Union Power Due Diligence Report

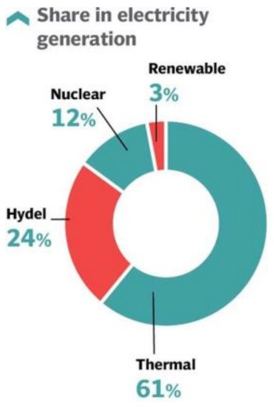
Introduction

The company is a Total Energy Solutions Provider, engaged in supply, rent, modification, overhauling, assembling, repair, servicing of electric generators and solar energy systems for banks, hospitals, telecommunication sites and other commercial sectors. They do installation, testing, and servicing of generators as well as preparation of telecommunication tower sites. Past clients include major telecommunication providers such as Telenor, Ufone, Zong/China Mobile, Huawei, Erricson, Mobiserve, Engro enfrashare, banks such as Habib Bank Limited, Bank Al- Habib, Atlas Bank, Faysal Bank, Dubai Islamic Bank, and Dadabhoy Cement Industries, State Life Insurance, Port Qasim Authority(PQA), and Pakistan State Oil(PSO). The company also has strategic partnerships with Yorking Power China (for which UPES is the sole provider of generators), Relacom Pakistan, Encon Energy, UHU Power, Engro Enfrashare and others, to promote and enhance their businesses in the market as well as procure services from them.

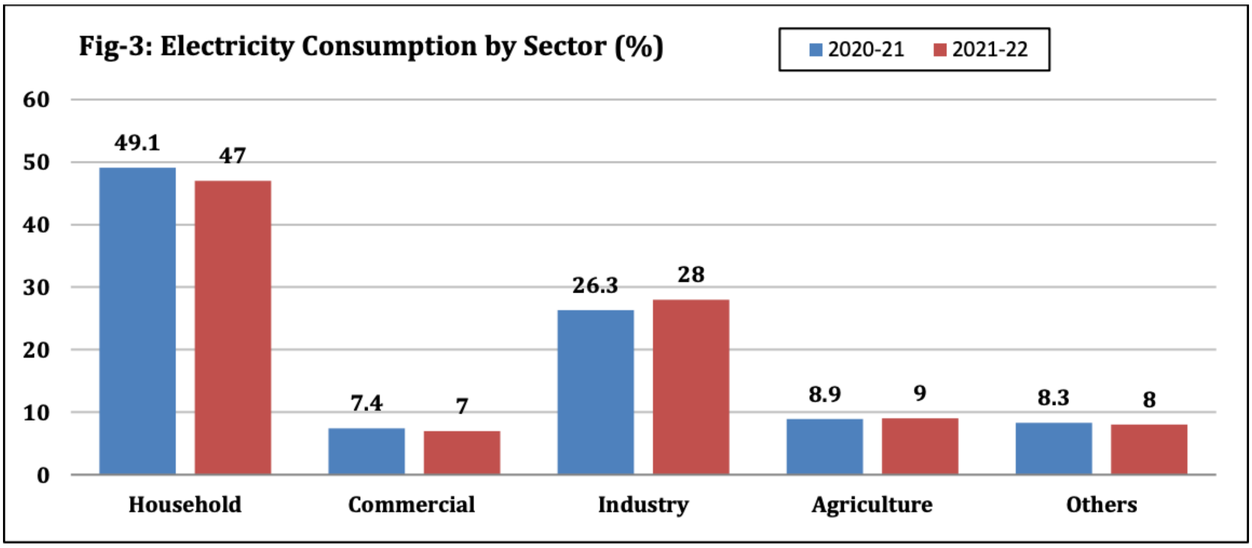
The energy sector of Pakistan plays a vital role in the economic development of the country and directly affects all other economic sectors of Pakistan. Electricity—as a highly versatile form of energy—stimulates economic performance and plays an important role in the development of every sector of the economy. Pakistan generates power from oil, gas (natural gas and liquefied natural gas (LNG)), coal, renewable sources (solar, wind and hydro energy), nuclear energy, and biomass. The country requires around 24,900 MWs of electricity while only producing 18,461 MWs. This shortfall has resulted in increase in demand of independent or alternative power generation sources. Commercial and industrial sectors are the second largest consumer base, after households, jointly consuming 35% of the electricity.

