RATING REPORT

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

REPORT DATE:
June 30, 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 30,'20*		*June 26,'19*	

COMPANY INFORMATION	
Incorporated in 2016	**Chief Executive Officer**: Brig Ahmed Shabbir Janjua
Private Limited Company	**Chairman:** Maj Gen Kamal Azfar
Key Shareholders (with stake 5% or more):	**External Auditor:** KPMG Taseer Hadi & Co. Chartered Accountants
Frontier Works Organization - 42% (Class 'A' Shares)	
Pakhtunkhwa Highways Authority - 58% (Class 'B' Shares)	

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). Registered office of the company is based in Rawalpindi.

RATING RATIONALE

The ratings assigned to Swat Expressway Planning Construction and Operations (Private) Limited (SEPCO) takes into account strong sponsorship profile of its two shareholders. Shareholding of the company is vested with Frontier Works Organization (FWO) (Class A shares) and Pakhtunkhwa Highways Authority (PKHA) (Class B shares), which have ample 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). Due to non-availability of Concession Area and revision in original construction plan, entailing construction of additional structures, 2 tunnels and 5 bridges, completion of expressway has not been achieved yet. However, a diversion is provided for the same route with adequate arrangements to facilitate commuters' journey. Therefore, the construction and implementation risks are largely addressed. Independent engineer has granted Extension of Time (EOT) upto September 30, 2020; however, the project is envisaged to be completed by August, 2020.

SEPCO is a Special Project Company (SPC), principally formed for construction of Swat Expressway (SER) on BOT basis. The company has entered into a concession agreement for a period of 25 years with PKHA for construction, management and maintenance of the 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 O&M Contractor.

Rating Drivers

Project status: The entire motorway is operational since 10th June'19. There are 7 interchanges, starting from Kernal Sher Khan (KSK) interchange upto Chakdara Interchange, out of these, 6 interchanges are operational (from KSK to Palai Intercahnge); toll is being charged for all operational interchanges. Road from 0-60km and 70-80km is 100% complete. The route of 60-70km, which includes additional structures, out of which 2 bridges and 1 tunnel are around 80% complete while the other 3 bridges and 1 tunnel are 100% complete. Regular maintenance of the road is outsourced to FWO while documented maintenance manual is in place.

Upon completion of construction, concession work in progress, constituting civil works and other capitalized costs, amounting Rs. 19.1b was transferred to concession assets, resultantly, concession assets after depreciation charge, stood higher at Rs. 18.3b (FY18: Nil). Meanwhile, concession work in progress amounted to Rs. 6.3b (FY18: Rs. 16.9b) by end-FY19. Long-term advance amounting Rs. 7.9b (FY18: Rs. 9.9b) represents mobilization advance disbursed to FWO under the EPC contract.

Revision in Operating Servicing Reserve Account (OSRA), project finance facility amount and waterfall mechanism for utilization of revenues: As completion of expressway was not achieved till May 31, 2019, release of Operating Servicing Reserve Account (OSRA) amounting to Rs. 3.5b by the syndicate of banks, equivalent to around 31% of total debt, was delayed to save markup cost. The same was made available to the company on November 22, 2019. The reserve has been built as part of the overall project cost. Given that the reserve amount is usually set equivalent to annual peak instalment, approximately amounting to Rs. 2.8b for the project, the OSRA amount was reduced from Rs. 4.7b to Rs. 3.5b to save additional mark-up costs and to ease cash flows, during the review period. The difference of Rs. 0.7b in OSRA amount from annual peak installment is maintained as a cushion to meet shortfalls in projected revenues. Further, given OSRA reserve amount has to be created from project finance facility, the total (Syndicate Term Finance Facility (STFF) amount has also been reduced from Rs. 12.7b to Rs. 11.5b. SEPCO has received full amount under this facility subsequent to drawdown of Rs. 3.6b during 1HFY20. The facility carries markup at the rate of 6 month KIBOR plus 75 bps per annum and repayable semiannually in arrears. The principal shall be repaid in 18 staggered semi-annual installments. The first such installment was due after six months from end of availability period (i.e. May 31, 2019). The company has repaid first installment with respect to this loan facility (excluding OSRA) amounting to Rs. 741m on December 2, 2019. Given relief by the GoP for Covid'19 and very low traffic volumes, management has opted to defer the principal amount of second installment due on *May 31, 2020* for one year, the same is currently pending for approval from respective bank, according to management. The OSRA will be maintained for 9 years till FY28 and will subsequently decline with semi-annual repayment of principal amount. Additionally, the waterfall mechanism for utilization of revenues has also been revised; previous terms entailed 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 to the O&M operator 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. The waterfall mechanism will be activated once the company achieve Commercial Operation Date (COD). The expected COD is September 30, 2020.

