

# Sui Southern Gas (SSGC PA)

## Burdened by structural woes

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 costs continue to deflate earnings

Persistent failure to meet OGRA's targets for UFG and rising financial charges (up by a whopping 248% from Rs1.8bn in FY07 to Rs4.4bn in FY09), 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, and 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 mounting 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.

Re-initiating Coverage: **SELL**

Target Price: **Rs14**

Gas Marketing

March 2010



JS Global Capital Limited

KATS Code:  
SSGC

Bloomberg Code:  
SSGC PA

Reuters Code:  
SUIS.KA

Market Price:  
Rs19.80

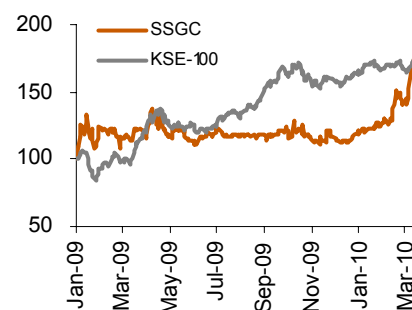
Market Cap:  
Rs13.3bn  
US\$157mn

1-yr Avg. Daily Volume:  
0.3mn shares  
Rs4.4mn  
US\$0.05mn

1-yr High/Low:  
Rs20.32/12.57

Estimated free float:  
201.4mn shares (30%)

### SSGC vs KSE-100 index



Source: KSE, JS Research

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## Rumours abound; scrip gains 34% in 23 sessions

### Possible revision in the formula

Persistent failure to meet OGRA's targets for UFG and rising financial charges, have severely hurt 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 from the current 17% of average operating assets adjusted for deferred credit. Although, no official clarification has been made so far, there are suggestions in the industry that the new formula would indeed be KIBOR based (KIBOR+8%). 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.

The following table reflects earnings' sensitivity to the suggested change in profit formula:

#### Sensitivity Analysis: Possible change in formula (EPS)

Return on operating assets	EPS		Target Price
	FY11F	FY12F	
Base case- 17%	1.14	1.50	14
KIBOR+8%	1.90	2.02	16

Source: JS Company

### UFG targets relaxation

Similarly, there has been talk of the UFG loss targets being jacked up by 50-100bps soon by OGRA. We have deduced from our discussions with the management and OGRA that such a change will not immediately come about. Even if it does occur within the next 3 months (before end of FY10), any likely reimbursement will be balanced off in the penalty for FY11. We have performed an earnings sensitivity analysis to gauge the likely impact of a 50bps and then a 100bps rise in UFG targets, which indicates the valuation would improve in either case:

#### Possible change in UFG Targets set by OGRA (with 17% formula retained)

Scenario	EPS		Target Price
	FY11F	FY12F	
Base Case UFG	1.14	1.50	14
UFG slab up 50bps	1.77	2.03	17
UFG slab up 100bps	2.24	2.52	20

Source: JS Research

Both SSGC and SNGPL have been simultaneously striving to have the profit formula and UFG targets revised, primarily because their revenue growth has little effect on the earnings, and is instead dented by the penalty charged for failing to meet the UFG loss benchmarks.

#### KIBOR assumptions

FY11F	FY12F	FY13
11.0%	10.5%	10.0%

Source: JS Research

## Finance costs & UFG continue to deflate earnings

Alongside the traditional UFG losses, finance costs which have ballooned off late, owing to the circular debt, have dampened earnings. This has also understandably restricted CAPEX growth and in turns the profitability of the company.

Considering the current fundamentals, we expect the company to post FY10E EPS of Rs0.85 and FY11F EPS of Rs1.14. The main growth driver would be the level of CAPEX incurred, as the operating profits are calculated as 17% of average operating assets (adjusted for average deferred credit). Finance costs nearly doubled in FY09, and stood at Rs2.6bn in 1HFY10 alone ( $\uparrow 136\%$ YoY), denting the operating profit by 84% and we expect it will land at around Rs5.3bn by the end of FY10. Part of this outlay was charged on short term borrowings, the company had to resort in 1HFY10 to deal with liquidity constraints. The rest was on the payments it owes to its main suppliers; all this being a consequence of the persisting circular debt. FY11 onward however, we believe this burden will lighten with the KIBOR easing off (according to our economist's expectations) as well as with the anticipated resolution of the circular debt. With an apparent breakthrough and the government pledging to arrange Rs52bn, the company is likely to recover some of what is due to it in the near term.

