EDISON

Spotlight - Initiation

OPG Power Ventures

Utilities

10 March 2021

Full power ahead

OPG has proved financially resilient through the COVID-19 driven economic slowdown, remaining healthily profitable and cash generative. As the Indian economy recovers (the OECD is forecasting 12.6% growth in 2021) demand for power will return. This should drive the recovery in sales and profits, in turn deleveraging the balance sheet, permitting a return to cash dividends and funding a strategy to develop renewables activities.

Thermal power plant generates cash

The group's 414MW coal fired thermal power plant is a fully operational and highly cash-generative asset (Q1–3 FY21 net cash generation of £34.5m). As OPG is an independent power producer (IPP), selling primarily to the local industrial captive consumers provides premium tariffs and reduced credit risk.

Renewables provide growth optionality

India is targeting 175GW of renewables capacity in 2022 (275GW by 2027) from 91GW in 2020. OPG has a stated strategy to develop 300MW of renewables in the medium term. Its only current asset is a 31% holding in 62MW solar scheme. With competitive public tenders we expect OPG to use a group captive model or develop additional capabilities with third parties looking to enter the Indian market.

Recent trading: Resilient H1 and encouraging Q3

H121 sales declined 54% due to lower power demand. Reported operating profit increased to £16.2m, assisted by £9.6m of historical contractual claims. The highlight of the Q3 update was a plant load factor (PLF) of 71% in December versus 54% in the first nine months, almost back to the 75% in FY2020 prior to the pandemic and, with net debt at £18.9m (from £53.4m at the start of the year), a plan for 'resuming dividends' based on 2021 financial results.

Valuation: Cash-generation attraction

Using the rating of listed Indian peers suggests a target price of 42p a share. The range is 62p using EV/MW of capacity to 21p on a P/E basis. The differences mainly reflect downtime required to install new environmental equipment and timing differences on tax. These should reverse from 2023 permitting profits to return to growth. Management has indicated a cash dividend in 2021. Consensus does not yet have a pay-out for 2022 although forecast results would suggest further cash generation and deleveraging which would support further cash dividends.

Consensus estimates

Year end	Revenue (£m)	EBIT (£m)	PBT (£m)	EPS (p)	DPS (p)	P/E (x)	Yield (%)
03/19	140.6	29.2	16.8	3.81	0.0	4.7	N/A
03/20	154.0	24.0	14.5	2.11	0.0	8.4	N/A
03/21e	93.6	26.4	18.9	3.40	1.1	5.2	6.2
03/22e	112.2	18.9	13.4	1.80	0.0	9.9	N/A

Source: OPG Power Ventures, Refinitiv (one provider)

Price	17.75p
Market cap	£71m

Share price graph

Share details

Code	OPG.L
Listing	AIM
Shares in issue	400.7m
Last reported net debt at 31 December	£18.9m

Business description

OPG is an independent power producer based in Chennai, India. Its key asset is a 414MW coal-fired thermal power plant in Chennai and it also has 62MW sole assets in Karnataka. The majority of power (c 80%) is sold to independent commercial captive consumers permitting preferential tariffs, improved payment terms and reduced concentration of risk with over 200 individual captive consumers.

Bull

- Strong cash-flow generation from a mature asset base (no development risk) and rapidly deleveraging balance sheet.
- Exposure to the high-growth Indian economy.
- Opportunities from nascent renewables business.

Bear

- Coal price volatility against fixed price tariffs affects margins (negatively and positively).
- Environmental legislation likely to require additional capex at the Chennai plant.
- Recent low solar tariff bid levels impact the returns available from new investment.

Analysts

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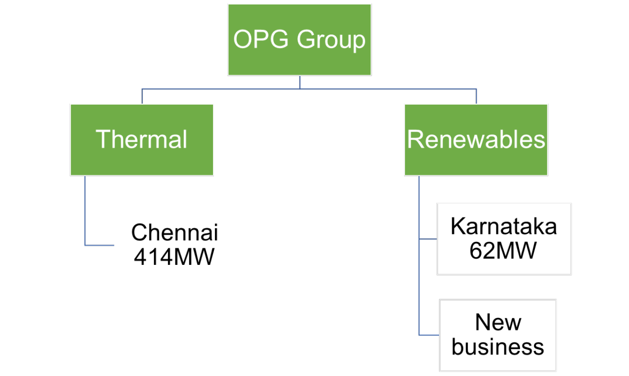
Edison profile page

Company description: Indian independent power producer

Overview

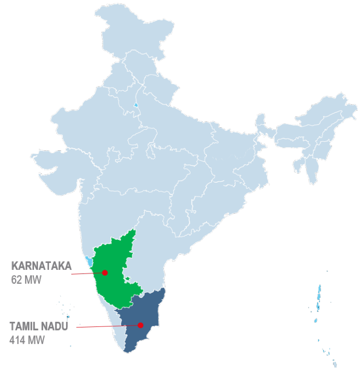
OPG is headquartered in Chennai in the state of Tamil Nadu where its main operating asset, a 414MW coal fired thermal power plant is located. The second arm of the business is a smaller renewables operation with a solar farm in Karnataka. Renewables is the area where future growth plans are being directed.

