Vadodara Gas Limited

March 24, 2021

Ratings

Facilities	Amount (Rs. crore)	Rating[1]	Rating Action
Long Term Bank Facilities	83.55 (Reduced from Rs.84.97)	**CARE A-; Stable (Single A Minus; Outlook: Stable)**	**Reaffirmed**
Short Term Bank Facilities	25.00	**CARE A2+ (A Two Plus)**	**Reaffirmed**
Total Facilities	**108.55 (Rupees One Hundred Eight Crore and Fifty-Five Lakhs Only)**		

Details of facilities in Annexure-1

Detailed Rationale & Key Rating Drivers

The ratings assigned to the bank facilities of Vadodara Gas Limited (VGL) continue to derive significant strength from its strong parentage of GAIL (India) Limited (GAIL; rated CARE AAA; Stable/ CARE A1+) and Vadodara Mahanagar Seva Sadan (VMSS), VGL's well-established City Gas Distribution (CGD) business operations in its authorized geographical areas (GAs) of Vadodara district along with established natural gas sourcing arrangements with GAIL and its diversified customer segment mix. The ratings further derive comfort from increase in VGL's scale of operations during FY20 (Audited; FY; refers to the period April 01 to March 31); albeit it declined during 9MFY21 due to adverse impact of the outbreak of Covid-19 pandemic and is expected to remain at modest level during FY21. The ratings are also underpinned by VGL's comfortable leverage, moderate debt coverage indicators and adequate liquidity apart from favourable demand outlook for CGD business.

The ratings, however, continue to remain constrained on account of VGL's low operating profit margin and return on capital employed (ROCE) compared to its peers due to its old pipeline network which results in high system losses and requires high repair and maintenance expenditure, project implementation risk associated with its partly debt-funded large size capex plan during the medium-term (FY21 to FY22) which is expected to result in some moderation in its debt coverage indicators till the time realization of envisaged benefits from capex, uncertainty regarding its ongoing litigation with Adani Total Gas Limited (ATGL) for the CGD authorization of Vadodara district, susceptibility of the demand for natural gas from its industrial and commercial segment customers to price dynamics of competing fuels of the respective business segments and high regulatory risk associated with CGD business. The ratings of VGL are also constrained due to short unexpired period of its infrastructure exclusivity opening up the possibility of competition from other CGD players.

Rating Sensitivities

Positive Factors

- Sizable increase in its scale of operations along with reduction in its system losses leading to improvement in its PBILDT margins to more than 15% and ROCE above 12% while maintaining overall gearing ratio below 0.75x on a sustained basis.

Negative Factors

- Overall gearing ratio exceeding 1x on a sustained basis along with its adverse impact on its debt coverage indicators.
- Any significant penalty levied on VGL by the Petroleum and Natural Gas Regulatory Board (PNGRB) for underachievement of its minimum work program (MWP); and its consequent adverse impact on its credit profile.
- Any adverse outcome of its dispute with ATGL with respect to the CGD authorization for Vadodara district resulting in adversely affecting VGL's business prospects.

Detailed description of the key rating drivers

Key Rating Strengths

Strong parentage: VGL is promoted by GAIL along with GAIL Gas Limited (GGL - unsupported rating of CARE AA; being a wholly owned subsidiary of GAIL) and VMSS [erstwhile Vadodara Municipal Corporation (VMC)]. GAIL has the largest gas transmission pipeline infrastructure in India and its activities range from gas transmission and distribution to production and marketing of petrochemicals and leasing bandwidth in telecommunications. GGL has been authorized by Petroleum and Natural Gas Regulatory Board (PNGRB) for implementing CGD projects in various cities. VMSS is the municipal corporation of Vadodara city.

