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SUKUK RATING REPORT

K-ELECTRIC LIMITED

February 2019

الوكالة الإسلامية الدولية للتصنيف

Islamic International Rating Agency

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K-ELECTRIC LIMITED

Report Date:

February 6, 2019

Analyst(s)

Mohammad Arsal Ayub, CFA

	Latest	Previous
	National Scale Rating (February 6, 2019)	National Scale Rating (March 27, 2017)
PKR 22bn Sukuk	AA+ (pk) (Double A Plus)	AA+ (pk) (Double A Plus)
PKR 6bn Sukuk	AA (pk) (Double A)	AA (pk) (Double A)
Outlook	Rating Watch	Rating Watch

Company Information

- **Established in 1913**
- **Vertically integrated power utility Company**
- **Sole electricity distributor for Karachi (and adjoining areas)**
- **Chief Executive Officer:** Syed Moonis Abdullah Alvi
- **Chairman:** Mr. Ikram Sehgal
- **External Auditors:** A.F. Ferguson & Co., Chartered Accountants (A member firm of PwC network) and BDO Ebrahim & Co., Chartered Accountants (A member firm of BDO network)

K-Electric – Corporate Profile

K-Electric Limited ('KE' or 'the Company'), is a vertically integrated power utility company engaged in generation, transmission and distribution of energy within the city of Karachi and its adjoining areas. The city of Karachi has always had its strategic importance, being the main port city and business hub of the country. It is the 7th largest city in the World, in terms of population. Being home to a thriving industrial area, the fast growth of the city is expected to persist with continuation of rural-urban migration and an improving law & order situation. Unlike the rest of Pakistan, the metropolitan city of Karachi has had its own dedicated utility Company since 1913, when KE was formed. During its long operational history, which exceeds a century, KE has undergone a number of changes at the helm including eras during which it was run by the Government, the Pakistan Army and WAPDA. The Company was privatized in 2005 and later Abraaj Group (Abraaj), through its investment in KES Power (Holding Company of KE) acquired major stake in 2008.

The resultant change in ownership structure transformed the Company from a government-owned entity into a private Company. A material shift in efficiency levels was noted subsequent to the change in management. The new management's strategy focused on cost rationalization and efficiency enhancement through capital expenditure and an improved fuel mix. About 8 years down the lane, the Company has transformed from a loss making Company to achieving profits in excess of Rs. 32bn during FY16. During this time the annual production of KE has increased to 10,323 Gwhs (Jun'18: 10,338 Gwhs). In line with its investment philosophy of exiting positions after a period of 4-5 years, Abraaj issued a press release in June 2014 indicating their intention to sell off their stake in KE.

In October 2016, Shanghai Electric Power Company Limited (SEP) signed a definitive agreement for acquisition of a 66.4% controlling stake in KE for USD 1.77bn, subject to receipt of government and regulatory approvals. SEP is a publicly traded company listed on the Shanghai Stock Exchange and is engaged in the business of generation, transmission and distribution of electricity in Shanghai and various overseas markets. SEP is majorly owned by State Power Investment Corporation (SPIC), which is one of China's big five state-owned power groups.

Table 1: Ownership Structure

	Oct'18
KES Power Limited[1]	66.4%
Government of Pakistan	24.4%
Mutual Funds	1.8%
Foreign Shareholder	1.0%
Local Institutions	2.7%
Others (General Public)	3.7%

In order to ensure compliance with the regulatory requirements, SEP's public announcement affirming their intention to acquire a 66.4% stake in KE had to be withdrawn and reinstated three times due to lapse in the prescribed time period for making a public announcement of the offer. In the latest development, a fresh public announcement of intention was received from SEP to acquire a 66.4% stake in KE on December 24, 2018, reaffirming SEP's commitment towards the transaction which will complete upon receipt of the remaining regulatory and other government approvals.

[1]KES Power Limited is the holding company of KE. Majority holding of KES Power Limited rests with Abraaj Group. Minority investors comprise Denham Capital and Al Jomaih Group.

