ICRA

May 26, 2017

Mahanagar Gas Limited

Instruments*	Amount Rated (Rs. crore)	Rating Action
Long-term debt programme	100.0	[ICRA]AAA (Stable) / reaffirmed
Long-term non-fund-based limits	200.0	[ICRA]AAA (Stable) / reaffirmed
Short-term non-fund-based limits	400.0	[ICRA]A1+ / reaffirmed

**Instrument details are provided in Annexure-1*

Rating action

ICRA has reaffirmed the long-term rating of [ICRA]AAA (pronounced ICRA triple A) to the Rs. 100 crore long-term debt programme and Rs. 200 crore non-fund-based limits and short-term rating of [ICRA]A1+ (pronounced ICRA A one plus) to the Rs. 400 crore non-fund-based limits of Mahanagar Gas Limited. The outlook on the long-term rating is Stable.

Rationale

The reaffirmation of ratings favourably factors in the strong parentage of MGL, its current monopoly position in Greater Mumbai (GA1) and surrounding expansion areas (GA2) and its diversified customer profile. Despite the expiry of MGL's marketing exclusivity in both GA1 and GA2 some years back, ICRA expects the company to continue to enjoy a dominant market share because of its first-mover advantage, as evident from its established infrastructure network. In addition, there are significant entry barriers for third-party marketers arising mainly from concerns regarding availability of gas at competitive prices. MGL continues to enjoy physical exclusivity (25 years from the year 1995 for Greater Mumbai and from 2005 for expansion areas, which can be further extended for a block of 10 years) which is another positive for the company's operations. The ratings also take into account the strong financial profile of the company characterised by healthy profitability levels, negligible borrowings and strong liquidity profile characterised by sizeable cash balances and liquid investments (of Rs. 576 crore as on September 30, 2016).

ICRA also notes that the Supreme Court ruling dated July 1, 2015 in favour of Indraprashta Gas Limited (IGL) in its dispute with the PNGRB has helped alleviate the regulatory risks that the sector was facing. The ruling provides pricing freedom (including network tariffs and compression charges) to CGD players operating through their own network thereby assuring stability in margins and viability of gas distribution operations.

The ratings also take into account the increase in price advantage of gas over alternate fuels (especially in the CNG and domestic segments) and the consequent positive impact on demand. The decline in global gas indices led to a decline in gas cost for the CGD sector with domestic gas prices announced by the GoI for the six-month period starting from April 1, 2017 being lower by about 20% compared to the prices announced for the six-month period starting from April 1, 2016. The company has passed on partially the benefit of lower gas costs to its customers leading to lower gas prices and therefore higher cost advantage against alternate fuels.

ICRA notes that MGL has sizeable capex in Mumbai and the surrounding areas to expand its network. The company is also undertaking capex for setting up its network in Raigad (its newly authorised GA). The large scale of capex (~Rs. 1,000 crore over 25 years) and the gestation period associated with build-up of sales volumes in Raigad is expected to moderately impact the company's return indicators and coverage metrics. However, the company is expected to benefit from the location of Raigad district as it is in continuity to its existing GAs and has an access to GAIL's pipeline network in the entire GA. The company has achieved limited progress on its infrastructure plans in Raigad compared to the MWP submitted to the GoI due to delays in receiving necessary approvals and thus ramp-up of operations remains to be seen. ICRA also notes that MGL's participation in bidding rounds for new cities could result in higher bank guarantee liabilities, going forward. Also, the company may look for inorganic growth and therefore any sizeable acquisition remains a key rating sensitivity.

