RATING REPORT

Swat Expressway Planning Construction and Operations (Private) Limited (SEPCO)

REPORT DATE:
July 01, 2019

RATING ANALYSTS:
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RATING DETAILS				
	Latest Rating		Previous Rating	
Rating Category	Long-term	Short-term	Long-term	Short-term
Entity	A-	A-2	A-	A-2
Rating Outlook	Stable		Stable	
Rating Date	*June 26,'19*		*April 25,'18*	

COMPANY INFORMATION	
Incorporated in 2016	**Chief Executive Officer**: Brig Muhammad Ashfaq Maitla
Private Limited Company	**Chairman:** Maj Gen. Inam Haider Malik
Key Shareholders (with stake 5% or more):	**Independent Auditor:** KPMG Taseer Hadi & Co. Chartered Accountants
Pakhtunkhwa Highways Authority	
Frontier Works Organization	

APPLICABLE METHODOLOGY(IES)

VIS Entity Rating Criteria: Industrial Corporates (May 2019)
https://www.vis.com.pk/kc-meth.aspx

VIS Rating Criteria: Toll Roads Rating (November 2018)
https://www.vis.com.pk/kc-meth.aspx

Swat Expressway Planning Construction and Operations (Private) Limited (SEPCO)

PROFILE

Swat Expressway Planning Construction and Operations (Private) Limited (SEPCO) was incorporated as a private limited company in 2016. Key sponsors include Pakhtunkhwa Highways Authority (PKHA) and Frontier Works Organization (FWO).

RATING RATIONALE

The ratings assigned to Swat Expressway Planning Construction and Operations (Private) Limited (SEPCO) takes into account strong sponsorship profile of the two shareholders of SEPCO. Shareholding of SEPCO is vested with FWO (Class A shares) and PKHA (Class B shares). Major stakeholders, PKHA and FWO have sizable experience in infrastructure projects. FWO has undertaken major projects under public private partnership and Build-Operate-Transfer (BOT) mandates. The ratings draw comfort from precise financial planning and execution resulting in avoidance of cost overruns. However, the ratings are constrained by absence of parent company guarantee and sponsor support agreement between SEPCO and the sponsor (FWO). Completion of Expressway by 31st May 2019 has not been achieved primarily due to non-availability of complete Concession Area and delay in shifting of utilities, however adequate arrangements have been provided to facilitate commuters' journey from Kernel Sher Khan Interchange to Chackdara Interchange. Therefore, the construction and implementation risks are largely addressed.

Incorporated in 2016, SEPCO is a Special Project Company (SPC) with registered office based in Rawalpindi. The company has entered into a concession agreement for a period of 25 years with Pakhtunkhwa Highways Authority (PKHA) for construction, management and maintenance of the Swat Expressway (SER); a project by Government of Khyber Pakhtunkhwa (GoKPK). Under the Concession Agreement, SEPCO as concessionaire is responsible for Construction as well as operations and maintenance. SEPCO has employed FWO as EPC Contractor and OM&M Contractor. SER is being constructed under the BOT mode. The entire motorway is operational since 10th June'19; however the toll is being charged for 50 Km up to Katlang Interchange. SEPCO has acquired sectional completion certificate upto Palai Interchange; tolling has not yet commenced however temporary arrangements for tolling are underway. Given the project includes construction of additional structures, 2 tunnels and 5 bridges, SEPCO has applied for extension of time; however the same has not yet been confirmed. Further, tolling on interchanges will commence on receipt of next sectional completion certificate till Chackdara.

