government of Nepal (GoN) considers hydropower generation as priority sector and tries to involve private sector participation in power generation by offering different incentives. The sector is exempt 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%. Furthermore, GoN has declared to provide grant of amount equivalent to Rs. 5 Mn per MW installed capacity after the formal COD of the power plant.

Major developments towards Power Evacuation

Power evacuation will be through 4 kms 132kV long transmission line to be built by the company to the delivery point at Dana substation (NEA's proposed substation). The power will be evacuated through Dana-Kushma-New Butwal (DKB) transmission line. From the MENL side, the excavation for the towers for transmission line is in progress. Further, Dana-Kushma transmission line construction works are in progress under the scope of NEA and the same is expected to be completed before RCOD.

For Kushma-New Butwal transmission line the works are yet to be started. NEA and the company entered into an agreement mentioning that until the completion of DKB transmission line, the power generated by MKHEP will be evacuated through Dana-Kushma-Pokhara transmission line, with agreed energy of ~68% from Mid April to Mid October and 100% for remaining months of the contracted energy.

About the Company

Mountain Energy Nepal Limited (MENL) is a public limited company promoted by business persons having long experience in the hydropower and other sectors for setting up Hydroelectric Project in the territory of Nepal. MENL had two subsidiaries companies namely ASBL (53.71% holding of MENL as on July 16, 2018) and REL (74.40% holding of MENL as on July 16, 2018). ASBL was involved in the operation of 5MW run-of-the-river TKHEP at Tadi Rural Municipality, Nuwakot District. REL was involved in the construction of 42MW MKHEP. MENL acquired ASBL and REL via special resolution adopted at the Annual General Meeting of all three companies held on January 05, 2017. Promoter group will hold 80% and public will hold 20% of total shareholding of the company after issuance of the proposed IPO.

The projects are operated/ constructed under BOOT (Build, own, Operate and Transfer) mechanism. As per the Generation License, from Government of Nepal – Ministry of Energy, the project shall be handed, on whatever conditions the project is, to the Government of Nepal after expiry of Generation License.

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Annexure 1

CARE Ratings Nepal Limited – 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.