The Pakistan Credit Rating Agency Limited

Rating Report

Sui Southern Gas Company Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
31-Dec-2018	A+	A1	Negative	Maintain	YES
30-Jun-2018	A+	A1	Negative	Maintain	YES
23-Jun-2017	A+	A1	Negative	Maintain	YES
25-Jun-2016	A+	A1	Rating Watch(-ve)	Downgrade	-
26-Jun-2015	AA-	A1	Rating Watch(-ve)	Downgrade	-

Rating Rationale and Key Rating Drivers

The ratings reflect significant pressure on the company's financial profile, emanating from substantially high UFG disallowance and other matters pertaining to operating / non-operating income. The management has cushioned it through various means. The recent developments include the proposal of Economic Coordination Committee (ECC) to OGRA to allow gas utility to stagger the impact of remaining amount of PKR 18bln to five years (from FY16 and onwards), which is a relief. Previously, the company had accounted for half impact of PKR 36bln at 4.5% UFG when Sindh High Court dismissed its plea against OGRA which resulted in gas utility booking a loss for year FY17. Furthermore, ECC proposes OGRA to finalize/adjust the provisional UFG benchmarks set from FYs 2012-13 to 2016-17 in next determinations of revenue requirements of Sui companies in line with the recommendations of benchmark rate in UFG study (fixed benchmark of 5% UFG plus 2.6% for local conditions). However, approval from OGRA is still pending on these both. Timely execution and expected positive financial impact of these is crucial to hold the ratings. High UFG disallowance remains a challenge for the company. Apart from this, timely settlement of pending receivables is also important as the company's liquidity profile is significantly streched. SSGC has not issued its financial statements for FY17, quarterly financials are also pending. However, the BoD is planned in January, 2019 for the approval of June 2017 financial statements. Given SSGC's exclusive license to operate in its area of franchise (provinces of Sindh and Baluchistan) and guaranteed return on its net operating assets (17%), the business profile is considered strong. The company's financial risk profile is stretched owing to (i) high leveraging - a factor of debt-driven CAPEX projects, and (ii) inadequate coverages - due to lower cashflows. The ratings take comfort from SSGC's strategic importance and association with the GoP.

SSGC is a part of Re-gassified Liquid Natural Gas (RLNG Phase I and II) project. Under the project, SSGC laid down the 338KMs pipeline at the cost of ~PKR 42bln with a capacity of 1.2bcfd to North; operational since Jan17. RLNG Phase III project is pending regulatory approvals. The loan raised to fund the projects carries a sovereign guarantee with repayments commencing in Jun18. Return on the resulting capitalised new assets as well as favourable decision of UFG benchmark rate should support SSGC's diminished profitability. Consequent cashflows should also provide some respite to financial risk profile in the medium term.

The negative outlook captures the downside arising from unfavourable resolution of UFG benchmark and increased debt level, which will have significant detrimental impact on the risk profile of the company.

Disclosure

Name of Rated Entity	Sui Southern Gas Company Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-18),Methodology | Criteria | Rating Modifier(Jun-18),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study | Gas Utilities(Jun-18)
Rating Analysts	Sehar Fatima | sehar.fatima@pacra.com | +92-42-35869504

Profile

Legal Structure Sui Southern Gas Company Limited (SSGC) was formed in 1989 as a result of merger of three pioneering companies, namely Sui Gas Transmission Company Limited, Karachi Gas Company Limited, and Indus Gas Company Limited. SSGC is listed on Pakistan Stock Exchange (PSX).

Background SSGC is primarily engaged in the business of purchase, transmission, and distribution of natural gas in its franchise area, comprising the Sindh and Balochistan provinces, where it enjoys a monopoly position.

Operations The company operates with transmission and distribution network of 49,276km, SSGC serves ~2.8mln customers across Sindh and Balochistan. Owns and operates gas meter manufacturing plant; annual capacity of 750,000 meters.

Ownership

Ownership Structure SSGC is majority (~67%) owned by Government of Pakistan including 13% through public sector companies and corporations

Stability The ownership structure is likely to remain same in foreseeable future.

Business Acumen The business acumen is considered adequate.

Financial Strength Given the strategic importance of the company as an extended arm of the government for its socioeconomic policy implementation, support from the GoP is expected to be forthcoming in times of crisis.

Governance

Board Structure The overall control of the company vests in thirteen member board of directors. Board members possess good mix of skill set; risk of political intervention remains

Members' Profile The board comprises Managing Director (MD) and twelve non-executive directors including four independent members. Seven directors are nominated by GoP, while one is from State Life Insurance Corporation and NIT each.

Board Effectiveness There are Audit, HR and Remuneration, Finance and Procurement, Risk Management and Litigation and Special committee of directors on UFG in place to assist the board. Audit Committee reports to board in line with code of corporate governance.

Financial Transparency The auditors of the company M/s. Deloitte Yusuf Adil, Chartered Accountants expressed an unqualified audit opinion pertaining to annual financial statements for FY16. The annual financial statements of FY17 and quarterly accounts are still pending. The company has planned its BoD meeting for approval of financial statements for year ending June, 2017 in January 2019.

