FitchRatings

Fitch Affirms Turkey's Cinigaz at 'A-(tur)'; Stable Outlook

Fitch Ratings-Warsaw/London-21 December 2018: Fitch Ratings has affirmed Turkish gas distributor Cinigaz Dogalgaz Dagitim Sanayi ve Ticaret A.S.'s (Cinigaz) National Long-Term Rating at '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 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, advance payments and security deposits from customers. Fitch-calculated funds from operations (FFO) adjusted net leverage, which includes adjustment for negative working capital, rose to 5.3x in 2017 from 5.1x in 2016. We project FFO adjusted net leverage to average 4.2x in 2018-2019, 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 and predictable operating cash flows. Recent regulatory changes including an increase of the real rate of return to 12.85% for the 2017-2021 regulatory period from 11.83% in the 2012-2016 regulatory period, and a detailed capex difference adjustment component are positive for Cinigaz. This, together with a higher regulatory asset base of Cinigaz due to large capex in the past few years, resulted in substantially higher revenue requirement from 2018 and higher tariffs approved by the regulator for customers with lower consumption volumes, positively influencing revenue and EBITDA.

Capex Predictability: One of the credit negatives for Cinigaz has been low predictability of capex and low visibility over capex feeding into tariffs swiftly. This was evident in 2014-2016 when Cinigaz had substantially higher capex for the gas network expansion than the annual investment cap set by the regulator at the beginning of the regulatory period 2013-2016. Although the regulatory decision from November 2016 to raise 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. We expect Cinigaz's capex in 2018-2021 to be in line with levels approved by the regulator.

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 provides incentives for higher-than-approved volumes. Management plans to reinvest free cash flow (FCF) into the business rather than use it for dividend payments. We expect Cinigaz to benefit in the next few years from growing demand for gas, due mainly to an expanding gas network in the Kutahya region.

Small Scale, Privately-Owned Company: Cinigaz's operations are small-scale compared with Fitch-rated distribution companies. In 2017 the company reported Fitch-adjusted EBITDA of TRY19 million (USD5 million), excluding new subscriber connection fees of TRY2 million.

The company is 81%-owned by its Chairman Rasim Akdogan and run by Akin Can Akdogan as General Manager. Rasim Akdogan also owns a majority stake in 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 on the rating. We understand from the company that construction capex is 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 rose to TRY35 million at end-2016 from TRY4 million at end-2014. In

2017 these trade payables were fairly flat and stood at TRY34 million at end-2017. 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 inter-dependent.

Deteriorated Turkish Economy: The economic slowdown in Turkey in 2018 has not materially affected Cinigaz's profitability due to the company's regulated tariffs. However, we expect growth in gas demand in Cinigaz's area of operations to be slower than in the previous years, in line with substantially slower economic growth until 2020. Fitch forecasts Turkey's average GDP growth for 2018-2020 at 2.5% compared with an average for 2010-2017 of 6.8%.

Limited Currency Impact: The company has also not been substantially affected by the significant depreciation of the Turkish lira against the US dollar in 2018 due to its limited US-denominated debt (USD3.5 million), which was fully repaid in June 2018. Considerably higher borrowing costs in the Turkish lira in 2018 have only partly affected Cinigaz due to its low unadjusted debt.

DERIVATION SUMMARY

Cinigaz's operations are small-scale compared with other network companies rated by Fitch, including Enerjisa Enerji A.S. (AA(tur)/Stable) and Baskent Elektrik Dagitim A.S. (AA(tur)/Stable) . As a result, the company has a less diversified asset base and scope to achieve efficiency, although 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 than assumed by management
- Tariffs for 2018-2021 in line with management expectations (following the approval by the regulator in February 2018)
- No major changes to payment 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 2018-2021
- No dividend payments in 2018-2021
- Gas purchase costs fully passed onto prices for customers, and as a result, generating 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 subscriber connection revenue, 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
- Improved predictability of capex and visibility over capex feeding into tariffs swiftly

However, in our view rating upside above the 'A(tur)' rating is limited by the company's scale of operations and 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 FCF on a sustained basis
- Reduced ability to pass on gas purchase cost to end-customers

LIQUIDITY

Limited Adjusted Liquidity: At end-September 2018, the company's reported cash and cash equivalents stood at TRY12 million, with no short-term debt obligations. The company has only a TRY5 million loan with maturity in May 2020. Therefore, we view its liquidity position as manageable.

In addition, the company has a permanent negative working capital position (TRY64 million at end-2017) 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 (TRY143 million as of 30 September 2018) but these are not legally committed, which is common in Turkey.

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 revenue received from customers and adjusted debt is the sum of borrowings, negative working capital and trade payables to related parties.

-Negative working capital is calculated as trade payables, advance payments and security deposits from customers minus trade receivables, inventory and pre-paid expenses.

Media Relations: Adrian Simpson, London, Tel: +44 20 3530 1010, Email: adrian.simpson@thefitchgroup.com

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.

Applicable Criteria
Corporate Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023785)
National Scale Ratings Criteria (pub. 18 Jul 2018) (https://www.fitchratings.com/site/re/10038626)

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