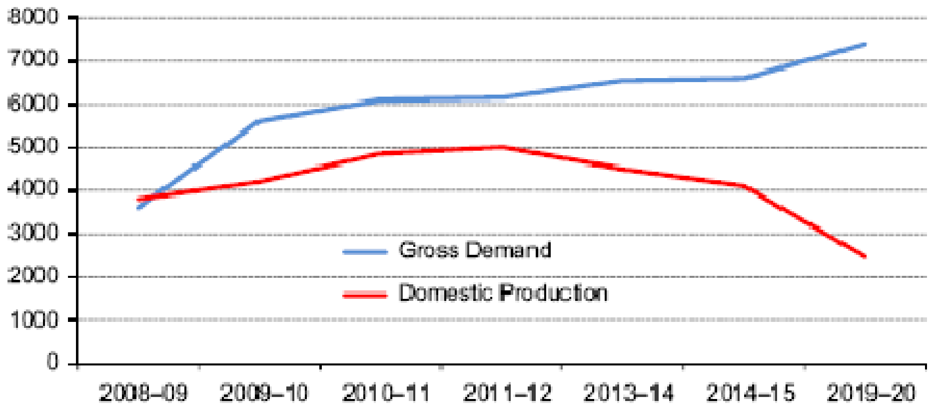
Power generation through conventional means has many disadvantages associated, out of which the most important is cost of power generation. Since, Pakistan does not have sufficient oil reserves, to meet oil requirement for power generation, it imports much of its oil from other countries. Fossil fuels are the highest contributor of world's primary energy and reserves are diminishing rapidly. The increasing prices of the oil has made this option difficult and in turn increased the power generation cost. Pakistan meets about 32.5% of its annual primary commercial energy needs from imported fuel by spending about US$5 billion.

The energy sector of Pakistan is in crisis as a result of insufficient energy production to meet increased demand over the last decades. Natural gas and oil are the most dominant energy sources, with more than 80% of energy supply companies dependent on them. Low and cheap energy production from hydro electrical and coal resources are the main constraints that result in energy shortages and inadequate electricity production.



The commercial sector consumes 7% of all electricity, while the industrial sector uses 28%. This makes the industrial sector one of the most energy-consuming of the economic sectors and its consumption of electricity is expected to increase over the years.





Energy Supply and Demand Gap Pakistan

Demand forecast results suggest that the overall primary energy demand of the country will increase from 75.5 million tons of oil equivalent to 99.2 million tons by 2030 with a major share of natural gas (including LNG) and oil, followed by coal and electricity and LPG. Increased demand for electricity is predicted in the agriculture and transport sector replacing the demand for oil by 2030.

Traction/Financials

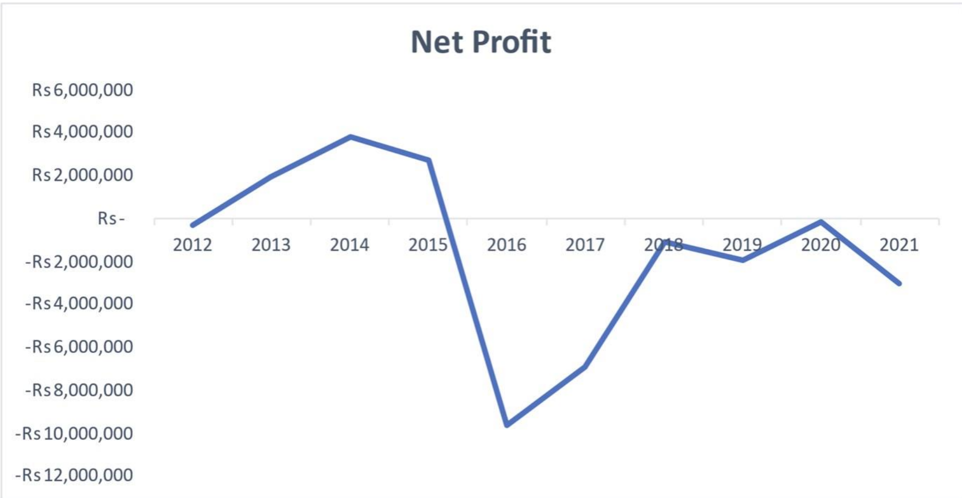
Since beginning operation in 2007, the company has earned Rs. 524,301,345 in total sales.