Exhibit 1: OPG's operational structure



Source: Company information

Exhibit 2: OPG's main operations



Source: Company information

Thermal: Chennai coal-fired power plant

OPG operates a 'group captive model'. India historically suffered from a significant power supply shortage leading to significant outage issues. This was particularly disruptive for industrial consumers. As part of the solution the government deregulated the electricity sector in 2003, permitting independent companies to set up power plants to sell directly to industrial consumers rather than to the state (which was still obliged to provide the transmission infrastructure). The industrial customers were required to take at least 51% of the output and have an equity stake in the projects. This formed the basis of the group captive model, of which OPG was an early pioneer.

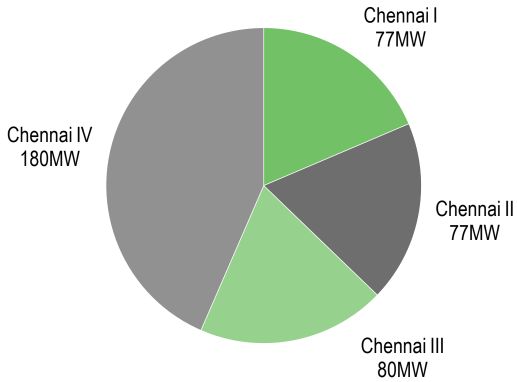
OPG has built 414MW of coal-fired capacity at Chennai in the state of Tamil Nadu. It consists of four separate units, details in Exhibit 3.

The strategy is to be 'coal agnostic'. Chennai is far from the domestic Indian coalfields in the north and attaining access to these resources can be problematic for many developers, especially those wanting to sell power outside the local grid companies. Hence the location close to the Ennore port of Chennai, and investment in boilers which can run on a range of coal (eg high sulphur content, high water content) permitting imported or domestic coal to be used. The plant has tended to be run largely on imported Indonesian coal.

The plant runs predominantly on a group captive model, selling to local industrial captive consumers. Tariffs are higher and payment terms preferable. In return, captive consumers receive guarantee of supply. Over 200 captive consumers and a broad industrial base reduces the risk profile. In addition, one of the four units is under a 'take-or-pay' agreement with the local utility, TANGEDCO, until 2029. Exhibit 4 details end captive consumer off-take by sector.

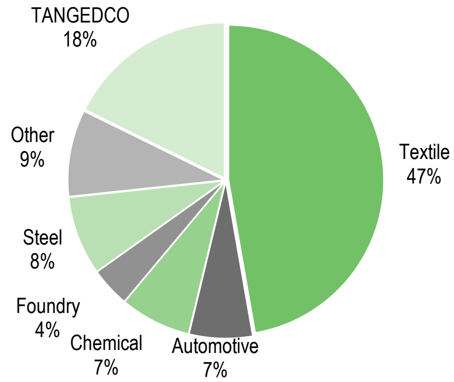
Environmental pressures are increasing in India, with coal-fired power plants under particular pressure. To meet regulations, management expects to invest up to £15m over the next two years (FY21 and FY22) on exhaust gas treatment such as flue-gas desulphurisation units. We note that the largest boiler is already compliant while the other three will need to be offline for around two months each during installation. Water is another growing issue. However, OPG's plant uses air rather than water for cooling. This reduces water usage by over 90%, which should help mitigate negating any potential environmental issues.

Exhibit 3: Chennai plant details



Source: Company Information

Exhibit 4: OPG exposure by sector



Source: Company information

Renewables

Solar operations: Karnataka 62MW

The group has a 31% stake in 62MW of solar assets in Karnataka which was commissioned in 2018. The operations are split over four sites (3x 20MW and 1x2MW). Sales are to the local state distribution company with a tariff of 5.0R/kWh lasting 25 years making this a standalone attractive project. The business is held within its own special-purpose vehicle including debt instruments. OPG has rights under the construction agreement and OPG capex funding to increase its share of ownership to 61%. The assets and liabilities are classified as 'held for sale' on the balance sheet as OPG has been looking at realising the value created in this project. However, given the current state of the marketplace and management's increased focus on renewables, this process is currently under review.