Key rating drivers

Credit Strengths
- Monopoly position in the gas distribution business in Greater Mumbai and expansion areas
- Strong parentage, with both promoters (GAIL and Shell) having a deep understanding of the gas business
- Diversified sales profile spread across CNG and PNG (industrial, commercial and domestic) segments
- Favourable outlook on demand growth in both the CNG and PNG segments, given the price differential between gas and liquid fuels apart from other advantages such as ease of handling, no storage requirement, and credit period
- Secure gas tie-up from GAIL for a large part of its existing operations; additionally the GoI-mandated provision of domestic gas for the CNG and PNG (domestic) segments ensures availability of gas for current consumption and growth in these segments
- Strong financial profile with healthy profitability and return indicators; strong coverage metrics and healthy liquidity profile

Credit Weaknesses
- Operations in the industrial segment exposed to changes in spread between PNG and alternate fuel prices; however, the recovery of crude oil prices to some extent in the past year has improved the cost advantage of PNG over alternate fuels
    - Ability to tie up new gas sources at competitive prices would be critical to cater to the increased demand and sustain the profit margins for PNG-Industrial and Commercial segments
    - However, the company's pricing flexibility is a protective factor as witnessed through its ability to pass on the price increases in input gas cost so far
- Threat from potential competition, especially in the industrial and commercial segments, remains a possibility after the end of the company's marketing exclusivity in GA1 in 2012 and GA2 in 2014; however, no new player has emerged so far
- Ongoing expansion plans (including the company's capex plans for Raigad) could subdue return indicators due to the gestation period associated with build-up of sales volume
    - Significant delays seen in meeting the initial targets for the Raigad expansion due to delay in approvals from multiple regulatory bodies as the concerned area lies in an eco-reserve

Description of key rating drivers:
MGL is the only company involved in city gas distribution in the Greater Mumbai region and has a diversified user segment portfolio comprising CNG, industrial, commercial, and domestic PNG consumer segments. The CNG segment accounts for 73-75% of the total sales. In FY2016, the company's total sales volumes grew ~2% y-o-y as volume sales across all segments remained largely muted. In 9MFY2017, the CNG segment reported higher demand resulting in a 6% overall sales volume growth for MGL on a y-o-y basis. Healthy sales growth was also seen in the PNG-domestic segment at 8% in 9MFY2017.

At present, MGL enjoys a near-monopoly status and also the first-mover advantage in retail gas distribution in Greater Mumbai (GA1) and its expansion areas (GA2). The company had a marketing exclusivity in these areas which expired in 2012 for GA1 and in 2014 for GA2. After the expiry of the marketing exclusivity, the company was required to make its network available to third-party marketers on an open-access basis. The company, however, enjoys physical exclusivity in GA1 and GA2 for 25 years from 1995 and 2005, respectively. While the expiry of marketing exclusivity, in principle, would imply an increase in competition for MGL, the actual competitive risk is expected to be fairly limited due to the company's first-mover advantage, established network and customer relationships, and security of existing gas supplies. Any third-party marketer looking to utilise the infrastructure of MGL for CNG/PNG sales is faced with multiple operational challenges and constraints related to regulatory uncertainty. The PNG – Commercial and Industrial segments, with large volumes and lower operational issues due to bulk customer management, are open to competition. Nevertheless, MGL's industrial/commercial portfolio in the Mumbai region is limited and therefore is not at severe risk from competition.

A favourable allocation policy has assured availability of gas from GAIL for CNG and PNG-domestic segments. In February 2014, the GoI announced allocation of 100% domestic gas towards the CNG and PNG (domestic) segments of CGD entities, up from the initial 80% proportional allocation. Further, in August 2014, the MoPNG issued another guideline as per which GAIL was directed to supply an additional 10% to meet incremental demand during the review period of the CNG and PNG (domestic) segments over and above the 100% allocated gas (based on past six months consumption). The above step was a positive to increase the penetration levels in the CNG and PNG-domestic market, with the assurance of extending domestic gas allocation to such increased volumes. However, for its PNG-Commercial and Industrial segments, where there is growth potential in the expansion areas, MGL's ability to meet additional gas requirements at competitive prices would remain critical.