Established CGD operations in Vadodara district; albeit ongoing dispute with ATGL: VMSS was operating PNG network in the city of Vadodara since 1972 which is one of the oldest CGD networks in India whereas GAIL was operating CNG network in some parts of the city of Vadodara. Looking at the growth prospects of the CGD business, both the entities contributed their PNG & CNG assets to VGL for business synergies. Post formation of VGL, PNGRB in October 2016 granted it an

[1]*Complete definitions of the ratings assigned are available at www.careratings.com and in other CARE publications.*

authorization for expansion of CGD network in the entire district of Vadodara. PNGRB has granted marketing exclusivity and infrastructure exclusivity to VGL, with expiry dates of October 26, 2019 and March 31, 2023 respectively. ATGL, which used to operate CNG stations in Vadodara district before the grant of such authorization to VGL, has however continued the operations of its CNG segment in Vadodara; albeit the dispute between VGL and ATGL for the CGD authorization of Vadodara district continues to be sub-judice. As of now, no other CGD entity has started marketing piped natural gas in the authorized areas of VGL due to practical difficulties in the implementation of the common carrier regulations and its evolving nature. Further, even if the common carrier regulations are implemented, VGL is envisaged to be compensated for the use of its CGD infrastructure for the supply of natural gas; albeit its adequacy needs to be seen.
As of September 30, 2020, VGL had a network of more than 1,60,000 PNG domestic customers, 17 PNG industrial customers, more than 2,500 PNG commercial customers and 18 CNG stations (including 5 online stations) in Vadodara district.

Established natural gas sourcing arrangements: The Ministry of Petroleum & Natural Gas (MoPNG), Government of India under its guidelines has accorded priority in natural gas allocation for PNG-domestic & CNG segments. Accordingly, VGL receives natural gas for its requirement for these segments under Administrative Price Mechanism (APM). For its balance requirement, VGL relies on imported R-LNG for its PNG-industrial and PNG-commercial segments. Entire gas sourcing is done from GAIL and VGL has full freedom for pricing of gas sold by it.

Growth in scale of operation during FY20 supported by favourable customer mix: VGL's sales mix is well diversified between PNG & CNG segments at 42% and 58% respectively during FY20. VGL's Total Operating Income (TOI) grew by around 14% during FY20 mainly driven by growth in the sales volume of its CNG and PNG-domestic segments by 11% and 12% respectively on Y-o-Y basis. VGL added 4 new CNG stations and around 24,000 new PNG-domestic customers during FY20 which contributed to growth in its sales volume. VGL added around 25,800 new PNG-domestic customers from April 2020 to February 2021. Further, it is also laying natural gas pipelines in Waghodia, Padra and Savli (adjoining areas of Vadodara city) to tap the industrial customers. These factors along with expected recovery in the sales of its CNG segment after the disruption during Q1FY21 on account of outbreak of Covid-19 are expected to support growth in VGL's scale of operations from FY22 onwards.

Low leverage and moderate debt coverage indicators: Despite increase in VGL's total debt by around Rs.33 crore during FY20 on account of drawl of term-debt for the purpose of ongoing capex, its overall gearing ratio remained at 0.28x as on March 31, 2020 (overall gearing ratio of 0.07x as on March 31, 2019) due to healthy tangible net-worth base of around Rs.157.27 crore as on March 31, 2020. Due to increase in its total debt, VGL's PBILDT interest coverage and total debt/GCA moderated to 3.91x and 3.38 years respectively during FY20 as against PBILDT interest coverage and total debt/GCA of 5.01x and 1.53 years respectively during FY19. VGL's leverage and debt coverage indicators are expected to remain moderate in medium term on the back of expected drawal of term-debt for the purpose of its ongoing capex while the expected benefits of the capex will accrue in a staggered manner.

Favourable demand outlook for CGD industry: VGL is expected to benefit from the continued increase in natural gas demand (CNG and PNG). There is an increase in the number of CNG operated vehicles on account of the favorable pricing economics of natural gas over conventional fuels. Also, domestic gas consumption being at a very nascent stage presents a growth opportunity for CGD companies; and VGL is working towards increasing customer connections to improve its reach. Going forward, the expected increase in number of CNG variant models by car manufacturers would also increase the number of CNG vehicles which could spur higher demand for CNG. Also, there is an ongoing expansion of imported R-LNG handling capacity in India which shall result in higher availability of natural gas in the future; albeit India's very high dependence on imports due to low domestic production is a concern. Further, CNG demand could be susceptible to technological disruptions such as the faster rollout of electrical vehicles (EVs).

