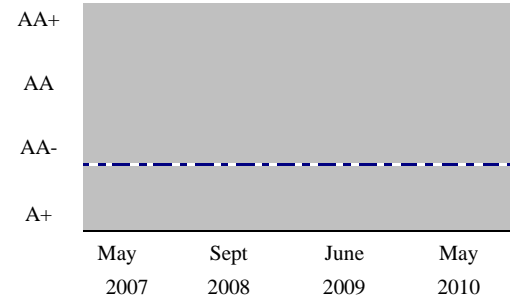




RATINGS (MAY 2010)

SUI SOUTHERN GAS COMPANY LIMITED (SSGC)

	New	Previous
Entity		
Long Term	AA-	AA-
Short Term	A1+	A1+
Debt Instrument		
Sukuk (PKR 4,700mln)	AA	AA
Outlook	Negative	Negative



FINANCIAL DATA

PKR (mln)

	3QFY10*	FY09	FY08
Total Assets	101,624	100,554	71,703
Average Operating Assets	31,426	29,239	25,692
Equity	9,391	9,684	10,315
Guaranteed Return	4,007	4,971	4,368
Net Income	(487)	259	992
Gross Margin %	2.9	5.3	7.2
ROA (%)	(0.4)	0.3	1.5
ROE (%)	(4.3)	2.6	9.9
EBITDA	3,545	6,508	6,705
Total Debt /Equity (%)	184.9	232.0	154.7

* Based on unaudited accounts for the 9 months ended March 31, 2010.

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SUKUK ISSUE

SSGC issued a privately placed Sukuk of PKR 4,700mln in December 2007. The Sukuk is for a tenor of 5 years (with 2 and a half years grace period) and carries profit at the rate of 3-month KIBOR plus 20bps, payable quarterly in arrears. The Musharaka investments will be repurchased in ten consecutive quarterly installments, commencing from the 33rd month (Sept '10). The instrument is secured by way of first pari passu charge over all present and future moveable fixed assets of the company, with additional 25% margin.

RATING RATIONALE AND KEY RATING DRIVERS

- The ratings reflect SSGC's sovereign ownership structure – majority ownership (64%) of the Government of Pakistan (GoP) – and its strategic importance. The ratings also take into account the company's low business risk emanating from its monopolist position in its area of franchise (Sindh and Balochistan) and guaranteed return on its net operating assets. However, the negative outlook indicates significant pressure on the company's financial profile due to sizeable upcoming debt maturities, coupled with subdued profitability – mainly due to sizeable UFG – and relatively constrained cashflows. This is further aggravated by the prevailing circular debt issue.
- The management's ability to proactively manage the company's upcoming financial obligations in a timely manner is critical for the ratings. Effective curtailment of gas losses, amicable resolution of the circular debt issue and uninterrupted gas supplies for continued network expansion also remain crucial. Meanwhile, adverse regulatory changes or weakening of governance structure may affect the ratings negatively.

ASSESSMENT

- There are two gas utilities in Pakistan – SSGC and Sui Northern Gas Pipelines Limited – having exclusive licenses for the distribution and transmission of natural gas in their respective areas of operation. The cost of gas, a major component of their cost structure, is a pass through item and is linked to international crude oil prices, which have been depicting a rising trend lately. While domestic gas wellhead prices are revised on a biannual basis, the impact of a change in gas prices is transferred to the customer with a time lag, so reported operating margins of the utilities come under pressure in rising price environment. SSGC's profitability remains dependent on the quantum of net average operating assets, on which it is entitled to a 17% guaranteed return. The net operating assets increased in FY09, leading to better guaranteed returns on YoY basis. However, disallowances (mainly PKR 2,800mln on account of UFG) made by the Oil and Gas Regulatory Authority (OGRA), higher financial charges, which nearly doubled due to capex borrowings and charges incurred on late payments to gas suppliers, affected the bottom-line.
- During 3QFY10, SSGC's operating assets increased moderately (~8%), but UFG losses of 8.6% resulted in large disallowances (PKR 2,574mln), negatively impacting profitability. Meanwhile, increase in operating costs due to the incremental salaries of the reinstated workers, significant financial charges and higher tax on account of the reintroduction of the minimum tax regime rendered the bottomline in red. Going forward, the aging underground network, high gas losses in Balochistan and increasing instances of theft will continue to form challenges. The management has taken up the issue of a revision in the UFG benchmark with OGRA. A decision in this regard may be achieved shortly, but the timing and extent remain uncertain.
- The company spent around PKR 6,600mln on capex during FY09. However, during 3QFY10, SSGC deployed only PKR 3,700mln for capex, against the budgeted amount of PKR 8,000mln for FY10, due to cash flow constraints. Going forward, it intends to focus on rehabilitating the existing distribution network. Given the pressure on SSGC's financial profile, capital expenditure might be reduced, which would impact profitability due to limited growth in assets. Moreover, total domestic gas production has remained flat (1% growth) on a YoY basis. Unless a major new discovery is made or additional gas is supplied (through LNG or gas from Iran), limited gas availability could impede future network expansion.

- The circular debt issue has resulted in large amounts of receivables accruing on SSGC's balance sheet. To manage its working capital needs, the company has delayed payments to suppliers. Its receivables, mainly on account of KESC, stand at around PKR 26,000mln, while its payables to suppliers amount to PKR 27,000mln (as at end April-10). The net payable position has benefited the working capital management and cash flows of the company positively. Additionally, PKR 9bln on account of sales tax refund remain outstanding.
- SSGC has a highly leveraged capital structure, signifying financial risk. The company increased its leveraging over the years, mainly to support capital expenditures and, of late, to meet working capital needs. Cognizant of this, the management reduced leveraging during 3QFY10. Its ability to prevent further deterioration in SSGC's financial profile and meet its current debt obligations is critical. Meanwhile, the coverages remain under pressure
- GoP had ordered the re-instatement of around 3,000 workers who were inducted during 1996-1998 and removed later on. It had previously agreed to fund the incremental costs till January 2010. Currently, the board has allowed the company to pay the outstanding salaries to the reinstated workers till May '10. These costs have now been adjusted in the HR benchmark by OGRA. Going forward, the company will gradually have to absorb these workers into its normal workforce.

PROFILE

- Sui Southern Gas Company Limited (SSGC), formed in 1989 as a result of a series of mergers, is an integrated gas company with transmission and distribution operations in its franchise area, where it enjoys a monopoly position. SSGC is currently catering to the gas requirements of around 2.2 million consumers with a network that spans over 34,282 kms. The GoP divested a portion of its stake in SSGC through the stock market in FY04 and now owns around 64% shares.
- Dr. Faizullah Abbasi, recently appointed as the MD, served as SSGC's Deputy Managing Director in the mid-90s. Meanwhile, the 14 member BoD has 11 representatives of the GoP.

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