

Grading Rationale

Madhya Bhotekoshi Jalavidyut Company Limited

Grading

Facility/ Instrument	Amount (Rs. In Million)	Grading	Grading Action
Initial Public Offering (IPO)	1500	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]’ to the proposed Initial Public Offering (IPO) of Madhya Bhotekoshi Jalavidyut Company Limited (MBJCL). ‘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. MBJCL is proposed to issue 15 Million equity shares having face value of Rs.100 each at par aggregating Rs.1500 Million representing 25% of total capital reserved for project affected locals (10%) and general public (15%).

Detailed Rationale & Key Grading Drivers

The grading assigned to MBJCL is constrained by project implementation risk - delay in execution of project and cost overrun, decrease in project life leads to low return from project, exposure to fluctuation in the foreign currency exchange rates for the unhedged contractual liabilities, financial closure not achieved for revised project cost, exposure to volatile interest rates, power evacuation risk and exposure to regulatory risk. The grading also factors in hydrology risk associated with run-of-the-river projects. The grading, however, derives strength from strong promoter group and management expertise in operating hydro power projects, power purchase agreement (PPA) with sufficient period coverage, moderate counter party risk, fixed priced civil & hydro-mechanical, electromechanical and transmission line contracts, shortage of power in the country and government support for the power sector.

Detailed Description of the Key Grading Drivers

Key Grading Weaknesses

Project implementation risk - delay in execution of project and cost overrun

The project is still under construction with expected commercial operation date (COD) in December 31, 2020 revised from earlier proposed COD of June 30, 2019. The project execution was delayed initially due to delay in land acquisition required for the project and then due to different natural calamities like Jure landslide of 2014,

Earthquake of 2015 and Bhotekoshi flood of 2016 and also due to border blockade during September 2015. Similarly, civil works at plant site was halted for considerable period of time for various reasons. Delay in the project execution due to various reasons, continuous devaluation of Nepalese Currency as compared to USD and inflation led to cost overrun of the project for around Rs.2.75 Bn leading to Rs. 2.40 Bn financing gap from the original cost estimates. Till June 15, 2019, the company incurred Rs.7255 Mn towards the project which shows the financial progress of ~42% of the total project cost. 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. However, further delays in execution cannot be totally ruled out, 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. Timely completion of the project within the revised cost estimates and transmission of the power through appropriate infrastructure are the key grading sensitivities.

Decrease in project life leads to low return from project

As per initial PPA, Required Commercial Operation Date (RCOD) of the project was June 15, 2017, which has been amended to April 10, 2020 as per revised PPA. Further, RCOD will be proposed to be extended to December 31, 2020 as the management expects further delay in project execution. However, the PPA entered with Nepal Electricity Authority (NEA) is valid for 30 years from the COD or till the validity of generation license, whichever is earlier. Even though the project is expected to commercially operate within the date envisioned by the management, the project life will be decreased by around 2 years as the validity of generation license will expire in December 2048. Decrease in project life will result in significant loss of revenue from project.

Exposure to fluctuation in the foreign currency exchange rates for the unhedged contractual liabilities

From the various contracts entered in by MBJCL, the company is exposed to foreign exchange fluctuation risk to the extent of USD 89.88 Mn. Out of the total exposure, USD 35.61 Mn has been already paid on different dates & exchange rates till July 16, 2019 and balance USD 54.26 Mn is yet to be paid. MBJCL has not taken any measures to hedge itself from foreign currency payment. The project is exposed to risk associated with fluctuation in foreign currency exchange rates.

Hydrology risk associated with run-of-the-river projects

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. MBJCL is proposed to utilize discharge from Bhotekoshi river (main river in the Sapta Koshi basin of Nepal), which are snow fed streams, having catchment area of 2388 sq kms, comprising of mountainous terrain. Hence, the project is exposed to risk associated with variation in discharge of water from the aforesaid river. Further, MBJCL's operations are restricted to single plant which exposes it to risks arising out of single site nature of operations.

Financial closure not achieved for revised project cost and exposure to volatile interest rates

The project was appraised by Employees Provident Fund (EPF) and the financial closure for the initial project cost was done as on December 8, 2011. The initial project cost estimates of Rs.12.28 Bn (excluding interest during construction (IDC)) was proposed to be financed in a debt-equity mix of 1:1. Due to delay in project execution the project cost is revised to Rs.17.07 Bn (including IDC) which is proposed to be financed in a debt equity mix of 61:39. The project is proposed to be completed at the cost of Rs.167 Mn per MW, which is relatively low as compared to other under-construction hydroelectric project. The equity portion of the project is Rs.6.00 Bn as per the loan agreement and additional amount required in excess of tied up cost, if any, shall be arranged by the MBJCL and Chilime Hydropower Company Limited (CHCL). MBJCL has already infused Rs.4.50 Bn equity from promoters and IPO issue at phase I¹ towards the project execution. The additional amount of revised project cost is proposed to be financed through Bridge Gap Loan, which is currently not tied up. The funding of the project is exposed to volatile interest rate, as the interest rate on loan will be reviewed annually based on prevailing market interest rates.

Power evacuation risk

Power evacuation will be through 4 kms of transmission line of 220 kV to the delivery point at Barhabise transmission hub (NEA's under construction hub), to be built by MBJCL at their own cost (included in the project cost). MBJCL has awarded contract to joint venture of Urja International Pvt., Ltd., Nepal and Ashtavinayaka Construction, India (Urja-AC JV) for design, supply, construction, testing & commissioning of 220kV transmission line and the contractor has started tower design works and land acquisition process has been initiated. Barhabise transmission hub is expected to be completed by April 2020.