Sales	Rs 92,171,767
Services	Rs 432,109,413
Total Sales	Rs 524,301,345

The majority of its revenue has come from CM Pak (otherwise known as Zong), bringing in almost half of the revenue i.e. Rs. 256,856,751.00.

Union Power had a rising trend in sales starting from 2012 till 2014 with an average YOY increase of 29%. In 2014, they reached total revenue of Rs. 104,161,173 which is the highest revenue recorded by Union Power since it started operations. After 2015, we observed a fall in revenue. 2016 till 2018 revenues were falling and in 2019 they closed down one side of their business which was to provide generators on rent. They started to only focus on providing services to their clients. Since then, their revenues have been stable and constant. However, in 2021 they again saw a dip which can be attributed to COVID pandemic.

Overall, the gross margins were constant averaging around 35%. However, the net profit margins were unsatisfactory. The company made profit in only 3 years 2013, 2014 and 2015. This suggests that Union Power failed to control costs and improve business operations efficiency over the years. We can look at the following graph to get a grasp of the profitability of union power over the years.



However, Union Power had a strong liquidity position from 2012 till 2018. Current ratios during this time period were on average around 30.4. Which is a strong indicator that the company was not facing any liquidity problems. We also have to consider the fact that Union Power had no inventories thus making this indicator very important to consider. After 2018, the current ratio fell to 1.8, 1.3 and 1.2 in 2019, 2020, and 2021 respectively. This was attributable to an increase in current liabilities. Suggesting that Union Power was facing cashflow issues during this period.

ROE was mostly negative due to the company making loss over the years.

Considering the analysis and considering the current economic situation of Pakistan we used the following factors to calculate the valuation of UPES.

Risk Free Rate	16%
Equity Risk Premium	13%
Uncertainty Risk Premium	8.5%

After finalizing the financial projections, we applied discounted cash flow method to arrive at an appropriate valuation figure i.e. PKR 301 million.

Challenges to Growth

UPES has been dealing with a host of problems, including limited capital, poor management, insubstantial innovation compared to competitors. They struggled to minimize costs, leading to low profit. They only made profit in years 2013-2015 and have been in loss since. They were also paying more withholding and income tax due to inefficient business processes, which they have now fixed. Their liabilities were as much as assets so they were unable to expand and procure new clients to provide services. They have also been limited in growing because their existing clients provide payments after intervals of time instead of upfront or advance payment.

The nature of this business model is such that a sizeable amount of working capital needs to be maintained due to which UPES has been unable able to scale up its operations. They are currently facing liquidity problems which makes it difficult for them to expand. They are unable to onboard more clients as they don’t enough cash in hand to provide them with services. This is because their clients take longer to pay. Selling or raising capital will make it easier for them to manage their working capital issues on hand. Moreover, they can look to expand their business by incorporating new products and services.

UPES has a strong presence in the Pakistani energy market, with a long list of notable clients and strategic partnerships. However, the company has struggled with profitability and has faced liquidity issues in recent years. In order to improve its financial performance, Union Power will need to focus on reducing costs and improving efficiency in its operations. In addition, the company will benefit from investing in capital improvements and expanding its services to capture a larger share of the growing Pakistani energy market. It will also be helpful for Union Power to diversify its revenue streams and enter into new markets or industries.

UPES should partner with a company that has expertise in the energy industry and a strong track record of growing and managing successful businesses. This partner could provide valuable resources and support to help it achieve its financial and strategic goals.

The company can scale current business by changing procurement methodologies and introducing new products and services. These can include trading of generators and solar panels, marine engineering products, services and maintenance of new products, and IoT (predictive & preventive maintenance) based performance.

The company is planning to expand its operations by following rigorous business development and entering into new and related markets. UPES is currently in the process of partnering up with AI-powered IoT solutions provider, M/S Monit, to install sensors in generators to trigger predictive and preventive maintenance reminders.

