Fitch Ratings

Mr A. Rasim Akdogan
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September 29, 2016

Dear Mr. Akdogan,

Re: Rating Letter for Cinigaz Dogalgaz Dagitim Sanayi ve Ticaret A.S.

Fitch (see definition below) assigned Cinigaz Dogalgaz Dagitim Sanayi ve Ticaret A.S. (Cinigaz) the following rating on 23 September 2016:

- National Long-term Rating of 'BBB+(tur)' with a Stable Outlook.

The rating reflects the predictable operating cash flow generated by Cinigaz's regulated gas distribution business, albeit cash flow predictability in Turkey is lower than under more developed regulatory frameworks in western Europe. The rating is constrained by the low predictability of capex given Cinigaz's significantly higher capex compared with the levels approved by the regulator for 2014-2015 as well as uncertainty regarding how the 2014-2015 capex overspend will feed into tariffs. The rating also reflects the company's small scale of operations compared with Fitch-rated gas distribution peers.

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) leverage adjusted for negative working capital and subscription fees from new customers is high after an increase to 5.4x in 2015 from 4.4x in 2014 driven by very large capex. We project FFO adjusted leverage to average 5.3x in 2016-2019, 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. A large part of the company's Fitch-adjusted EBITDA comes from regulated gas distribution characterised by predictable operating cash flow. 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 Fitch-adjusted EBITDA is the allowed return on the regulatory asset base (RAB). On the cost side, capex and operating expenditure that are approved by EMRA are passed on to customers through tariffs. In addition, subscription fees from new customers connected to the network are also regulated by EMRA. However, Fitch excludes the subscription fees from its adjusted EBITDA and FFO and treats them as the source for capex co-funding.

Higher-than-approved Capex
We view the potential for uncompensated capex overspend as a key credit constraint. In 2015 actual gross capex was substantially higher than approved by EMRA (TRY46.2m vs. TRY6.2m). Substantial capex

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overspend also occurred in 2014 when the company spent TRY24m on capex vs. TRY5.8m approved by EMRA). It is not clear how this capex overspend for 2014 and 2015 will be reflected in regulatory revenues in the next few years.

The higher-than-approved capex in 2015 and 2014 resulted from gas network expansion (also to a planned industrial zone in the Tavsanli area). Based on note 12 to the 2015 financial statements the 2015 and 2014 capex was spent mostly on land improvements, however based on additional information received from the company this capex was spent on plant and equipment for infrastructure investment and region expansion. This capex supports future growth as it will allow to connect new customers in the next few years. The expansion is part of management's aim to outperform regulatory targets for gas volumes as the remuneration system gives incentive for higher-than-approved volumes sold and distributed.

This additional capex in 2014-2015 on top of the regulatory-approved capex has not be reflected in the tariffs in the current regulatory period until end-2016. Cinigaz is in discussions with the regulator to reflect the additional capex in tariffs for the next regulatory period starting in 2017, which may result in much higher RAB and higher depreciation. The company informed us that additional capex before 2013 was subsequently approved by the regulator. However, this concerned substantially smaller amount and the 2014-2015 overspend has not been approved yet and we therefore do not assume it for the rating case.

Cost Pass-through Beneficial
The regulated gas distribution business usually allows for EBITDA predictability and stability, although with some variation in the company’s operating cash flows, as in 2012, due to the pass-through of gas purchase cost to end-customers. We view the price risk within the supply component of the tariff as a constraint of the regulatory framework. We assume in the projections that Cinigaz is able to fully pass on gas purchase costs to customers, and as a result, generates close to zero margin in its supply business. A reduced ability to reflect gas purchase costs in prices for end-customers would be negative for the rating.

Focus on Network Expansion
The main strategic goal of management is to expand the company’s distribution network and grow the customer base. 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.

Volume Risk
The tariff system in Turkey results in volume risk for Cinigaz. Higher-than-EMRA approved gas volumes are positive for the company’s cash flows as the remuneration is calculated as a regulated tariff per unit multiplied by gas volumes. Conversely, lower-than-approved volumes are negative for cash flows.

Fitch views exposure to volume risk, though limited to a 10% cap, as negative. More developed and mature regulatory frameworks such as in the UK, Germany or Italy have limited or no exposure to volume risk. Cinigaz’s tariff is adjusted for changes in volumes every five years for the next five-year regulatory period.

Negative Working Capital
The company has a permanent negative working capital position not covered with cash. This could lead to a liquidity crunch if suppliers decide to shorten payment terms. However, in the case of Cinigaz, the negative working capital position has been fairly stable (excluding trade payables to related parties) as Turkey’s main gas supplier state-owned BOTAS Petroleum Pipeline Corporation (BOTAS) has continued to allow gas distribution companies including Cingaz to pay for gas about 15-30 days after the distributors have received cash from end-customers.

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High Adjusted Leverage
Fitch-calculated FFO leverage adjusted for negative working capital and subscription fees from new customers is high after an increase to 5.4x in 2015 from 4.4x in 2014 driven by very large capex. We project FFO adjusted leverage to average 5.3x in 2016-2019, which is consistent with the rating.

FFO adjusted leverage reflects two key adjustments, FFO is reduced by subscription fees received from customers and adjusted debt is the sum of borrowings and negative working capital not covered with unrestricted cash. The formula for adjusted debt is the following: borrowings plus trade payables (including to related parties) plus advances from customers (unearned revenues) plus security deposits from customers minus trade receivables minus inventory minus prepaid expenses minus unrestricted cash).