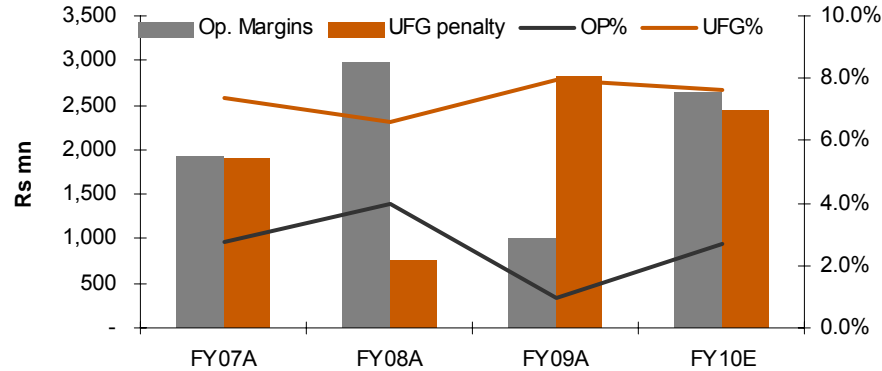
Another major profit depressant are UFG losses which we estimate will total to about 7.6% in FY10E (likely penalty of Rs2.6bn if the presently set UFG slabs are not revised) and our PBT for FY10E thus arrives at Rs1.13bn. Going further, we opine, UFG loss percent will stay around 7.6% for FY11F and then go down to 7.5% FY12F onward. Another influencing factor - though less so - would be international oil prices on which cost of gas is dependent. Any significant change in prices will reflect in the operating profit through a rise in the monetary value of UFG losses, albeit after a six month lag.

Interestingly, the company has had been paying a minimum tax of 0.5% in the recent past, which has considerably affected margins (PAT dipped by 74%YoY in FY09). This has been done to fulfill the government's requirement; the company pays the higher of 0.5% of revenues or 35% corporate tax. Given the current state of the fundamentals, we expect SSGC will qualify for the 35% tax rate in FY14 when its PBT would be ~Rs1.5bn.

## UFG Losses – continuing earnings dampener

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).

### UFG losses vs Operating profits



Source: JS Research & Company accounts

We believe, UFG losses will reduce going forward, as the company intends to continue expending on improving the distribution network and will even receive part of the US\$250mn assistance from the ADB recently to work on the same. Considering some possible scenarios, we conducted an analysis to calculate the consequent EPS in the event, the loss percent varies from our estimation:

### Possible change in our UFG estimates (with 17% formula retained)

Scenario	Resultant EPS (Rs)		Target Price (Rs)
	FY11F	FY12F	
UFG up 25bps	0.77	1.13	12
Base Case UFG	1.14	1.50	14
UFG down 25bps	1.50	1.79	15

Source: JS Research

To recount, OGRA since 2003, has set certain UFG losses' benchmarks for gas marketing companies to achieve. UFG refers to the supplies lost in the transmission and distribution of gas. If the losses cross the limits assigned, penalties are charged and accounted for in the Gas Development Surcharge (GDS) balance. The break-up of these standards and the related compensation is summed up below:

### UFG benchmarks-FY10

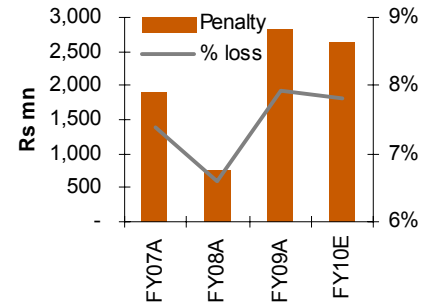
#### UFG loss slab Compensation strategy

