

March 17, 2010

Pakistan Market**SSGC: Burdened by structural woes****MORNING BRIEFING**

KSE100 Index: Closing 10017.71 ↓ (-70.74)

We re-initiate coverage on SSGC with a 'Sell' stance and DCF based target price of Rs14 per share. Backed by rumours of the revision in the operating profit formula and relaxation in Unaccounted for Gas (UFG) targets the stock has rallied by a massive 34% in the past one month. However, we believe, this hearsay has already been priced in, and even if either rumour becomes a reality, our target price rises to a maximum Rs20 per share. The company's valuations appear stretched as SSGC trades at a FY10E of 22x and FY11F PE of 17x (170% and 156% premium to the market, respectively). Some of the key risks to our thesis, apart from the probable change in the operating profit formula and UFG benchmarks include; (1) non-resolution of the circular debt after June 2010 and (2) awarding of contract for constructing the Pak Iran pipeline.

Finance cost & UFG continue to dent earnings

Persistent failure to meet OGRA's targets for UFG and rising financial charges, have severely dented SSGC's profits in the past few years. The company has thereby requested OGRA for a revision in the pricing formula. Discussions are underway between the regulatory authority and the two gas companies to change the formula to KIBOR+8%, from the current 17% of average operating assets adjusted for deferred credit. If this materializes, the rate of return would rise to around 20% (assuming 6M KIBOR: ~12%), while our target price would inflate to Rs16 per share.

UFG losses

Though SSGC has been strategizing continually to curb UFG losses, it has been unsuccessful thus far with the company ended up paying Rs.2.8bn in fines in FY09 alone, as its UFG touched 7.93%. Our UFG loss estimate for FY10E is 7.6% of total volumes purchased (penalty estimate: Rs2.5bn).

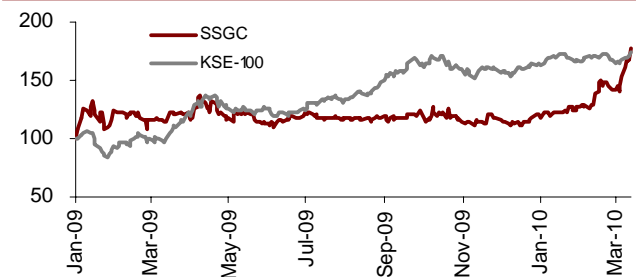
CAPEX being hampered

The spiralling inter-corporate debt has been a major irritant for SSGC as it has had to curb its aggressive growth plans. The

management though intends to remain focused on the maintenance and improvement of existing distribution lines in the medium term. An estimated Rs.4.5-6.5bn annually is planned to be expended in years post FY10, for the said purpose. However, in light of the circular debt situation, we expect FY10 CAPEX to remain in the vicinity of Rs4bn.

Valuation

Our DCF based target price of Rs14 per share has been valued using the Free Cash Flow to Equity technique assuming a discount rate of 16% and a terminal growth of 3%. Based on a FY11F PE multiple 17x, the stock is trading at a substantial premium to the market. Additionally, in comparison to its regional peers, SSGC is trading at a 7% premium on FY10 PE basis and even for FY11F, it is at a mere 3% discount, which supports our 'Sell' stance on the stock. We do not anticipate a cash dividend this year, owing to the circular debt, however, from FY11F onward, we expect the company to begin paying dividends.

SSGC vs KSE-100 index

Source: KSE, JS Research

For more details please refer to our detailed report titled "SSGC: Burdened by structural woes".

angela.memon@js.com
92 (21) 111-574-111 (ext. 3097)

Also in focus**President signs 7th NFC award**

The President yesterday, signed the 7th National Finance Commission (NFC) into a presidential order in a ceremony attended by politicians from across the country. The NFC award will now be implemented from July 1, 2010. The historic consensus was reached in a meeting in Gwadar in December last year. Under the NFC formula, the weights for the distribution of resources among provinces will be based on population (82%), poverty (10.3%), revenue (5%: 2.5 per cent each for revenue generation and collection), and area size (2.7%).

JS Global Capital Limited

6th Floor, Faysal House, Main Shahrah-e-Faisal, Karachi

Research:

Tel: +92 (21) 32799005
Fax: +92 (21) 32800163
js.research@js.com

Fixed Income Sales:

Tel: +92 (21) 32799541-44
Fax: +92 (21) 32800163
tariq.usman@js.com

Equity Sales:

Tel: +92 (21) 32799513
Fax: +92 (21) 32800166
junaid.iqbal@js.com

Corporate Finance:

Tel: +92 (21) 32799005
Fax: +92 (21) 22800163
azhar.iqbal@js.com

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