Small Scale, Privately-Owned Company
Cinigaz is a small company compared with Fitch-rated gas distribution peers and, as a result, 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. In 2015 the company reported Fitch-adjusted EBITDA of TRY20.6m (USD8m) excluding new subscriber connection fees of TRY3.8m. 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 man 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 than EMRA approved capex in 2015 was partly funded with increased trade payables to Setas as trade payables to related parties grew to TRY28.2m from TRY4.1m during 2015. The majority owner of Cinigaz and Setas considers these related party trade payables from Cinigaz to Setas as akin to an equity-convertible loan between group companies. However, it is not yet determined when or if this loan will be converted to equity or be repaid in the future. This liability to Setas does not have any specific payment date and does not bear interest.

In 3Q16, Cinigaz repaid to Setas TRY7m out of TRY28.2m, undermining the consideration that it is equity-like. The owners increased paid-in-capital of Setas to TRY25m from TRY10m during 2015 to partly compensate Setas for the increased trade receivables from Cinigaz for construction services in 2015. This equity increase was a non-cash transaction covered from retained earnings, special funds and reserves. Setas had a net cash position at end-2015 with cash and cash equivalents of TRY32.8m and no external debt. Work for Cinigaz represents a substantial part of Setas's revenue and we therefore view the businesses as interdependent. Cinigaz's trade payables to Setas at end-2015 corresponded to more than 50% of Setas's revenue in 2015.

We treat trade payables of TRY28.2m to Setas in the same way as other trade payables. As a result, they are included in our adjusted debt by adding to borrowings negative working capital not covered with unrestricted cash.

Exposure to FX Risk
The company has a currency mismatch between debt, which is denominated in the US dollar, and local-currency operating cash flows. This exposes Cinigaz to deterioration in credit metrics if the Turkish lira depreciates significantly in a short period of time. This currency mismatch is often the case for Turkish corporates that borrow in US dollars and do not hedge their position.

Concentrated Counterparty Risk
Turkish incumbent gas transmission and wholesale trade company BOTAS remains the dominant supplier in Turkey in the wholesale market and is also the main gas supplier to Cinigaz. We do not view this as a

constraint for the rating given BOTAS's size and diversification of its gas supplies, coming mostly from imports.

Political and Economic Situation in Turkey
Fitch revised Turkey's Long-Term IDR of 'BBB-' to Negative from Stable in August 2016 due to heightened risks to political stability evidenced by a coup attempt in July 2016. Political uncertainty is expected to impact the country's economic performance and poses risks to economic policy. Fitch forecasts that the Turkish economy's growth will slow slightly to 3.4% in 2016 from 4% growth 2015. We forecast growth of 3.3% for 2017.

We understand from the company that the coup attempt and heightened risks to political stability in the country have had no direct impact on Cinigaz's operations. Gas volumes supplied and transport have not been affected.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- 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.
- Tariffs for 2017-2019 in line with the company's expectations from July 2016
- No major changes to payments terms with BOTAS and customers resulting in limited working capital changes in projected cash flows.
- Capex in line with the company's plan for 2016-2019
- No dividend payments in 2016-2019.
- Cash FX loss of about TRY2m per year in 2017-2019.

RATING SENSITIVITIES (if the rating was to be maintained and monitored)
Positive: Future developments that may, individually or collectively, lead to positive rating action, if the rating is maintained, include:
- Better predictability of capex and visibility that it feeds into tariffs quickly.
- FFO adjusted leverage (adjusted for subscription fees and negative working capital) below 5x on a sustained basis.
- Longer track record of the current regulatory framework resulting in improved predictability of cash flows.

Negative: Future developments that may, individually or collectively, lead to negative rating actions include:
- FFO adjusted leverage above 6x 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 AND DEBT STRUCTURE
At end-December 2015 the company's unrestricted cash of TRY18m was largely sufficient to cover its short-term debt of TRY20.5m. The company's debt maturity profile and liquidity improved in June 2016, when Cinigaz refinanced a maturing bank loan with new bank debt. At end-June 2016, the company's unrestricted cash and cash equivalents stood at TRY5.4m above short-term debt of TRY4.6m. However, the company has a permanent negative working capital position as its trade receivables, inventory and pre-paid expenses are not sufficient to cover trade payables and advance payments from customers.

At end-December 2015 the company had negative Fitch-calculated working capital of TRY78.3m. Liquidity adjusted for negative working capital was sufficient if available unused lines of TRY276.1m as of end-December 2015 (TRY128.5m and USD50.6m) are taken into consideration. However, we do not view liquidity lines and limits in Turkey as legally committed.

Restricted cash (TRY6.2m at end-2015) relates to cash generated from natural gas sales that, in accordance with the agreements with banks, must be kept in the deposit account for an average of six working days without any withdrawals.

The company's debt consists of bank loans in the US dollar. Debt excluding Fitch adjustments decreased to TRY22.8m at end-2015 from TRY25m at end-2014.

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We are pleased to have had the opportunity to be of service to you. If we can be of further assistance, please contact Arkadiusz Wicik at +48 22 338 62 86, Ross Macaulay at +44 20 3530 1395 or me at +44 20 3530 1287.

Sincerely,

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By:

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