For this reason, they are looking for an investment of around Rs. 50.8 million. The intended use of the capital would be for existing products, sourcing generators and parts through third parties which reduces margins significantly, direct import of generators and parts to save costs, build in-house teams for servicing and overhauling contracts, purchase generators to maintain enough working capital in hand. The company will also benefit from entering the renewable energy market by importing solar panels and accessories, using IOT technology to remind customers of preventive maintenance, and marine engineering sales and services by leveraging employee connections in the Navy.

Market

Since the commercial sector is the target market as well as the second biggest customer base, the company can incorporate more banks and other financial institutions, warehousing and storage centers, shopping malls, hospitals, private office buildings, hotels, restaurants. UPES can also provide alternative energy solutions industrial factories such as construction, textile, sugar or others that use heavy machinery.

Competitive Landscape

The market for power generation and rental Gen.Sets is considerable and rising in Pakistan due to the persistent energy shortfall in the country. There are a handful of competitors also providing alternative energy solutions. Of these, Energy Solutions, Multiline, Orient Modoraba, Pak Power, Synergy and Lahore Generators have the most comparable clients. Orient is the strongest contender in the market with more than 350 clients including Unilever, Proctor & Gamble, Phillip Morris, Toyota, PSO, FFBL, NICVD, Shifa International Hospital. Multiline's major clients include the Armed Forces and telecommunication providers Mobilink, Ufone, and Ericsson and they also do operations, repair, maintenance of generators like UPES. PakPower Engineering and Lahore Generators are lesser of a competition, with clients including Pizza Hut, Shezan, Samsung, DHA, Dar-e-Arqam franchise schools, Subway, PTCL, Zong, and Bahria Town. Energy Solutions' clients include Coca Cola, Allied Bank, Bahria Town, and Telenor. Enpower's clients include Bata, Unilever, PCB, NADRA, Pepsi, and Nestle. Khan Generators has a portfolio of embassy clients including Qatar, Nigeria, Saudi Arabia as well as NIH Pakistan and UN Migration. It is evident from above that:

1. The largest multi-nationals' companies in Pakistan have a dedicated energy provider.

2. Pakistan's dependency on alternative energy solutions is not going away any time soon.

This market has a handful of competitive players, and certainly not a monopoly or duopoly, which would not be very hard for UPES to break. Further, these companies do not exclusively source generators from one company, as can be seen in the case of Bahria town, Al Karam,DHA, Zong, and Wateen, which presents the opportunity for UPES to win contracts with the same entities. Additionally, note that Multiline is the only company to provide generators on an extensive scale to the Armed Forces, while UPES has the opportunity to use its relationships with the Navy and other forces to supply generators to them.

Risks

Orient Modoraba and Multiline have some of the largest clients in the market, such as the Armed Forces, oil marketing companies, multiple hospitals, and telecommunication companies which can raise the question of the size of UPES's client relationships. Despite this heavy competition, the company has retained one of the strongest presences in the market. It has an impressive client list with the biggest corporations in the country, such as PQA, PSO, Zong, Huawei, Erricson, Ericsson, Ufone, Telenor, Wateen, PTCL, DHA Karachi Habib Bank Limited, Al Karam Textiles, Dubai Islamic Bank, and Faysal Bank. These relationships have been built and sustained over decades.

UPES operates in a competitive market and one which will only grow bigger over time since Pakistan's energy demand is rising faster than supply can meet it. The Pakistan diesel genset market is projected to grow at a CAGR of 3.8% during 2021-2027 on the back of frequent power failures due to low access of grid electricity and outmoded electricity supply mechanisms in the country. This means it will need to be propped with capital investment to retain its largest clients and display profitability. As can be seen in the financial reports, UPES has struggled to maintain consistent profit, having only maintained a strong liquidity position from 2012 till 2018. It has been in loss since then because of limited capital which has prevented expanding to more clients. Despite this, the company continued operating and contracting with large corporations. This displays strong management, technical expertise, and corporate relationships on the part of the leadership team, which can be trusted to take the company to profitability following the capital injection it needs to become profitable.

Conclusion

It is advised to make stock purchases so the acquirer can gain a controlling interest in the company in order to influence the decision making process. The acquirer should buy around 70-100% of the company.

Union Power provided valuation report (June 2022).