The group has a stated strategy to establish up to 300MW of renewables capacity over the next three years. However, recent bidding has seen tariffs of around 2.5R/kWh. Despite the reduction in the cost and improved performance of solar panels, this affects returns and management is cognisant of the requirement to earn above OPG's cost of capital. As a consequence, the company is exploring other options such as the captive model or third-party bilateral sales to set up new capacities as opposed to the traditional bidding route in order to attain preferential tariffs.

Additional activities

Management is looking at developing partnering with overseas companies looking to establish a presence in the Indian renewables sector. India plans to add c 170GW of renewable capacity over the next seven years against the current capacity of 90GW (Source: Central Energy Authority of India). This is broadly similar to the global investment in renewables of 176GW in 2019 according to the International Renewable Energy Agency. In addition, corporates are under pressure from investors and customers to reduce their carbon footprint. OPG has proven experience in the power sector, of working with corporates (as shown by its captive model) and the scrutiny of a London listing. This should all assist in gaining trust and opportunities with companies looking to expand into the Indian market. Further clarity can be expected as and when agreements are announced.

Market overview

Key drivers for OPG's end markets are the overall power market in India, the growing renewables segment and the continuation of thermal power.

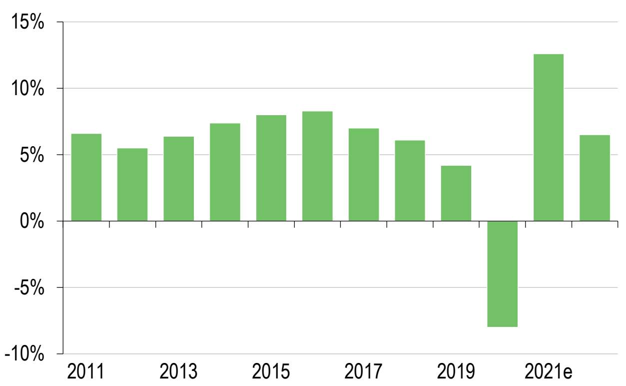
Indian power market

The Indian power market was historically centrally controlled through regions and state, which also run the local distribution companies. While theoretically opened up to the private sector in the 1990s, it was not until The Electricity Act of 2003 that regulatory barriers were removed, and the private sector began to invest.

The growth in demand for energy is driven by GDP growth and rising living standards which increase the consumption per head. India has been severely affected by COVID-19 but the economy is expected to bounce back strongly over the next few years with the IMF forecasting growth of 11.5% in 2021 and 6.8% in 2022 (Exhibit 5). The second key driver is electricity consumption per head which in India remains at a third of world levels and at only 30% of Chinese levels (Exhibit 6). As the country industrialises, middle classes grow and rural economies are connected to the grid so consumption per capita will grow. Overall power demand is expected to continue to grow at c 6% CAGR to 2027 according to the Central Electricity Authority (CEA).

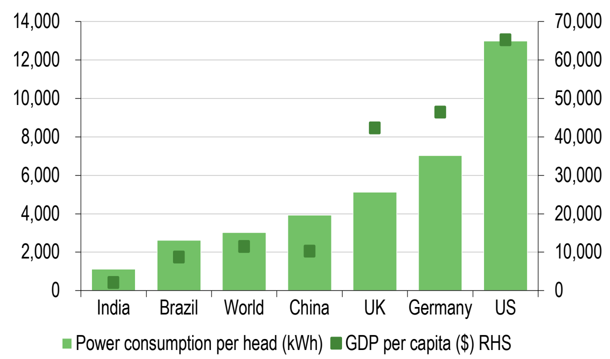
While the overall picture is important it is worth noting that OPG has capacity of 0.4GW versus total capacity in Tamil Nadu state, where it operates, of 32GW. Hence what is important for OPG is that its commercial captive consumers continue to purchase power from IPPs rather than the state grid. Guarantee of supply and historic relationships support this.