Up till 4.5%	Company absorbs no loss
4.5%-5.5%	50% of the loss is accounted for by the company 50% of the loss is adjusted in the ERR (Estimated Revenue Requirement)
Above 5.5%	Absorbed entirely by the company, as part of the Gas Development Surcharge

Source: OGRA

The minimum slab's rates are revised each year based on several factors such as, estimations provided by the company to OGRA, the security situation in Balochistan (parts of gas pipelines being blown up is not a rare occurrence) and

### UFG loss % & subsequent penalty



Source: Company accounts

more. Regardless, the industry players consider these targets unrealistic; that they are more suitable for countries that have more developed systems and with stable domestic security situations. SSGC has resultantly been demanding an upward adjustment in these, as it struggles to retain funds for improving the distribution system.

Any cutback in the coming years in planned CAPEX therefore, will directly and negatively impact UFG loss levels.

## CAPEX being hampered; restraining EPS growth

Since, the operating returns are tied with the asset base; the company's CAPEX is of utmost importance for sustainable long term earnings. SSGC has had to slowdown in pursuing its aggressive growth plans, as it became cash strapped; a result of the circular debt. According to the management, CAPEX in the medium term is to remain focused on the maintenance and improvement of existing distribution lines. An estimated Rs.4.5-6.5bn annually is planned to be expended in the years post FY10, for the said purpose. However, for FY10E we expect the CAPEX to stand around Rs4.1bn due to circular debt.

The projects that the company has chosen to become involved in for the time being are those requiring it to provide consultancy/facilitation services and those commissioned and financed by various industrial institutions. For LNG 'Mashal', SSGC acts as a project facilitator, and any other fee earned for this is added to Other Operating Income, thereby raising the GDS balance.

Similarly, SSGC alongside SNGPL is playing the role of a consultant for the Pak Iran pipeline project, the total consultancy fee for which is US\$1mn, according to some news reports. Assuming both have an equal share and continue working till the project is completed (3 years construction period), SSGC will be earning approximately Rs14.2mn annually off of this (as Other Operating Income). This would technically have no effect on the EPS because, as mentioned before, earnings are tied to CAPEX.

However, handing over the task of the construction of this pipeline to SSGC and SNGPL is also under consideration. Construction cost estimates according to some recent news reports, for the ~1000km pipeline, come around \$2.5billion to be incurred over a period of 3 years. If this materializes SSGC would witness an unprecedented rise in CAPEX, and logically a substantial boost in earnings as well.

Since, historically the company has resorted to debt financing for approximately 50-60% of such projects, we assume this strategy will not change, and that finance cost will remain a prominent component affecting margins. The need to continue with heavy debt financing, we rationalize is essential till the inter-corporate debt issue is resolved. To point out here though, current financial cost levels are abnormally high owing to this particular problem and are expected to go down as soon as the latter 'mess' is cleared up. This is bound to restrict growth in EPS for FY10E and FY11F at least, current estimates for which stand at Rs0.83 and Rs1.14, respectively.

## Risks to valuation

### Circular debt

The circular debt encompassing the fuel and power sectors since 2007 continues to persist despite several rounds of power and gas tariff hikes. If the matter is prolonged even after FY10, earnings are likely to remain under pressure due to higher financial charges as the company's reliance on short term borrowings would continue to meet working capital requirements. On a similar note, the company will continue to sag beneath the weight of its medium term debt, and consequently remain unable to pursue major CAPEX plans hampering its long term profitability.

### Iran-Pak pipeline

For now, Pakistan and Iran have finalized the 'heads of agreement'/operational agreement for the Iran-Pak pipeline project and have signed the agreement in mid March 2010. It is yet to be clarified if SSGC will end up only as a consultant for the project or also be responsible for the construction of the main line itself. We will accordingly have to revise our estimates for CAPEX if the latter materializes. Reiterating, since the costs, fee and initiation date for the project have not been decided upon, we have not accounted for these in our valuation.