…… Issues Impeding the Finalization of the Transaction

KE's MYT determined in 2009 (MYT 2009 - 16) for a seven-year period expired on June 30, 2016. Prior to expiry of the MYT 2009 - 16, KE, on March 31, 2016, filed a tariff petition with NEPRA for continuation of the MYT for a 10-year control period starting from July 1, 2016, along with certain modifications.

In response to KE's tariff petition, NEPRA vide its determination dated March 20, 2017, determined a new rebased and restructured MYT with a base tariff level of PKR 12.07/kWh for the period commencing July 1, 2016 till June 30, 2023. Given differences over certain underlying assumptions in the revised MYT, KE filed a review motion with NEPRA on April 20, 2017.

NEPRA issued its decision on KE's review motion on October 9, 2017 wherein the Authority revised the base tariff to a level of PKR 12.77/kWh, however, largely maintained its earlier decision. In response, the Government of Pakistan (GoP) filed a 'Reconsideration Request' with NEPRA on October 26, 2017 requesting the Authority to consider afresh its earlier determination. In response thereof, NEPRA issued its decision on July 5, 2018 wherein KE's base tariff was increased from PKR 12.77/kWh to PKR 12.82/kWh along with revision to the criteria for claiming actual write-offs in future, including verification by auditors.

Further, the revised tariff provides room for additional investments in the generation business, subject to regulatory approval, and includes a Mid-Term review to re-assess certain assumptions including working capital and the exchange rates projected by NEPRA within the tariff for the purpose of USD indexation allowed in return on equity.

Even though the revised tariff with the updated underlying assumptions makes KE’s operations sustainable, KE has challenged a few aspects of tariff and obtained a stay order from the Court. As a result of the stay order from the Court, the tariff has not been notified to KE by GoP. Until it is notified, the financial statements cannot be finalized and as a result cannot be audited and published beyond FY 2016.

Rating Rationale

The latest publicly avaialable audited financial statements of the Company pertain to Financial Year July-June' 2016. More recent financial data has not been published.

IIRA has reviewed data made available by the Company along with the projections. IIRA has ascertained the debt service coverage and debt sustainability ratios, which remained within the benchmark for the assigned rating band (AA).

The rating assigned to Rs. 22bn KE Azm Sukuk, is supported by the additional securitization arrangement in place with earmarked recievables from 495 identified industrial consumers; historical recovery ratio from these consumers has been recorded at around 100%. This, along with uniform consumer tariff policy of the government across Pakistan, insulates Sukuk investors against any risk associated with final MYT notification. As per the agreement between the trustee and KE's bankers, the payments from these earmarked consumers are routed through an escrow account, whereby the banker marks a lien on an amount each month equivalent to one-third of the next installment plus 20% margin, while the remaining amount is released to KE.

Given quarterly repayment structure, by the end of 3 months, the bank can route the requisite payment to the trustee to the issue, in lieu of the due installment. It is, however, important to note that recievables from these consumers are also earmarked against servicing other long term loans. However, collection from 495consumers are enough to service the debt securitized against these receivables.

According to management representations, bills of 495 earmarked consumers are being routed through the designated escrow account on a monthly basis in accordance with Sukuk agreement between KE & trustee. A confirmation, of compliance with the terms set out in the trust deed, has been taken from the trustee. The actual collections, as presented in the table below (for the latest two quarters), depict considerable surplus over minimum retention requirement.

Table 2: Actual Collection & Retention Requirement

Figures in PKR' Billions	Collection	Retention Requirement	Surplus
Qtr 1 (16th Jun'18 – 15th Sep'18)	7.6	(2.6)	5.0
Qtr 2 (16th Sep'18 – 15th Dec'18)	7.3	(2.9)	4.4

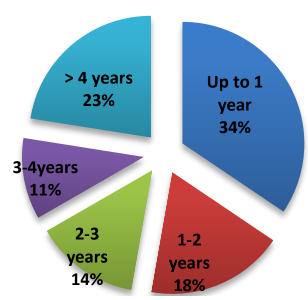
Key Risk Factors

……Credit Risk

Given the volume of receivables at any point in time, credit risk remains noteworthy. Significant counterparties include the Government of Pakistan (GoPs) with receivables thereof representing subsidy claims. The delay in payments of GoP receivables is an industry-wide phenomenon also experienced by IPPs. However, this credit risk, with respect to subsidy claims is mitigated by the netting off mechanism in place, whereby the payments to government in lieu of power purchase are netted off against receivables in lieu of subsidy claims. As per management projections, the net balance with the GoP will remain positive, during the rating horizon, which means that from a credit risk perspective, KE's exposure shall be nil.