Exhibit 5: India GDP growth (%)



Source: Refinitiv, OECD

Exhibit 6: Power consumption and GDP per capita



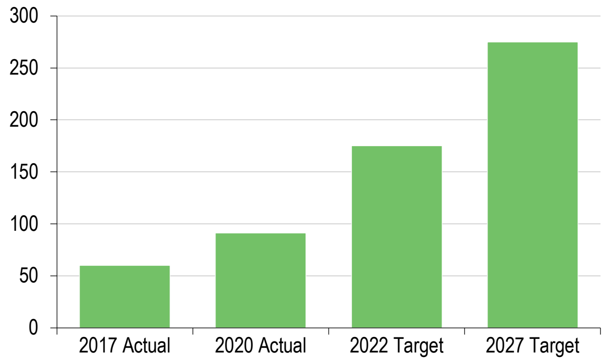
Source: World Bank

Renewables

India is a signatory to the Paris Agreement. India has pledged that, by 2030, the non-fossil fuel share of its power generation capacity will reach 40% and that emissions intensity to GDP will be 33–35% below 2005 levels. The government is also committing a COP21 agreement for renewables to make up 32% of capacity by 2024.

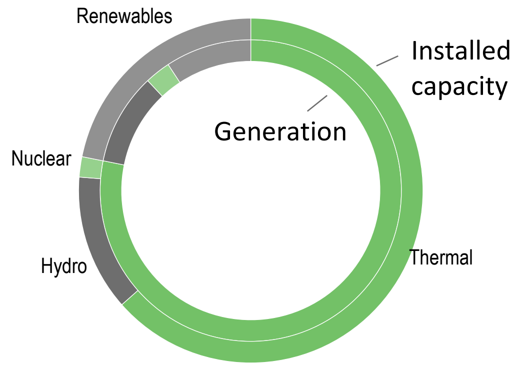
Electricity is planned in five-year cycles. The National Electricity Plan (NEP 13) targets renewables capacity to increase from 60GW in 2017 to 175GW in 2022, see Exhibit 7. Note, 2020 capacity had increased to 91GW. Although this would increase renewables from 18% of installed capacity to 36%, the lower load factors mean that the proportion of electricity generated from renewables will be significantly lower with coal still expected to be the dominant power source. Exhibit 8 shows 2019 figures with renewables accounting for 22% of installed capacity but less than 10% of power generated.

Exhibit 7: Renewables capacity expectations



Source: CEA

Exhibit 8: Generation versus installed capacity (2019)

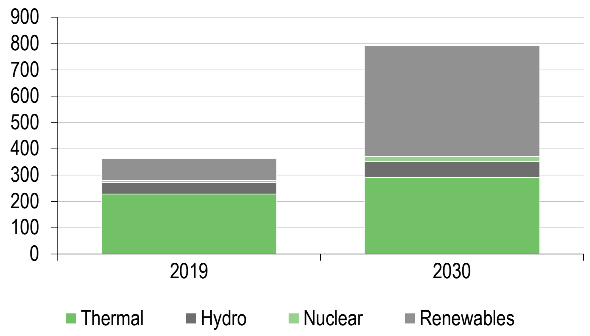


Source: CEA

Thermal

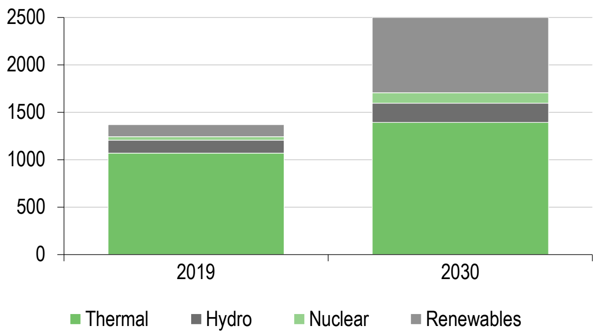
Thermal power generation is currently the dominant power source in India (2019 63% of installed capacity and 76% of power generated). The growth of the Indian economy and the requirement for alternative power sources to enable the grid to balance the renewables segment ensure that thermal will remain the most important source of power generation or some time to come. A recent report by the CEA 'Optimal generation capacity mix for 2029/30' suggests that thermal will still account for 56% of power generated in 2030 and that installed thermal capacity will actually have to increase by 28% over the decade. This suggests that despite environmental concerns (which thermal power plants are addressing through emissions treatment, carbon capture etc) the fundamentals for thermal power in India remain positive.