Exposure to regulatory risk

Government of Nepal (GoN) has recently established Nepal Electricity Regulatory Commission (NERC) for regulating generation, transmission and distribution of electricity in Nepal. NERC has issued a directive to take approval before public issuance of share capital. It poses a new challenge to hydropower companies which has to go through an additional approval process before it can issue shares to public. Hence, the hydropower companies planning for public issuance of share capital is exposed to risk associated with delay in approval process which may delay project funding and eventually delay the project.

Key Grading Strengths***Strong Promoter Group and management expertise in operating hydro power projects***

NEA and CHCL are major promoters of MBJCL. NEA is a Government of Nepal corporation established to generate, transmit and distribute power by planning, constructing, operating and maintaining all generation, transmission and distribution facilities in Nepal's power system. CHCL was incorporated in 1995 by NEA with an objective of hydroelectricity generation. NEA holds majority ownership in CHCL (51% shareholding) and remaining 49% shares is held by general public. CHCL owns and operates 22.1 MW power plant. CHCL through its subsidiaries MBJCL, Rasuwagadhi Hydropower Company Limited and Sanjen Jalavidhyut Company Limited is developing four hydropower projects with aggregate capacity of 270.3 MW.

¹MBJCL has issued and allotted Rs.1440 Mn equity shares to contributors of EPF (Rs.1170 Mn), employees of promoter entities (Rs.210 Mn) and employees of EPF (Rs.60 Mn) during IPO issue at Phase I.

MBJCL is managed under the overall guidance of the company's Board of Directors (BoD), mostly from NEA, who possesses wide experience in the Power sector. Mr. Hara Raj Neupane is the Chairman of the Company. Mr. Neupane is an employee of NEA from last 29 years and currently serving as Deputy Managing Director at NEA and Director in CHCL. The company is led by CEO Mr. Mani Kumar Kafle; who has more than 28 years of experience in NEA and is assisted by senior management team members with wide experience in their respective fields.

Power purchase agreement with sufficient period coverage

MBJCL had signed a long term power purchase agreement (PPA) with NEA as on November 14, 2011 for a period of 30 years from the date of COD or till validity of Generation License (which was obtained on 3rd December 2013 for 35 years), whichever is earlier. Tariff for wet season (Mid-April to Mid-December) is Rs. 4.80 per kWhr and for dry season (Mid-December to Mid-April) is Rs. 8.40 per kWhr with 3% escalation on base tariff for 8 years. The contracted Plant Load Factor (PLF) of 102 MW is 60.69%.

Moderate counter party risk

MBJCL is exposed to counter party payment risk pertaining to NEA, which has been making consecutive losses in past and carry huge accumulated loss in its book. However, as per the annual report published by NEA, during FY19 (prov., refers to the 12 months period ended July 16, 2019), NEA earned profit of Rs. 7,205 Mn (Rs 2,897 Mn during FY18). The counter party payment risk is moderated by the fact that, NEA is fully owned by GoN, net loss is declining over the period and NEA is generating positive gross cash accruals. Further, NEA has been making timely payment to independent power producer (IPPs) in past.

Fixed priced Civil & Hydromechanical, Electromechanical and Transmission Line Contracts

MBJCL has appointed Guangxi Hydroelectric Construction Bureau, China for Civil & Hydro-mechanical Works as on January 1, 2014. The works as per contract shall be completed within December 31, 2020 (revised completion date). Andritz Hydro Pvt. Ltd, India has been appointed for Electro-mechanical Works as on July 10, 2014. The works as per contract shall be completed within December 31, 2019 (revised completion date), however the same is proposed to be revised to December 31, 2020. Further, MJBCL has appointed joint venture of Urja-AC JV for design, supply, construction, testing & commissioning of 220kV transmission line as on July 27, 2018. These contracts are fixed priced contracts, therefore, mitigating the risk of any cost over runs in these contracts.

Shortage of power in the country

As per NEA's Annual Report for FY19, the current peak electricity demand is 1320 MW. The total domestic installed capacity stands 1178 MW which includes 617 MW owned by NEA and 561 MW by private sector IPPs. During FY19, overall energy demand was 7,584 GWh which was met by import of 2,813 GWh from India whereas balance was met by domestic generation. The gap of demand and supply is expected to be increased substantially in coming days.

Government support for the power sector

GoN considers hydropower generation as priority sector and intends to maximize private sector participation in generation of hydroelectricity by offering different exemptions and facilities. GoN has announced full tax exemption for first 10 years and 50% tax exemption for next 5 years to those who generate electricity within mid-

April 2024. Income tax will be levied only 20% despite the normal tax rate for entity in Nepal is 25%. Also, GoN has declared to provide grant of amount equivalent to Rs. 5 Mn per MW installed capacity after receiving evidence of formal COD of complete power plant.

About the Company

Madhya Bhotekoshi Jalavidyut Company Ltd. (MBJCL) is a public limited company incorporated on July 29, 2010. It is promoted by NEA (a GoN Corporation) and Chilime Hydropower Company Limited (CHCL, 51% subsidiary of NEA) for setting up 102 MW run-of-river, Middle Bhotekoshi Hydroelectric Project in Sindhupalchowk district of Nepal. The project include headrace tunnel and penstock pipe of 7125 meters and 730 meters respectively. The project is constructed under BOOT (Build, Own, Operate and Transfer) mechanism. As per the Generation License, from GoN – Ministry of Energy, dated December 3, 2013, the project shall be handed, on whatever conditions the project is, to the Government of Nepal after expiry of Generation Licence, which is 35 years. The paid up capital of the company is proposed to be Rs. 6.00 Bn which will be held by promoters and public in the ratio of 51:49.

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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.