Key Rating Weaknesses

Decline in scale of operations during 9MFY21 along with continued low profitability and return indicators: VGL's TOI declined by around 18% during 9MFY21 on Y-o-Y basis as the sales volume of its CNG segment declined due to outbreak of covid-19 and subsequent imposition of the nation-wide lockdown. Hence despite its growing CGD network, its scale of operations is expected to be lower during FY21 on Y-o-Y basis. VGL's operating profit (PBILDT) margin although improved by 287 bps during FY20 on Y-o-Y basis, remained low (at 9.70% during FY20) compared to its peers due to its old pipeline network which results in high system loss, high repairs and maintenance expenses and rapidly increasing PNG-domestic connections for which VGL recovers only part of installation cost. VGL's PBILDT margin improved by around 222 bps during 9MFY21 on Y-o-Y basis despite decline in its scale of operations and unfavourable change in the sales mix (decline in share of sale of high gross margin yielding CNG segment in total sales) as natural gas prices also declined during FY21, benefit of which was not fully passed on to customers. VGL's PBILDT margin is expected to remain low compared to its peers as long as high system losses persist.

VGL's return on capital employed (ROCE) remained low at 2.96% during FY20 (ROCE of 2.05% during FY19) due to its low operating profit and high base of capital employed of around Rs.320 crore as on March 31, 2020 (including goodwill of Rs.106 crore).

High level of system losses due to old network: Due to leakages in the old pipeline network (VMSS commenced natural gas distribution in the city in 1972), VGL incurred a system loss of 38% during FY20 (system loss of around 37% during FY19) and high repairs and maintenance expenditure. VGL has increased the pressure of gas supplied through this network which has further increased the system loss. Furthermore, due to change in the sales mix, its system loss increased to around 45% during H1FY21 (system loss of around 34% during H1FY20). High level of system loss is the key reason for VGL's low profitability. However, part of VGL's ongoing capex plan includes replacing some of its old pipelines which is expected to bring down the system loss to a certain extent.

Project execution risk associated with the large-size partially debt-funded capex: VGL is planning to incur capex of around Rs.120 crore during the three years (FY20 to FY22) which is being funded through term debt of Rs.75 crore and remaining through internal accruals and customer deposits. Part of the capex is being incurred to replace its old pipeline network and part to expand its CGD network in its authorized GAs. VGL plans to connect more than 50,000 PNG customers, establish new CNG stations and tap the industrial customers in the adjoining areas of Vadodara city through the capex. VGL has already incurred capex of around Rs.62 crore during FY20 and H1FY21. Timely completion and operationalization of the planned capex plan and consequently generating envisaged return on the incremental capital employed will be crucial for the adequacy of its debt coverage indicators going forward.

Short unexpired infrastructure exclusivity period: VGL's infrastructure exclusivity in the Vadodara district will end on March 31, 2023. After end of its infrastructure exclusivity period any other CGD player can set up their infrastructure in Vadodara district which may lead to competition especially in the CNG segment which contributed around 58% of VGL's total income during FY20.

Demand from industrial and commercial customers has close linkages with prevailing price of competing fuels: VGL faces higher susceptibility of changes in demand for natural gas from industrial & commercial segments (which accounted for nearly 14% of its total sales value during FY20) due to any major change in the price of other competing fuels. In the industrial segment, furnaces are designed for easy switch of fuel and during times of relatively higher gas prices, the customers can shift to alternate fuels which could reduce gas off-take from VGL. Most of the equipment in the PNG - commercial segment is designed to use LPG as a fuel, with natural gas as an option. Further, demand from the CNG - segment is also susceptible to the prevailing price of its competing fuel, i.e. petrol and diesel.

Regulatory risk associated with the CGD sector: As per existing regulations, CGD companies are allotted APM gas to meet their requirement to cater to the PNG-Domestic & CNG segments. However, looking at the subdued domestic gas production, the continuation of the same allocation of APM gas shall be critical going forward. Both these segments contribute heavily to the profitability of CGD companies, accordingly, any adverse regulatory changes on this front can affect the profitability of CGD companies directly. However, both CNG & PNG - domestic segments are the focus areas of GoI which may result in the continuation of APM pricing of gas to be supplied to both these segments.
Furthermore, on the regulatory front, PNGRB has come out with a discussion/concept paper for allowing third party access to existing CGD players' infrastructure network for supply of natural gas after expiry of the marketing exclusivity period. If and when such regulatory changes are implemented and the form in which they are implemented would be a key monitorable for the CGD sector going forward as this could result in possible entry of competitors in existing GAs through implementation of common contract carrier regulation after expiry of the marketing exclusivity period and could lead to concomitant impact on the CGD sectors profitability.