As per agreement, 23.6% of the project cost amounting Rs. 9.2b has to be funded by FWO, out of which FWO has contributed Rs. 8.3b by end-1HFY20. FWO will inject remaining equity of Rs. 851m by end of September'20, as per the management. While PKHA has already injected its full equity and sub-ordinated loan amounting Rs. 11.5b and Rs. 5.5b, respectively at the inception of the project. As a result of recognizing the difference between fair value and the loan amount, given the fair value is calculated using imputed interest rate of 6 months' KIBOR plus 0.75% per annum, and after taking into account effect of subsequent remeasurement and related amortization, long-term borrowings from PKHA stood at Rs. 3.7b (FY18: Rs. 3.5b) at end-FY19. Rating also draws comfort from terms of the sub-ordinated loan where first repayment will be made at the end of 11th year of concession period (i.e. 2027). Debt repayment capacity of SEPCO may be affected in case traffic volumes are lower than projected. 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.

Revenues have fallen short of projected growth on account of change in scope of project and current impact of pandemic: While toll collection amounted to Rs. 135.0m during 1HFY20 (FY19: Rs. 47.9m), it witnessed a significant decline from March'20 onward due to prevalent lockdown. The management expects an increase in toll collection due to growth in traffic resulting from project completion and seasonal impact, going forward. However, it will depend on the relaxation of lockdown for tourists in the related areas during FY20. Further, subsequent to COD, operational toll rates will be applied and heavy traffic, which is currently being diverted from Katlang Interchange, will also support the topline. With higher profitability, Funds from Operations (FFO) is expected to increase steadily over the years. Liquidity profile draws support from projected growth in revenues.

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) visà-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 related to toll rates remains largely addressed: 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. Contribution margin from service areas amounted to Rs. 0.2m during 1HFY20. In case toll rates are revised downwards, SEPCO will be compensated by PKHA for loss in toll revenues.

Swat Expressway Planning Construction and Operations (Pvt.) Ltd. Appendix I

BALANCE SHEET *(in PKR millions)*	FY18	FY19
Concession Assets	-	18,303.2
Concession Work in Progress	16,944.9	6,328.7
Long Term advance	9,917.6	7,921.6
Cash and Bank Balances	504.5	141.7
Other Assets	2.4	3.1
Total Assets	27,369.4	32,698.3
Long Term Loan (including current maturity)	8,071.0	11,559.2
Deferred Tax Liability	464.7	236.7
Retention Money Payable (including current maturity)	-	336.0
Tarde and Other Payables	48.9	195.4
Other Liabilities	220.9	284.6
Total/Tier-1 Equity	18,563.8	20,086.2
Paid-up Capital	16,695.6	19,170.3
INCOME STATEMENT	**FY18**	**FY19**
Net Sales	-	47.9
Gross Profit / (Loss)	-	(827.1)
Operating Profit	(28.4)	(862.0)
Profit / (Loss) Before Tax	48.2	(1,179.8)
Profit After Tax	199.0	(952.3)
Funds from Operations (FFO)	-	-
RATIO ANALYSIS	**FY18**	**FY19**
Gross Margin (%)	-	-
Net Margin (%)	-	-
Current Ratio (x)	4.2	0.16
Net Working Capital		
FFO to Total Debt (x)	-	-
FFO to Long Term Debt	-	-
Debt Leverage (x)	0.47	0.63
Gearing (x)	0.43	0.58
DSCR (x)	-	-
ROAA (x)	-	-
ROAE (x)	-	-

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix II

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 III
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

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
		RATING TYPE: ENTITY		
30/06/2020	A-	A-2	Stable	Reaffirmed
26/06/2019	A-	A-2	Stable	Reaffirmed
25/04/2018	A-	A-2	Stable	Initial

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.
Disclaimer	Information herein was obtained from sources believed to be accurate and reliable; however, VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. VIS is not an NRSRO and its ratings are not NRSRO credit ratings. For conducting this assignment, analyst did not deem necessary to contact external auditors or creditors given the unqualified nature of audited accounts and diversified creditor profile.

Due Diligence Meetings Conducted

	Name	Designation	Date
1	Mr. Imran Naeem	Company Secretary	17th Feb, 2020
2	Miss Farzana Kausar	CFO	8th Jun, 2020
3	Miss Mahrukh Afsar	AM Finance	8th Jun, 2020