Exhibit 9: Installed capacity by type



Source: CEA

Exhibit 10: Power generation by source type



Source: CEA

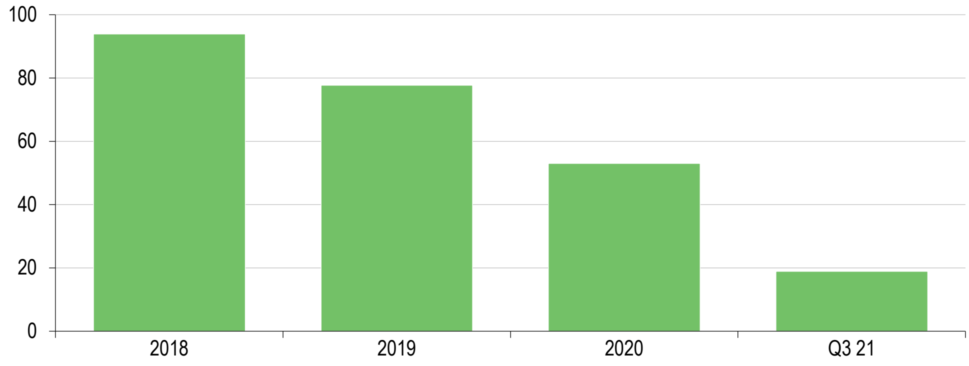
Strategy

Management has two key elements to its strategy with an overall goal of maximising cash returns from its existing portfolio of operations while also building a renewables side to the business.

Generate cash to pay down debt and return cash through dividends

As a well-established power business providing relatively stable operations the business is highly cash generative, even in the current year when affected by the COVID-19 driven economic downturn in demand and lower load factors. The company's plan is to continue to pay back debt which is relatively expensive in India (note the recent £21.1m three-year bond issue with a 9.85% coupon) and pay cash dividends to shareholders. At the recent nine-month trading update the chairman commented that the company expects to meet the market expectations for its FY21 results and to provide returns to shareholders by resuming dividends based on FY21 results.

Exhibit 11: Group net debt (£m)



Source: Company information

Build a renewables business

We are awaiting details on how management intends to expand this business. Any new assets are likely to be held within a special purpose vehicle with its own debt structure limiting capital required from the group. Additional services are likely to be in conjunction with third parties and capital light, again limiting investment requirements.

Financials

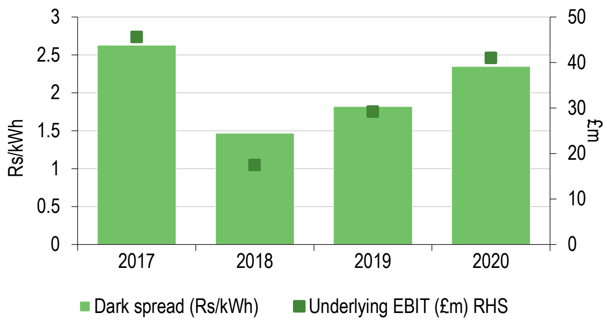
Operating characteristics

Key to OPG's operating performance are the dark spread and PLF. The dark spread is the margin over coal cost measured per kWh of power generated, which is the key variable accounting for around two thirds of the operating costs. The company's commercial captive consumers tend to be on three-year fixed price contracts exposing the group to the vagaries of the coal price. The primary source of coal is Indonesia where prices can be volatile, see Exhibit 12. Exhibit 13 highlights this factor showing dark spread and underlying group EBIT (Note: adjusted for credit loss on receivables in 2020).

Exhibit 12: Indonesian coal price ($/T)

Source: Refinitiv

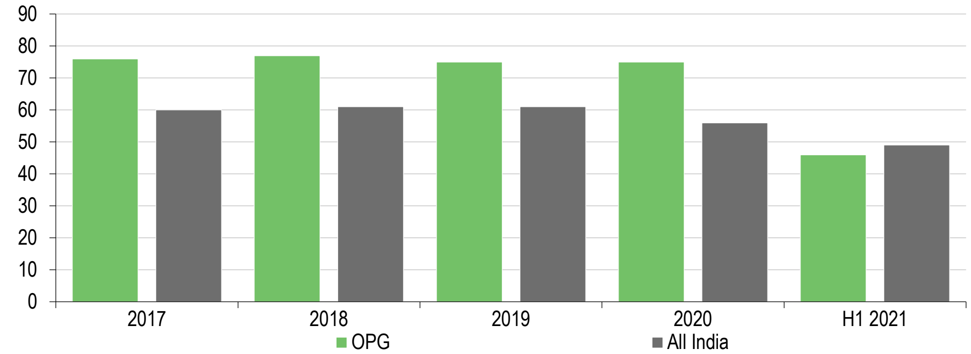
Exhibit 13: Dark spread and group EBIT



Source: Company information

PLF provides the second key operational measure for the plant, determining the level of output and also efficiency given the operational gearing from a relatively fixed cost base. Exhibit 14 shows OPG's PLF record relative to all India coal-fired plants. Note that with annual maintenance downtime and auxiliary requirements, load factors are unlikely to surpass the mid 80%.