In line with fall in global gas prices, the domestic gas prices too have declined by 20% for the 6-month period from April 2016 and then by 18% for the six-month period from October 2016. The latest announced price of US$2.48/mmbtu[1] is 1% lower for the next six-month period starting from April 2017. The company has passed on the benefits of lower gas cost to customers partially with a reduction in CNG prices and has managed to retain part of the benefits resulting in higher contribution margin. The reduction in costs has improved the cost advantage of gas over alternate fuels, which has further supported the demand for CNG and PNG.

The gas distribution business is highly capital-intensive, which is apparent from the capital deployments made by the company over the past decade. Under the fourth round of bidding conducted by the PNGRB for 14 GAs, MGL won the bid for Raigad, Maharashtra. MGL is therefore, authorised to set up its CGD network in the district and also gave a Performance Bank Guarantee (PBG) to PNGRB for the same. The company is planning to fund the capex through internal accruals only. During the last two fiscals, the company incurred limited capex in Raigad, significantly lower than the MWP, mainly due to delay in regulatory approvals, which are beyond the scope of the company.

Analytical approach:
For arriving at the ratings, ICRA has applied its rating methodologies as indicated below:

Links to applicable Criteria
Rating Methodology for City Gas Distribution Companies
Corporate Credit Ratings: A Note on Methodology

[1] Million British Thermal Unit

About the company:
Mahanagar Gas Limited (MGL) is the sole distributor of compressed natural gas (CNG) and piped natural gas (PNG) in Mumbai, its adjoining areas and the Raigad district in Maharashtra. The promoters of MGL, viz. GAIL (India) Limited and BGAPH[2] (BG Asia Pacific Holdings Pte Limited), hold 32.5% equity stake each in the company. The company issued its Initial Public Offering (IPO) in July 2016 to provide partial exit to the promoters (pre-IPO stake was 49.75% each). MGL plans to expand its gas distribution network in its current geographical areas (GA), i.e. Greater Mumbai (GA1) and surrounding regions (GA2) such as Mira-Bhayander, Thane (Urban) -Vashi-Belapur, Kharghar-Panvel-Taloja, Kalyan-Dombivali-Ambernath and Ulhasnagar. The company won the bid for Raigad in the fourth round of bidding conducted by the Petroleum and Natural Gas Regulatory Board (PNGRB) and would be setting up its city gas distribution (CGD) network in the district (GA3). The company procures natural gas primarily from GAIL (India) Limited.

The company recorded sales of Rs. 2,079 crore in FY2016 and sales of Rs. 1,509 crore in 9MFY2017 (unaudited).

Status of non-cooperation with previous CRA: Not Applicable.

Any other information:

Disclosure: A Member of the Board of Directors of ICRA Limited is also an Independent Director on the Board of Directors of Mahanagar Gas Limited. This Director was not involved in any of the discussions and processes related to the Rating of the instrument(s) mentioned herein.

[2] BG Plc, ultimate holding company of BGAPH has became 100% subsidiary of Royal Dutch Shell Plc, during the month of February, 2016

Rating history for last three years:
Table:

S. No.	Name of Instrument	Current Rating			Chronology of Rating History for the Past 3 Years		
		Type	Amount Rated (Rs. crore)	Date & Rating	Date & Rating in FY2017	Date & Rating in FY2016	Date & Rating in FY2014
				May 2017	April 2016	May 2015	March 2014
1	Non-fund-based	Long-term	200	[ICRA]AAA (Stable)	[ICRA]AAA (Stable)	-	-
2	Debt Programme	Long-term	100	[ICRA]AAA (Stable)	[ICRA]AAA (Stable)	[ICRA]AAA (Stable)	[ICRA]AAA (Stable)
3	Non-fund-based	Short-term	400	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	-

Complexity level of the rated instrument:
ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1
<u>Instrument Details</u>

Instrument	Date of Issuance/ Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. Crore)	Current Rating and Outlook
Long-term, debt programme	Not placed	-	-	100.00	[ICRA]AAA (Stable)
Long-term, non-fund based	-	-	-	200.00	[ICRA]AAA (Stable)
Short-term, non-fund based	-	-	-	400.00	[ICRA]A1+

Source: MGL

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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