Mr A. Rasim Akdogan
Cinigaz Dogalgaz Dagitim Sanayi ve Ticaret A.S.
N. Akar Mah. 1400.
Sok. No:34/3 Balgat
06520 Ankara
Turkey

May 1, 2015

Dear Mr. Akdogan,

Re: Rating Letter for Cinigaz Dogalgaz Dagitim Sanayi ve Ticaret A.S.

Fitch (see definition below) assigns Cinigaz Dogalgaz Dagitim Sanayi ve Ticaret A.S. (Cinigaz) the following rating:

- National Long-term Rating of 'A(tur)' with a Stable Outlook.

The rating reflects Cinigaz's regulated gas distribution business, which is characterised by good predictability of cash flow, although lower than in the case of more developed regulatory frameworks in western Europe. The company has a small scale of operations and is privately-owned. Debt levels are low, however Cinigaz has a permanent negative working capital position as its trade receivables and inventory are substantially lower than trade payables and advance payments. Fitch-calculated leverage adjusted for negative working capital and subscription fees from new customers decreased considerably between 2012 and 2014. We project FFO adjusted leverage to improve further to about 2.5x in 2015 from 3.6x in 2014, which is consistent with the rating.

KEY RATING DRIVERS
Predictable Gas Distribution
Cinigaz's rating is supported by the regulated nature of the company's operations. A large part of the company's Fitch-adjusted EBITDA comes from regulated gas distribution characterised by good predictability of cash flow. The company was granted its natural gas distribution license for the region of Kütahya in western Turkey by the Turkish Energy Market Regulatory Authority (EMRA) in 2004 for 30 years.

One of the key drivers for Fitch-adjusted EBITDA is the allowed return on the regulatory asset base. On the cost side, capex and operating expenditures that are approved by EMRA are passed on to customers through tariffs. In addition, subscription fees from new customers connected to the network are also regulated by EMRA. However, Fitch excludes the subscription fees from its adjusted EBITDA and funds from operations (FFO) and treats them as the source for capex co-funding.

Cost Pass-through in Supply Business
Regulated gas distribution business usually allows for EBITDA predictability and stability, although historically there was some variation in cash flows, for instance in 2012, related to the pass-through of gas purchase cost to end-customers. We view the price risk within the supply component of the tariff as concerns within the regulatory framework. We assume in the projections that Cinigaz is able to fully pass through gas purchase costs in its prices for customers, and as a result, generates close to zero margin in its supply business. Reduced ability to reflect gas purchase cost in prices for end-customers would be negative for the rating.

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Focus on Network Expansion

The main strategic goal of management is to expand the company's distribution network and grow the customer base. Management plans to reinvest free cash flow into the business rather than pay dividends. We expect Cinigaz to benefit in the next few years from the growing demand for gas due to an expanding gas network in the Kutahya region, connections of planned economic zones and also a growing local economy.

Capex Overspent Risk

We view the potential for uncompensated capex overspent as a credit constraint. In 2014, actual capex was substantially higher than approved by EMRA (TL24m vs TL5.8m) and it is not certain how the capex overspent will be reflected in regulatory revenues in the next few years.

The higher than approved capex in 2014 was because Cinigaz focused on gas network expansion (also to a planned industrial zone in the Tavsanli area) to connect new customers and support future growth as management wants to outperform the regulatory targets for gas volumes given that the remuneration system gives incentive for higher than approved volumes.

According to Cinigaz's management this additional capex on top of the regulatory-approved capex will not be reflected in the tariffs in the current regulatory period until 2016. Cinigaz is in discussions with the regulator to reflect in tariffs the additional capex resulting in much higher RAB and higher depreciation in the next regulatory period after 2016. We understand from the company that EMRA sent letters to Cinigaz saying that they are aware of the capex spent in 2014. The capex overspent was also the case in 2013, but to a lesser extent (TL7.7m vs. TL5.3m).

Volume Risk

The tariff system in Turkey results in volume risk for Cinigaz. Higher than EMRA-approved gas volumes are positive for the company's cash flows as the remuneration is calculated as a regulated tariff per unit multiplied by gas volumes. Conversely, lower than approved volumes are negative for cash flows. Exposure to volume risk is viewed negatively compared with some more developed and mature regulatory frameworks such as in the UK, Germany or Italy where there is limited or no exposure to volume risk. The tariff is adjusted for changes in volumes every five years for the next five-year regulatory period.

Moderate Financial Policy

We assess Cinigaz's financial policy as moderate due to management's focus on organic growth and the policy not to pay dividends as positive free cash flow is retained within the company.