Exhibit 14: Plant load factor (%)



Source: Company information, CEA

H121 results

The first half results to September 2020 were resilient in the face of lower volumes due to the impact of COVID-19. Total units generated of 831m kWh in H121 versus 1,440m kWh in H120, a 43% reduction, and PLF of 46% versus 79%. Tariffs were broadly flat at R5.60 versus R5.66, the slight decline due to a COVID-19, leading to a 54% decline in revenues. In these circumstances the financial performance was encouraging, with PBT of £12.8m up 30%, benefiting from £9.6m of historical contractual claims. Adjusted for this one-off contribution payment, profits would have been £6.9m versus £14.4m, still a healthy margin at 19.4% versus 18.3% in H120. Reported EPS of 2.92p was up 48% y-o-y. Another highlight was the reduction in debt of £18.1m taking net debt to £34.9m.

Q321 trading update

For the nine months to 31 December 2020, total generation of 1.47bn units (-30%) and PLF at Chennai was 54% versus 77% for nine months FY20. Encouragingly for the month of December 2020, PLF was 71%. The average tariff was R5.52 versus R5.67. Net debt reduced to £18.9m (versus £53.4m at 31 March 2020 and £34.9m at 30 September 2020). In addition, management expects to meet current market expectations for the current financial year to March 2021.

Financials: P&L

Exhibit 15 provides a summary of recent results and consensus forecasts.

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Exhibit 15: Financial summary

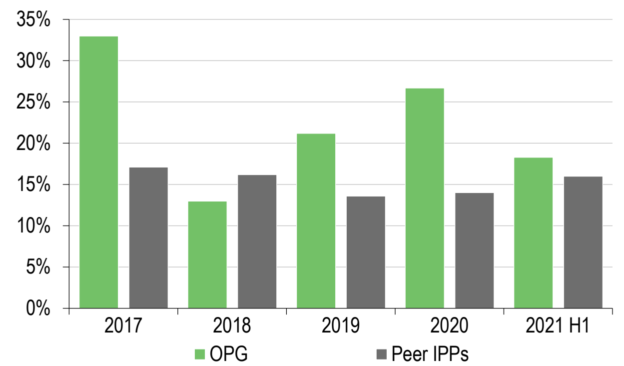
£m	2018	2019	2020	2021e	2022e
Year end 31 March	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT					
Revenue	140.1	140.6	154.0	93.6	112.2
Cost of Sales	(100.2)	(91.7)	(90.0)	(58.7)	(75.8)
Gross Profit	39.9	48.9	64.0	34.9	36.4
EBITDA	24.7	35.3	31.2	33.0	24.7
Normalised operating profit	18.2	29.2	24.0	26.4	18.9
Exceptionals	(4.0)	0.0	0.0	0.0	0.0
Reported operating profit	14.2	29.2	24.0	26.4	18.9
Net Interest	(12.0)	(12.4)	(9.5)	(7.5)	(5.5)
Exceptionals	4.0	0.0	0.0	0.0	0.0
Profit Before Tax (norm)	6.2	16.8	14.5	18.9	13.4
Profit Before Tax (reported)	2.2	16.8	14.5	18.9	13.4
Reported tax	(3.1)	(1.8)	(4.3)	(6.6)	(6.2)
Profit After Tax (norm)	3.1	15.0	10.2	13.2	7.2
Profit After Tax (reported)	(0.9)	15.0	10.2	12.3	7.2
Minority interests	13.7	0.0	0.0	0.0	0.0
Discontinued operations	(100.0)	(1.0)	(2.1)	0.0	0.0
Net income (normalised)	(0.9)	12.0	10.2	13.2	7.2
Net income (reported)	(87.2)	14.0	8.0	12.3	7.2
Basic average number of shares outstanding (m)		353	368	393	401
EPS - basic normalised (p)	0.89	4.09	2.59	3.40	1.80
EPS - diluted normalised (p)	0.89	4.09	2.59	3.40	1.80
EPS - basic reported (p)	(24.68)	3.81	2.11	3.40	1.80
Cash dividend (p)	0.0	0.0	0.0	1.1	0.0
Scrip dividend equivalent (p)	1.0	0.6	0.0	0.0	0.0
Revenue growth (%)	3.0	0.4	9.5	(39.2)	19.9
Gross Margin (%)	28.5	34.8	41.6	37.3	32.4
EBITDA Margin (%)	17.6	25.1	19.7	35.3	22.0
Normalised Operating Margin	13.0	20.8	15.6	28.2	16.8
BALANCE SHEET					
Closing net debt/(cash)	81.9	71.9	53.4	25.1	24.1

Source: Company information, Refinitiv based on one contributor

The group paid a cash dividend of 0.98p in 2017 and a scrip dividend in 2018 and 2019.