Another source of credit risk is the non-payment of electricity bills from Public Sector Companies (PSCs). A major PSC is Karachi Water & Sewerage Board (KWSB), which is categorized as lifeline consumers, to which KE cannot legally discontinue electricity supply, GoP has formed a sub-committee for resolution of issues related to KE and accordingly in the recent past an amount of Rs 12.4bn has been adjusted from electricity duty payable by KE.

Figure 1: Aging of Gross Credit Exposure (Jun'16)



As of end-FY18, KE had outstanding trade debts constituted over 24% of the Company's asset base.

…… Supply Side Risk

The Company faces two-tiered supply-side risk which includes the possibility of reduced gas supply from its sole supplier, Sui Southern Gas Company Limited (SSGC), and the potential discontinuation of 650 MW power supply from the National Grid as the Power Purchase Agreement (PPA) between KE & National Transmission and Despatch Company (NTDC) expired in January 2015.

KE is in continuous engagements with Ministry of Energy (Power Division), CPPA – G and NTDC for renewal of the PPA. Further, the matter of any reduction in supply to KE from the National Grid is sub-judice and the court has ordered to maintain status-quo. Given the strategic importance of Karachi and the socio-economic implications that prolonged power outages may have and considering that the matter is sub-judice, the probability of complete discontinuation or any reduction of power from the National Grid is considered highly unlikely.

With respect to gas supply to KE, considering the recent development where SSGC is supplying RLNG in addition to natural gas, the risk of reduced gas supply is mitigated. Further, several rounds of discussion in the matter of Gas Supply Agreement (GSA) between KE and SSGC have taken place, and the same will be finalized upon mutual agreement with regard to the quantity of gas to be supplied to KE on a firm basis and other outstanding matters

…… Liquidity Risk

The Company's liquidity is dependent on recovery of bills from its customer base which mainly include residential (47%), industrial (32%) and commercial (21%) consumers. Inflation, any increase in consumer tariffs, or other macroeconomic indicators, can impede the Company's recovery ratios thereby impacting the Company's cash flows. Historical trend of recovery ratios is indicative of YoY improvement. Due to the securitization structure of the Sukuk, their investors are not exposed to any liquidity risk.

…… Legal Risks

There are sizable amounts of off-balance sheet contingencies and commitments in excess of Rs. 60bn, which the Company may need to pay in case of adverse court decisions. Management and legal representatives remain confident of favorable outcome.

KE Sukuk

KE presently has 2 Sukuk certificates outstanding under the KE Sukuk programe which include the Rs. 6bn Sukuk issued in FY14 and the Rs. 22bn Sukuk issued in FY15.

The former is arranged using a Shirkat-ul-Milk structure and features bullet repayments at maturity. The Rs. 6bn KE AZM Sukuk Certificates features variable tenures with the shortest being 13 months (Rs. 0.75bn), intermediate being 3years (Rs. 3.75bn) and longest 5years (Rs. 1.5bn) respectively. The 13 month and 3 year certificates have already matured, whilst the longest maturity certificate is schedueled to mature in March’2019, in case the attached Early Purchase Option is not utilized by the Sukuk holders.

The latter, i.e the Rs. 22bn KE Sukuk ul Shirkah, which was issued in May 2015, and featured an initial grace period of two years, which has already elapsed and principle repayment commenced in September 2017. As of end-December 2018, the outstanding prinicpal amount of the sukuk stood at R. 15.4bn. The Sukuk is scheduled to mature in June 2022 and is protected by additional covenants and securitization arrangements raising the credit quality of the issue over and above other debt of KE. In line with the Diminishing Musharaka structure, the instrument is fully asset-backed by Generation Equipments.