## Valuation

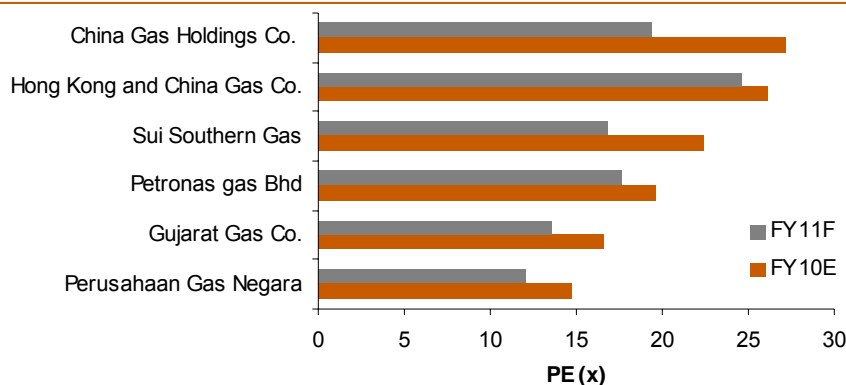
Our DCF based target price of Rs14 per share has been valued using the Free Cash Flow to Equity technique assuming a discount rate of 16% and a terminal growth of 3%. Based on a FY11F PE multiple 17x, the stock is trading at a substantial premium to the market. Additionally, in comparison to its regional 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.

### Assumptions

Risk free rate	11%
Market premium	6%
Beta	0.81
Terminal Growth	3%
Cost of Equity	16%

Source: JS Research

### PE comparison with regional peers



Source: Reuters & JS Research

We do not anticipate a dividend payout this year; owing to the circular debt which has squeezed its cash flows, and forced it to rely on short term borrowings to meet working capital requirements. However as we are of the opinion, that the circular debt situation will improve going forward, the company may be in a position to pay out dividends next fiscal year on.

## About the company

Sui Southern Gas Company (SSGC) is Pakistan's second largest integrated gas company and is listed on the Karachi, Lahore and Islamabad Stock Exchanges. It is engaged in the business of transmission and distribution of natural gas besides construction of high pressure transmission and low pressure distribution systems, manufacturing and sale of gas meters and construction contracts for the laying of pipelines. SSGCL transmission system extends from Sui in Balochistan to Karachi in Sindh comprising over 3,200 KM of high pressure pipelines. The distribution activities covering over 1200 towns in the Sindh and Balochistan are organized through its regional offices. An average of about 384,522 million cubic feet (MMCFD) gas was sold in 2008-2009 to over 2.1 million industrial, commercial and domestic consumers in these regions through a distribution network of around 34,282 Km. The company also owns and operates the only gas meter manufacturing plant in the country, having an annual production capacity of over 509,328mmcf. SSGC, as is the case with SNGPL is guaranteed an operating profit from the government, in this case a return of 17% of averaged operating assets. The company has an authorized capital of Rs. 10 billion of which Rs 6.7 billion is issued and fully paid up. The Government owns the majority of the shares which is presently over 60%.

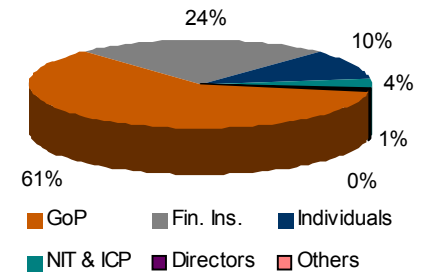
### SNGPL

Sui Northern Gas Pipelines Limited (SNGPL) is the largest integrated gas company serving more than 3.4 million consumers in North Central Pakistan through an extensive network in Punjab and NWFP. It is SSGC's only other prominent competitor and has a similar business model. SNGPL was incorporated as a private limited Company in 1963 and converted into a public limited company in January 1964, and is listed on all the three Stock Exchanges of the country. SNGPL's transmission system extends from Sui in Baluchistan to Peshawar in North West Frontier Province (NWFP) comprising over 7,347 KM of Transmission System (Main lines & Loop lines). SNGPL is guaranteed a fixed return of 17.5% of its average operating profits. It has an authorized capital of Rs15bn; Rs5.5bn is issued and subscribed. The President of the country is the major shareholder holding a 36% stake in the company.