Liquidity: Adequate
VGL's cash flow from operations remained adequate at around Rs.19.51 crore during FY20 (cash flow from operations of around Rs.21.03 crore during FY19). Further, VGL had unencumbered cash and cash equivalent of around Rs.16 crore as on March 31, 2020 which increased to around Rs.29 crore as on September 30, 2020 providing it adequate liquidity cushion. VGL has term-debt repayment of around Rs.1.90 crore during FY21 and Rs.9.04 crore during FY22. Apart from its term-debt repayment obligation, VGL is also incurring capex on its on-going project. VGL's undrawn sanctioned term-debt, its envisaged cash accruals from operations and existing liquid surplus are expected to remain adequate to meet its capex requirement and term-debt repayment obligations. Further, CARE also notes that the company has not availed any moratorium as a Covid relief measure under the guidelines of RBI for the interest payment or principal repayment on its existing bank facility. Current ratio of VGL remains below unity at 0.82x as on March 31, 2020 mainly on account of classification of deposits from its customers (sticky in nature but repayable on demand) of around Rs.28 crores as current liabilities as on March 31, 2020. Its liquidity is further underpinned by access to need-based support from its strong JV partners.

Analytical approach: Standalone while factoring management and operational linkages with one of its parent GAIL.

Applicable criteria
[Criteria on assigning 'Outlook' and 'Credit Watch' to Credit Ratings]
[CARE's Policy on Default Recognition]
[Criteria for Short Term Instruments]
[Liquidity Analysis of Non-financial sector]
[Rating Methodology – City Gas Distribution Companies]
[Rating Methodology – Notching by factoring linkages in ratings]
[Financial ratios - Non- Financial Sector]

About the Company
VGL is a joint venture between GAIL, GGL & VMSS and is engaged in marketing and distribution of natural gas (piped and compressed). The company presently supplies PNG to industrial, commercial and domestic customers apart from supplying CNG to transportation sector. VGL has presence in Vadodara district of Gujarat with user base of over 1,60,000 PNG domestic customers, 17 PNG - industrial customers, more than 2,500 PNG - commercial customers along with 18 CNG stations as on September 30, 2020.

Brief Financials (Rs. Crore)	FY19 (A)	FY20 (A)	9MFY20 (UA)	9MFY21 (UA)
Total operating income (TOI)	157.89	180.72	142.13	117.25
PBILDT	10.78	17.53	10.77	11.49
PBT	5.26	4.78	4.00	1.04
PAT	5.53	(5.26)	2.86	0.78
Interest coverage (times)	5.01	3.91	4.11	3.36
Overall gearing (times)	0.07	0.28	-	-

A: Audited, UA - Unaudited
Status of non-cooperation with previous CRA: Not Applicable
Any other information: Not Applicable
Rating History for last three years: Please refer Annexure-2
Complexity level of various instruments rated for this company: Annexure-3

Annexure-1: Details of Facilities

Name of the Instrument	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Fund-based - LT-Term Loan	-	-	July 2028	83.55	CARE A-; Stable
Non-fund-based - ST-Letter of credit	-	-	-	25.00	CARE A2+

Annexure-2: Rating History of last three years

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating history			
		Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2020-2021	Date(s) & Rating(s) assigned in 2019-2020	Date(s) & Rating(s) assigned in 2018-2019	Date(s) & Rating(s) assigned in 2017-2018
1.	Fund-based - LT-Term Loan	LT	83.55	CARE A-; Stable	-	1)CARE A-; Stable (30-Mar-20)	1)CARE A-; Stable (28-Mar-19) 2)CARE A-; Stable (20-Feb-19)	1)CARE A-; Stable (16-Jan-18)
2.	Non-fund-based - ST-Letter of credit	ST	25.00	CARE A2+	-	1)CARE A2+ (30-Mar-20)	1)CARE A2+ (28-Mar-19) 2)CARE A2+ (20-Feb-19)	1)CARE A2+ (16-Jan-18)

Annexure 3: Complexity level of various instruments rated for this Company

Sr. No.	Name of the Instrument	Complexity Level
1.	Fund-based - LT-Term Loan	Simple
2.	Non-fund-based - ST-Letter of credit	Simple

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