There are a few covenenats specified in the Trust Deed; these include a threshold on additional financial indebtedness, wherein debt to equity ratio is required to be maintained under 70:30, and debt service coverage, which should not fall below 1.2x.

The structure of both instruments has been reviewed by a panel of 4 eminent Shari’a scholars in Pakistan. The panel through its Fatwa on the structure has stated that following a review of all transaction documents, the transaction structure and the relevant documents have been found to not contain any element, repugnant to Shari’a and that the structure is in line with the Shari’a guidelines as issued by regulatory authorities, in its entirety.

IIRA Rating Scales & Definitions

Ratings on International Scale

Foreign Currency Ratings

The foreign currency ratings by IIRA measure the ability of the rated entities to service their foreign currency obligations. These ratings incorporate all the sovereign risks of a country, including the risk of converting local currency to foreign currency.

Local Currency Ratings

The local currency ratings by IIRA measure the ability of the rated entities to service their local currency obligations. These ratings incorporate all the sovereign risks of a country, except the risk of converting local currency to foreign currency.

Ratings on National Scale

The national scale local currency ratings assigned by IIRA are tiered against an assumed local government rating of 'AAA' and, therefore, do not incorporate all the sovereign risks of a country.

Issue/Issuer Rating Scale & Definitions

Medium to Long Term

IIRA uses a scale of AAA to D to rate credit worthiness of the issuer and long term issues, with AAA being the highest possible rating and D being the lowest possible rating.

AAA: Highest credit quality. Represent the least credit risk.

AA : High credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A : Good credit quality. Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB : Adequate credit quality. Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB : Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B : Obligations deemed likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC : Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC : A high default risk

C : A very high default risk

D: Defaulted obligations

Note: IIRA appends modifiers + or - to each generic rating classification from AA through B. The modifier + indicates that the obligation ranks in the higher end of its generic rating category; no modifier indicates a mid-range ranking; and the modifier - indicates a ranking in the lower end of that generic rating category.

Rating Outlook : The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of rating change.

Rating Watch-list : IIRA places entities and issues on 'Watch-list' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). A 'Watch-list' announcement means that the status of the assigned rating(s) is uncertain and an event or deviation from an expected trend has occurred or is expected and additional information is necessary to take a rating action.

Short Term

IIRA uses a scale of A1+ to C to rate credit worthiness of the issuer and its short term obligations, with A1+ being the highest possible rating and C being the lowest possible rating.

A1+ : Highest certainty of timely payment. Short-term liquidity, including internal operating factors and / or access to alternative source of funds, is outstanding and safety is just below risk free short-term obligations.

A1 : High certainty of timely payment. Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A2 : Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A3 : Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B : Speculative investment characteristics. Liquidity may not be sufficient to ensure timely payment of obligations.

C : Capacity for timely payment of obligations is doubtful.

Fiduciary Rating Score

(91-100) – Very Strong Fiduciary Standards
(91-93), (94-97), (98-100)*
Rights of various stakeholders are well protected and the overall governance framework is strong.

(76-90) – Strong Fiduciary Standards
(76-80), (81-85), (86-90)*
Rights of various stakeholders are protected. Minor weaknesses have been identified in the overall governance framework.

(61-75) – Adequate Fiduciary Standards
(61-65), (66-70), (71-75)*
Rights of various stakeholders are adequately protected. Certain weaknesses have been identified in a few governance related areas.

(40-60) – Basic Fiduciary Standards
(40-46), (47-53), (54-60)*
Rights of various stakeholders are relatively vulnerable. Significant weaknesses have been identified in the overall governance framework.

(Less than 40) – Low Fiduciary standards
Rights of various stakeholders are at high risk and the overall governance framework is weak.

**Apart from the lowest score range, all score ranges have been split into three sub-divisions for further clarity*

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The rating assignment has been carried out with cooperation of the rated entity. The information contained herein is obtained by IIRA from sources believed to be accurate and reliable. IIRA does not audit or verify the truth or accuracy of any such information. As a result, the information herein is provided "as is" without any representation or warranty of any kind. IIRA, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the rating(s) mentioned. Rating is an opinion and not a warranty of a rated entity's current or future ability to meet contractual obligations, nor it is a recommendation to buy, sell or hold any security.