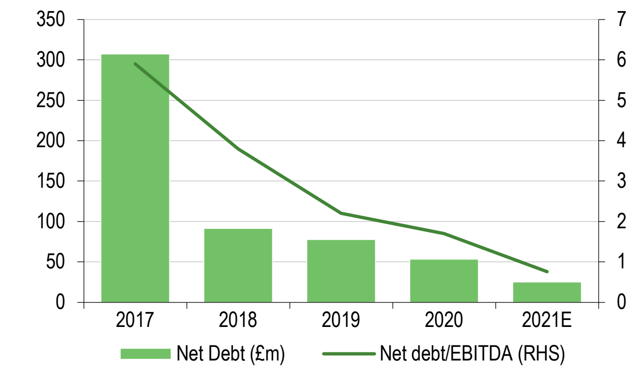
Note that in FY20 the company reported 'expected trade credit losses' of £17.0m while in the first half of FY21 OPG reported 'historical contract claims' of £9.6m which is also in the consensus forecasts for the full year. While these are part of the normal course of business and therefore not classified as exceptionals, they are highly unusual and distort the underlying performance. Exhibit 16 shows the operating margin for the group excluding these large one-offs. While there has been some inevitable volatility, they have averaged over 20%. The chart also shows the average operating margin for their core peer group of private power companies. Exhibit 17 highlights the financial position of the group. Note the capital expense of power plants tends to lead to significant levels of debt funding.

Exhibit 16: Underlying operating margin



Source: Edison Investment Research

Exhibit 17: Debt position and EBITDA cover



Source: Edison Investment Research

Management, organisation and corporate governance

Supervisory board and management board

The management structure reflects the continued influence of the founding Gupta family.

- Chairman. Arvin Gupta's early experience was with Kanishk Steel where he became president. He established the Captive Power model and commissioned the first power project as OPG, an 18MW gas plant, in 2004. He was subsequently responsible for OPG's plant development and strategy. Arvin Gupta moved from CEO to chairman in 2016.
- CFO. Dmitri Tsvetkov was appointed CFO in 2017.November His previous experience includes Advance International Exploration, interim CEO and CFO of Mart Resources and chief financial controller of Heritage Oil.
- COO. Avantika Gupta joined OPG in 2010 as legal counsel. She was subsequently responsible for the development of a 300MW plant in Gujarat and became COO in 2018.
- Non-executive deputy chairman. Jeremy Warner Allen's previous experience includes being the head of the growth companies' team at Cenkos Securities and a non-executive director of TP Group.
- Non-executive director. Mr N Kumar is vice chairman of The Sanmar Group, a diversified industrials group based in Chennai.
- Non-executive director. Mike Grasby, an experienced executive in the power sector, was reappointed to the board in February 2021 having been a non-executive director from 2008–2019.

Shareholders and free float

Exhibit 18 shows OPG's major shareholders. Key is the Gupta family, the original founders of the business, who retain a controlling stake in the group.

Exhibit 18: Major shareholders

	%
Gupta family	51.7
M&G	13.0
British Steel	3.6
Premier Miton	2.9
AJ Bell	2.7
Hargreaves Lansdown	2.5
Interactive Investors	2.4
Prana	2.3
Close Brothers	2.1
Armstrong Inv	1.5

Source: Company information

Valuation

Peer group valuation

OPG is the only Indian power company listed in London. Exhibit 19 shows Indian listed peers operating similar independent power models, we have excluded the listed state-run companies. We note that the key Indian listed companies are somewhat larger in scale than OPG and part of a clear utilities sector. This would suggest greater understanding by the investment community.

Exhibit 19: Indian independent power company peer valuations (based on FY22 consensus)

	Market Cap (£m)	Capacity (MW)	EV/MW	EV/Sales	EV/EBITDA	EV/EBIT	PE
OPG	76	414	0.24	0.9	4.1	5.3	10.6
Tata Power	2907	12972	0.56	2.1	9.1	12.5	14.9
Adani	2198	12450	0.58	2.6	7.0	10.0	12.5
CESC	826	1225	1.52	1.6	5.7	7.6	6.1
JSW	1232	4559	0.43	2.3	6.6	10.1	12.7
Torrent	1579	3092	0.77	1.6	6.3	9.5	11.5
Gujaret Power	116	1086	0.11				
Average			0.66	2.0	6.9	9.9	11.5

Source: Refinitiv, Edison Investment Research

Exhibit 20 uses 2022 consensus-based valuations and forecasts for OPG to provide a peer-based valuation matrix. The table suggests an average valuation of 42p a share based on the five valuation metrics, but also a relatively wide range from 21p to 62p. We see two primary reasons for this.