Rating Drivers

Debt Servicing Coverage: The financial close for the project was achieved in May'17. Ratings are supported by the presence of Operating Servicing Reserve Account (OSRA) amounting to Rs. 3.5b equivalent to around 31% of the total debt; this has been built as part of the overall project cost. During the year in review, the OSRA amount was proposed to be reduced owing to the fact that the reserve amount is usually set equivalent to annual peak instalment, approximately amounting to Rs. 2.8b for the project, therefore amount of Rs. 4.7b will be reduced to save additional mark-up costs and to ease cash flows. Further, given OSRA reserve amount has to be created from project finance facility, the total SPFF facility amount will be also reduced from Rs. 12.7b to Rs. 11.5b. The OSRA will be maintained for 9 years till FY28 and will subsequently decline with semi-annual repayment of principal amount. The request letter for the change was presented to lenders after negotiations with stakeholders; the contract in this regard has been drafted, meanwhile the execution is yet to be made. In addition to reduction in OSRA amount, the waterfall mechanism for utilization of revenues is also proposed for revision; the existing terms entail 15% payment of operating costs to the O&M contractor prior to full servicing of debt obligations, however; as per the revised terms 50% payment of operating cost will be made before clearing of financial obligations. Moreover, as per the undertaking from the sponsors of SEPCO, in case of shortfall to meet O&M expenses, the O&M contractor will continue its operations as long as it is getting 50% of the budgeted amount.

PKHA has injected its full equity and sub-ordinated loan amount. Rating also draws comfort from terms of the sub-ordinated loan where repayment is made in the last 5 years of the concession period. Gross revenue is expected to increase on account of growth in traffic and escalation in toll rates. With higher profitability, FFO is expected to increase steadily over the years. Liquidity profile draws support from projected growth in revenues. Debt repayment capacity of SEPCO may be affected in case traffic volumes are lower than projected. Debt servicing is low in the initial years but is projected to increase with growth in traffic and increase in toll rates. The company will have to utilize built in reserves for meeting shortfall in debt repayment. The company has to maintain Debt Service Coverage Ratio (DSCR), excluding OSRA reserve, greater than 1.0x; meanwhile DSCR inclusive of OSRA reverse is to be maintained higher than 1.4x.

Revenue Risk (Volume): Traffic profile depicts that majority travel will pertain to tourism and commuter related travel. Since time savings over the course of the entire journey on this route would be significant (~3-4 hours) vis-à-vis competing route, traffic volumes are expected to be sustainable. Higher time taken over the competing route is a function of greater distance and challenging terrain of the road. If PKHA or any other public-sector entity decides to establish a competing route, then it will be ensured that the competing route shall be tolled at least equivalent to an amount 1.5 times higher than prevailing toll rates imposed at SER. Otherwise, SEPCO is entitled to receive losses in toll revenues from PKHA.

Revenue Risk (Price): Growth in projected revenues will also be a function of increase in toll rates, as specified in the concession agreement (CA). Toll rates will be revised upwards every year at a rate of 8%. Despite significant stake of GoKPK in the project, hindrance or political interference in increasing tolls is mitigated by contractual mechanism in place for increasing tolls. Apart from tolls, growth in revenues from other sources (service area) is expected; however, their proportion is expected to remain small. In case toll rates are revised downwards, SEPCO will be compensated by PKHA for loss in toll revenues.

Project Maintenance: Regular maintenance of the road is outsourced to FWO while documented maintenance manual is in place.

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix I

VIS Credit Rating Company Limited

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

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

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

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

BB+, BB, 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+, B, B-
Obligations deemed less 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

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
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.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

REGULATORY DISCLOSURES	Appendix II
Name of Rated Entity	Swat Expressway Planning Construction and Operations (Private) Limited (SEPCO)
Sector	Toll Roads
Type of Relationship	Solicited
Purpose of Rating	Entity rating
Rating History	(see table below)
Instrument Structure	N/A
Statement by the Rating Team	VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.
Probability of Default	VIS' ratings opinions express ordinal ranking of risk, from strongest to weakest, within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.
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Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
		RATING TYPE: ENTITY		
26/06/2019	A-	A-2	Stable	Reaffirmed
25/04/2018	A-	A-2	Stable	Initial