Management

Organizational Structure Tall organization structure; adequately long associated and experienced management team. Operational infrastructure requires regular capital expenditure.

Management Team Mr. Amin Rajput joined as acting MD in Mar16; frequent changes at top management were witnessed in the past.

Effectiveness The board has constituted four committees, namely (i) Human Resource andRemuneration, (ii) Audit, (iii) Finance and Procurement, and (iv) Unaccounted for Gas (UFG) Committee. Each committee is headed by a board member and consists of other non-executive board members.

MIS Deploys oracle based ERP; comprehensive MIS reporting mechanism.

Control Environment Various MIS reports are generated for the senior management on a daily basis. These include reports pertaining to gas supply & demand, pending connections, field activities, metering, customer billing, etc. However, UFG reports are submitted to the management and board on quarterly basis.

Business Risk

Industry Dynamics Currently, there are two gas distribution companies – SNGPL and SSGC – operating in Pakistan. The companies have a combined network of 168,686km and serve ~8.6mln customers as on end-Jun17. Currently, there is a gas shortfall (demand vs. supply) especially in south, which is also being investigated by the government. Each distribution company is a sole supplier of gas in the jurisdiction it serves thus enjoying monopoly over gas distribution.

Relative Position The company operates with transmission and distribution network of 49,276km, SSGC serves ~2.8mln customers across Sindh and Balochistan, where it enjoys a monopoly position.

Revenues In Nov-15, OGRA approved Final Revenue Requirements for three years (FY13-FY15); the company enjoyed legal stay on UFG benchmark of 7% versus OGRA allowed 4.5% till UFG Sindh High Court decision 2016. Post Sindh High Court decision at 4.50%, company has to account for the loss of PKR 36bln. The loss was to be charged in equal amounts during FY16 and FY17. However, lately the decision of Economic Coordination Committee (ECC) suggests OGRA to allow company to stagger the remaining amount of PKR 18bln in equal amounts over a period of five financial years effective from FY16-17 and onwards – the decision is pending by OGRA. Furthermore, Economic Coordination Committee (ECC) proposes OGRA to finalize/adjust the provisional UFG benchmarks set from FYs 2012-13 to 2016-17 in next determinations of revenue requirements of Sui companies in line with the recommendations of benchmark rate in UFG study (fixed benchmark of 5% UFG plus 2.6% for local conditions). However, approval from OGRA is still pending.

Margins Net operating assets witnessed nominal increase during FY17, leading to minimal increase in guaranteed returns on YoY basis. Increase in UFG losses (FY17: 13.29%, FY16: 13.73%; FY15: 13.6%) translated into higher UFG disallowance (FY16: PKR 14,100mln; FY15: PKR 10,282mln). During FY17, the company's bottom-line being supported by operating income and other operating income turned green. SSGC is part of process of laying down gas pipelines for LNG in three phases. Phase-1 and Phase-II (338KM) pipeline along with ancillary equipment at the cost of PKR 42bln was completed on Jan17. Phase III is pending regulatory approvals. Inclusion of LNG project assets in net operating asset base will significantly increase the guaranteed return upon completion of the project.

Sustainability Going forward, the finalisation of financial statements for year ending June, 2017 is of vital importance. Furthermore, asset-liability mismatch, UFG losses and weakened liquidity position are the factors which need urgent attention.

Financial Risk

Working Capital In recent years, the circular debt issue has weakened the liquidity position as the receivables surged; working capital managed by delaying payments to gas suppliers resulting in an increase in trade payables.

Coverages Coverages are below adequate level. Significant asset-liability mismatch at end-Jun17.

Capitalization High leveraging due to debt driven CAPEX projects. Weak operational performance has effected equity base in recent years.

Rating Scale

Credit Rating Scale & Definitions

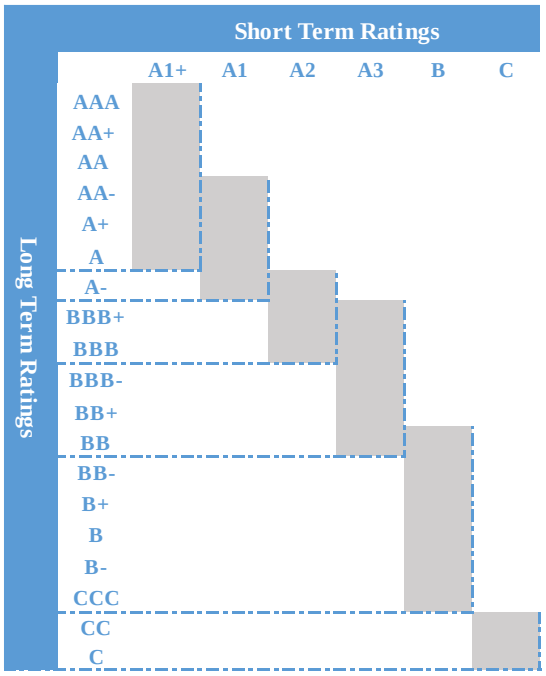
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings

A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
Proprietary Information