Firstly, the company is undertaking environmental upgrade works through the year. These require the individual plants to be off-line for around two months reducing the total power production and revenue expectations hence the lower rating on EV/Sales. Associated negative operational gearing will impact profitability hence the further impact on EV/EBITDA and EV/EBIT valuations.

Secondly, the group's current tax rate is relatively high reflecting timing variances with consensus suggesting 46% rate in the P&L for FY22 whereas MAT (minimum alternative tax) in India is 17% and determines the cash tax payable. These differences should reverse over time but at present are negatively impacting the earning and hence the P/E valuation is further depressed.

The first of these factors should unwind in FY23 as the company completes the upgrade although the tax element can be expected to have a longer time frame.

Exhibit 20: OPG value using peer multiples and consensus FY22 estimates

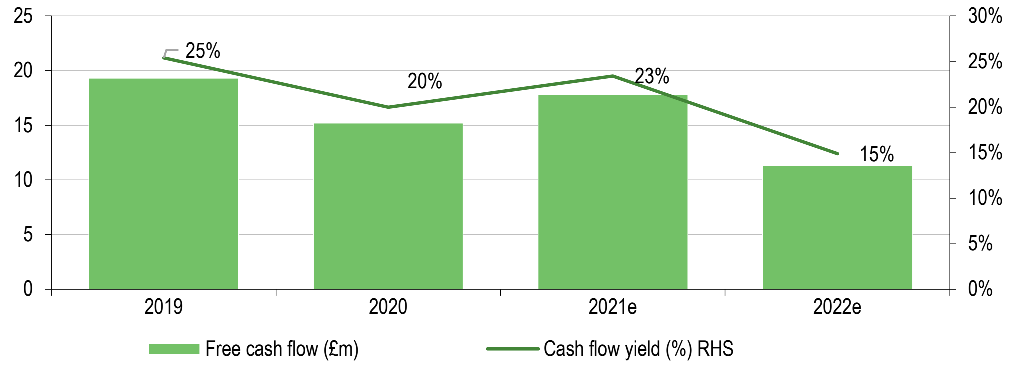
Measure	Peer multiple (x)		OPG measure	Implied EV (£m)	Implied value per share (p)
EV/MW	0.7	MW	414	274	62.2
EV/Sales	2.0	Sales	112	228	50.8
EV/EBITDA	6.9	EBITDA	24.7	171	36.6
EV/EBIT	9.9	EBIT	18.9	188	40.7
PE	11.5	EPS	1.8		20.8
Average					42.2

Source: Refinitiv, Edison Investment Research

Cash flow generation potential

OPG's plants are fully commissioned. Hence cash generation reflects the potential of the asset base. Exhibit 21 looks at free cash generation (EBITDA less interest, tax and estimated maintenance capex). This suggests a cash flow yield of c 23% in FY21e, or c 11% excluding the contractual claims benefit, and 15% in FY22e despite the COVID-19 affected consensus numbers. Note that this excludes environmental capex which could reduce cashflow by as much as £15m over a two-year-period.

Exhibit 21: Free cash flow



Source: Edison Investment Research, Refinitiv consensus

Sensitivities

The key asset for the group at present is the Chennai coal-fired power plants. As a consequence, the key sensitivities, particularly for financial performance, surround the fortunes of this asset.

- **Coal price.** Over 80% of OPG's sales are to industrial captive consumers on fixed tariffs. As a result, the group is exposed to the price of coal, particularly Indonesian coal, which has been the key fuel in recent years. The group does buy forward to limit exposure.
- **Economic activity.** As seen over COVID-19, reduction in economic activity reduces power demand and hence off take from OPG's clients. Strong growth obviously has the reverse benefit. There is some certainty from one of the units selling power to the state distribution company as it includes a fixed capacity related charge.
- **Environmental issues.** As a thermal power plant, OPG's key Chennai asset is exposed to government changes in environmental legislation which could bring additional remedial costs.
- **Foreign exchange.** The group's income is in Indian rupees, its primary cost is thermal coal which is predominantly imported and priced in US dollars and the group reports in sterling. Hence the group is exposed to weakening/strengthening of the rupee.
- **Customer credit.** The group has a broad spread of industrial captive consumers limiting credit risk although the contract for 74MW to TANGEDCO brings timing risk given the financial position of the distribution companies in India, leading to extended credit terms. Note OPG has letters of credit available as security to mitigate risk.

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