### OGRA

Oil and Gas Regulatory Authority (OGRA) has been set up under the Oil and Gas Regulatory Authority Ordinance dated 28th March 2002 to foster competition, increase private investment and ownership in the midstream and downstream petroleum industry, protect the public interest while respecting individual rights and provide effective and efficient regulations.

### Shareholding pattern



Source: KSE, JS Research

## Appendix I: Income statement & Balance sheet

Year ended June (Rs mn)	FY08A	FY09A	FY10E	FY11F	FY12F
<b>Income Statement</b>					
Net Sales	74,626	108,151	99,608	103,003	106,850
COGS	69,238	102,389	94,091	96,933	99,860
Gross Profit	5,387	5,762	5,517	6,070	6,990
Operating Profit	2,980	1,017	2,651	2,382	2,529
Other Income	7,480	9,920	10,569	9,860	10,233
Financial Charges	2,371	4,410	5,311	3,857	3,686
<b>PBT</b>	<b>2,382</b>	<b>417</b>	<b>1,135</b>	<b>1,340</b>	<b>1,599</b>
Tax	1,391	159	561	575	591
<b>PAT</b>	<b>991</b>	<b>257</b>	<b>573</b>	<b>764</b>	<b>1,008</b>
<b>Balance Sheet</b>					
Issued, subscribed and paid-up capital	6,712	6,712	6,712	6,712	6,712
Reserves	3,459	2,878	3,451	3,719	3,920
<b>Shareholder's Equity</b>	<b>10,315</b>	<b>9,684</b>	<b>10,257</b>	<b>10,524</b>	<b>10,726</b>
Non current Liabilities	27,932	31,619	26,480	26,456	29,633
Current Liabilities	33,456	59,251	59,880	49,689	48,743
<b>Total Liabilities &amp; Equity</b>	<b>71,703</b>	<b>100,554</b>	<b>96,617</b>	<b>86,669</b>	<b>89,102</b>
Total Fixed Assets	35,424	39,521	42,034	44,863	48,020
Total Current Assets	36,279	61,033	54,584	41,807	41,081
<b>Total Assets</b>	<b>71,703</b>	<b>100,554</b>	<b>96,617</b>	<b>86,669</b>	<b>89,102</b>

Source: JS Research & Company Accounts

## Appendix II: Ratio Analysis

	FY08A	FY09A	FY10E	FY11F	FY12F
<b>Valuation</b>					
Earnings per share (Rs)	1.48	0.38	0.85	1.14	1.50
Book value per share (Rs)	15.4	14.4	15.3	15.7	16.0
Price to Earnings (x)	18.9	43.4	22.4	16.8	12.8
Price to book value (x)	1.8	1.2	1.3	1.2	1.2
<b>Profitability</b>					
Gross Margin	7.2%	5.3%	5.5%	5.9%	6.5%
Operating Margin	4.0%	0.9%	2.7%	2.3%	2.4%
Pre-tax Margin	3.2%	0.4%	1.1%	1.3%	1.5%
Net Margin	1.3%	0.2%	0.6%	0.7%	0.9%
Return on Assets	1.4%	0.3%	0.6%	0.9%	1.1%
Return on Equity	1.4%	0.3%	0.6%	0.9%	1.1%
<b>Momentum</b>					
Sales growth	8.0%	44.9%	-7.9%	3.4%	3.7%
Operating Profit Growth	54.9%	-65.9%	160.8%	-10.2%	6.2%
Net Profit Growth	241.3%	-74.0%	122.7%	33.3%	31.9%

Source: JS Research and Company Accounts

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## JS Global Capital Limited



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