Negative Working Capital

The company has a permanent negative working capital position not covered with cash. Such a situation could lead to a liquidity crunch in case suppliers decide to shorten payment terms. However, in the case of Cinigaz, the negative working capital position has been steady as Turkey's main gas supplier state-owned BOTAŞ Petroleum Pipeline Corporation (BOTAS) allows gas distribution companies including Cingaz to pay for gas 15-30 days after the distributors have received cash from end-customers. Cinigaz has trade payables days outstanding to BOTAS of 60-70 days, and trade receivables days outstanding of 30 days.

Improving Fitch-Adjusted Leverage

We project FFO adjusted leverage to improve to about 2.5x in 2015 from 3.6x in 2014 and a high level of 5.3x in 2013. FFO adjusted leverage reflects two main adjustments:

- FFO is reduced by subscription fees received from customers (for instance TL3.6m in 2014) and

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- gross adjusted debt is the sum of borrowings and negative working capital not covered with unrestricted cash (trade receivables plus inventory minus trade payables and advances from customers (unearned revenues) plus unrestricted cash).

Small Scale, Privately-Owned Company
Cinigaz is a small company (EBITDA of TL18m (USD8m) in 2014) compared with Fitch-rated gas distribution peers, albeit its current regulatory framework does not pose significant efficiency challenges that would not be achievable given its scale. The company is owned by its chairman and general manager Rasim Akdogan who owns 81% of the shares. Mr Akdogan also owns construction company Setas A.S., which is Cinigaz's main related party as a contractor for network capex. This results in key man risk and is a constraining factor for the rating. Nevertheless, we do not view the current financial transparency as a limiting factor.

Exposure to FX Risk
The company has a currency mismatch of debt and operating cash flows. This exposes Cinigaz to deterioration in credit metrics if the Turkish lira depreciates significantly in a short period of time. This currency mismatch is often the case for Turkish corporates who borrow in US dollars and do not hedge their position. FX risk has increased from 2013 given that the new transportation tariff is denominated in TL while the previous tariff applicable for 2004-2012 was set in USD.

Concentrated Counterparty Risk
Turkish incumbent gas transmission and wholesale trade company BOTAS remains the dominant supplier in Turkey in the wholesale market and is also the main gas supplier to Cinigaz. We do not view this as a constraining factor for the rating given BOTAS's size and diversification of its gas supplies coming mostly from imports.

RATING SENSITIVITIES (if the rating was to be maintained and monitored)
Positive: Rating upside is limited. Future developments that may, individually or collectively, lead to positive rating action, if the rating is maintained, include:
- Reduction of FFO adjusted leverage (adjusted for subscription fees and negative working capital) to 1.5x or below on a sustained basis.
- Longer track record of the current regulatory framework resulting in improved predictability of cash flows.
- Better predictability of capex.

Negative: Future developments that could lead to negative rating actions include:
- FFO adjusted leverage above 4x on a sustained basis.
- Deterioration of regulatory predictability would be negative for Cinigaz's business profile.
- Change in financial policy, for instance an aggressive dividend policy or large debt-funded acquisitions.
- Negative free cash flow on a sustained basis.
- Reduced ability to reflect gas purchase cost in prices for end-customers.

LIQUIDITY AND DEBT STRUCTURE
Negative Working Capital Weights on Liquidity
Liquidity is sufficient given that at end-December 2014 the company had unrestricted cash of TL15.9m versus virtually no short-term debt. However, the company has a permanent negative working capital position as its trade receivables and inventory are not sufficient to cover trade payables and advance payments from customers. At end-December 2014 unrestricted cash of TL15.9m was not sufficient to cover negative working capital of TL39.3m. Such a situation could lead to a liquidity crisis in case suppliers decide to shorten payment terms. However, in the case of Cinigaz the negative working capital position has been steady as Turkey's main gas supplier BOTAS allows gas distribution

companies including Cingaz to pay for gas 15-30 days after the distributors have received cash from end-customers. Liquidity adjusted for negative working capital was sufficient if available unused lines of TL190.5m (TL142.9m and USD20.5m) are taken into consideration . However, committed/available liquidity lines in Turkey are not equivalent to committed lines in the EU.

Restricted cash (TL9.3m at end-2014) relates to cash generated from natural gas sales that, in accordance with the agreements with banks, must be kept in the deposit account for an average of 6 working days without any withdrawals.

The company's debt comprises of bank loans in the US dollar (USD10.8m), equivalent of TL25m at end-2015.

TERMS OF THIS LETTER

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We are pleased to have had the opportunity to be of service to you. If we can be of further assistance, please contact Arkadiusz Wicik at +48 22 338 62 86, Ross Macaulay at +44 20 3530 1395 or me at +44 20 3530 1287.

Sincerely,

Fitch

By:

Josef Pospisil

Head of EMEA Utilities and Transport

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