Fitch Assigns Turkey's Cinigaz 'A-(tur)' National Rating

Fitch Ratings has assigned Turkish gas distributor Cinigaz Dogalgaz Dagitim Sanayi ve Ticaret A.S. (Cinigaz) a National Long-term Rating of 'A-(tur)' with a Stable Outlook.

The rating reflects the predictable operating cash flow generated by Cinigaz's regulated gas distribution business. However, we view the capex and tariff approval process as less predictable and subject to substantial delays than in more developed regulatory frameworks in Europe. The company's small scale of operations compared with other Fitch-rated distribution companies and key-person risk stemming from majority ownership by one individual of the company and its main contractor for capex are also limiting factors.

Debt levels are low; however, Cinigaz has a permanent negative working capital position as its trade receivables and inventory are substantially lower than trade payables and advance payments. Fitch-calculated funds from operations (FFO) adjusted net leverage, which includes adjustment for negative working capital, rose to 5.1x in 2016 from 4.4x in 2014 due to large capex also lower FFO in 2016. We project FFO adjusted net leverage to average 4.4x in 2017-2018, which is consistent with the rating.

KEY RATING DRIVERS

Predictable Gas Distribution: Cinigaz's rating is supported by the regulated nature of the company's operations and predictable operating cash flows. The company was granted its natural gas distribution license for the region of Kutahya in western Turkey by the Turkish Energy Market Regulatory Authority (EMRA) in 2004 for 30 years.

One of the key drivers for EBITDA is the allowed return on the regulatory asset base (RAB). On the expenditure side, capex and opex that are approved by EMRA are passed on to customers through tariffs.

Period of High Capex: In 2014-2016 Cinigaz had substantially higher capex for gas network expansion than the annual investment cap set by the regulator at the beginning of the regulatory period 2013-2016. It would be a concern for the rating if this large capex was not approved by the regulator and not reflected in increased tariffs through higher RAB and asset depreciation. In November 2016, EMRA increased the investment cap by TRY36 million to address Cinigaz's over-investment in 2013-2016 and also increased tariffs. The company expects additional tariff increases to be approved in the next 1-2 months. Although the regulatory decision from November 2016 raising the investment cap has reduced the risk of capex not feeding through in tariffs, we view the capex and tariff approval process as less predictable and subject to substantial delays than in more developed regulatory frameworks in Europe.

Also there seemed to be a different interpretation of capex by Cinigaz and EMRA in the past few years (late investment capitalisation and non-approved expenses such as interest and FX losses). Cinigaz has updated its accounts charts in accordance with EMRA latest request to avoid recurrence.

Focus on Network Expansion: The main strategic goal of management is to expand the company's distribution network and grow the customer base and outperform regulatory targets for gas volumes as the remuneration system gives incentive for higher-than-approved volumes. Management plans to reinvest free cash flow into the business rather than pay dividends. We expect Cinigaz to benefit in the next few years from the growing demand for gas due to an expanding gas network in the Kutahya region, connections of planned economic zones and also a growing local economy.

Small Scale, Privately-Owned Company: Cinigaz has a small scale of operations compared with Fitch-rated distribution companies. In 2016 the company reported Fitch-adjusted EBITDA of TRY18.5 million (USD6 million) excluding new subscriber connection fees of TRY1.9 million.

The company is 81% owned by its Chairman and General Manager Rasim Akdogan. Mr Akdogan also owns construction company Setas A.S., which is Cinigaz's main related party as a contractor for network capex. This results in key-person risk and is a constraint for the rating. We understand from the company that construction capex are contracted on market terms.

Increased Trade Payables to Related Parties: The substantially higher capex in 2015-2016 was partly funded with increased trade payables to Setas as they grew to TRY34.8 million at end-2016 from TRY4.1 million at end-2014. We include these payables in Cinigaz's adjusted debt. These liabilities do not have any specific payment dates and do not bear interest. Work for Cinigaz represents a substantial part of Setas's revenue and we therefore view the businesses as interdependent.

DERIVATION SUMMARY

Despite solid growth in the past few years, Cinigaz is small compared with other network companies rated by Fitch, including Baskent Elektrik Dagitim A.S. ('AA(tur)'/Stable Outlook) and Enerjisa Enerji A.S. ('AA(tur)'/Stable Outlook). As a result, it has a less diversified asset base and scope to achieve efficiency albeit under its current regulatory framework the small size does not have a significant impact on regulatory remuneration.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- Slower gas sales volumes growth and tariff growth than assumed by management
- No major changes to payments terms with state-owned BOTAS Petroleum Pipeline Corporation and customers resulting in limited working capital changes in projected cash flows.
- Capex in line with the company's plan for 2017-2020.
- No dividend payments in 2017-2020.
- Cinigaz is able to fully pass through gas purchase costs in its prices for customers, and as a result, generates close to zero margin in its supply business.

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action

- FFO adjusted net leverage (adjusted for subscription fees, negative working capital and trade payables to related parties) significantly below 4x on a sustained basis.
- Longer track record of the current regulatory framework resulting in improved predictability of cash flows.
- Better predictability of capex and visibility that it feeds into tariffs quickly.

However, in our view rating upside above the 'A(tur)' rating is limited due to the company's scale of operations, fairly low predictability of capex and its impact on tariffs as well as key-person risk.

Developments that May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 5x on a sustained basis.
- Deterioration of regulatory predictability, which would be negative for Cinigaz's business profile.
- Change in financial policy, for instance an aggressive dividend policy or large debt-funded acquisitions.
- Negative free cash flow on a sustained basis.
- Reduced ability to reflect gas purchase cost in prices for end-customers.

LIQUIDITY

Limited Adjusted Liquidity: At end-June 2017, the company's reported cash and cash equivalents stood at TRY8.9 million, below short-term debt of TRY12.3 million (due in June 2018), however we view this liquidity position as manageable.

In addition, the company has a permanent negative working capital position (TRY58 million at end-2016) as its trade receivables, inventory and pre-paid expenses are not sufficient to cover trade payables, security deposits and advance payments from customers. This could lead to a liquidity crunch if suppliers decide to shorten payment terms.

The company has access to bank lines (TRY343.1 million as of 12 July 2017) but these are not legally committed, which is common in Turkey.

The company's debt is denominated in US dollars. However, the company's foreign currency risk is manageable given Cinigaz's low net debt (excluding Fitch adjustments for negative working capital and payables to related parties which are denominated in the Turkish lira).

FULL LIST OF RATING ACTIONS

Contact:

Principal Analyst
Maria Delia Linares
Analyst
+34 93492 9512

Supervisory Analyst
Arkadiusz Wicik
Senior Director
+48 22 338 6286
Fitch Polska S.A.
Krolewska 16
00-103 Warsaw

Committee Chairperson
Josef Pospisil
Managing Director
+44 20 3530 1287

Summary of Financial Statement Adjustments –
FFO adjusted net leverage reflects two key adjustments, FFO is reduced by subscriber connection revenues received from customers and adjusted debt is the sum of borrowings, negative working capital and trade payables to related parties.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.