GCR | Global Credit Rating Co.
Local Expertise • Global Presence

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CREDIT RATING ANNOUNCEMENT

GCR accords Electricity Supply Corporation of Malawi a first time rating of $BBB_{(MW)}$, Outlook stable.

Johannesburg, 13 December 2016 -- Global Credit Ratings has today accorded Electricity Supply Corporation of Malawi a first time national scale long term debt rating of $BBB_{(MW)}$ and a national scale short term debt rating of $A2_{(MW)}$. The ratings have been accorded a Stable outlook, and are valid until December 2017.

SUMMARY RATING RATIONALE

Global Credit Ratings ("GCR") has accorded the above credit ratings to Electricity Supply Corporation of Malawi ("ESCOM") based on the following key criteria:

ESCOM is tasked with managing the generation, transmission and distribution of electricity across Malawi, as well as being responsible for related capex. However its ability to provide consistent and sufficient electricity supply has been impeded by a relatively old and underdeveloped electricity infrastructure (with substantial capex backlogs), as well as the complete reliance on hydro-electric generation, which has been constrained by the severe drought impacting Southern Africa. Notwithstanding this, ESCOM's income growth trajectory has continued, with revenue spiking by 33% to MKW72bn in F16 (30% ahead of budget). This was driven by a steep rise in tariffs, signifying a productive working relationship with the regulator, whereby ESCOM has been allowed to adjust towards a cost reflective tariff. Nevertheless, the low income per capita in Malawi suggests that such high tariff increases may be unsustainable, even if key exogenous costs continued to rise. Positively, following a campaign by ESCOM to reduce commercial losses, pre-paid electricity continues to evidence rapid growth and accounted for around a third of electricity sold in F16. This contributed to strong cash generation, which has been sufficient to meet operating requirements.

ESCOM's operating margin has narrowed over the review period, as the company has up scaled operations. This has partly been driven by the rising cost of generation (due to drought conditions and water quality issues), and the cost of connecting new customers to the grid. While such expenditure should contribute to future earnings, of some concern was the steep rise in supply and services costs in F16, which represents consumptive expenditure. Staff costs have been well managed, and at 25% of total costs in F16 are well below GCR's benchmark of 35%.

A key factor supporting the ratings is the ungeared balance sheet. Supported by funding from donor agencies, ESCOM has been able to increase capex spend substantially, without the need to resort to debt. Although the company is considering raising debt finance from the private sector for new projects, this will be done cautiously as ESCOM's ability to raise commercial debt is governed by its Sustainable Debt Management Plan, which places a limitation on overdrafts and the total level of interest exposure that can be assumed. The technical and financial support being offered by development agencies is also positively considered and critical to enabling Escom to meet its generation targets. Strong support from the Government of Malawi ("GoM") is also factored into the rating, demonstrated by its commitment to the development of the electricity sector.

ESCOM and the GoM have made noticeable progress in laying the foundations for modernising the electricity sector, with the GoM passing of the Electricity Act Amendment Bill in June 2016. The bill has provided the framework for Independent Power Producers ("IPPs") in the sector and for splitting ESCOM as a means to increase competition in the sector. It is expected that this will encourage private sector investment in the power sector, with a discussion having been initiated with over 30 potential partners. Nevertheless, while steps to form a separate generating company should yield long term benefits, this needs to be carefully managed, as there is the potential for short term disruptions. A key concern is ensuring that incentives or tariffs offered to attract IPPs do not place ESCOM, as the off-taker, under financial strain.

Positive rating migration is dependent on some of the proposed projects coming to fruition and the demonstrated ability to increase electricity availability through higher generation and lower distribution losses. This would translate into steady earnings growth and ultimately allow the company to be self-funding. Conversely, the financial structure of Escom post the unbundling is still unclear, and any change that fundamentally impact the financial structure would necessitate a rating review. Continued operational challenges, leading to increased blackouts, and lower sales could also negatively impact the rating.

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NATIONAL SCALE RATINGS HISTORY

Initial/last rating (February 2016)
Long term: BBB(MW); Short term: A2(MW)
Outlook: Stable

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APPLICABLE METHODOLOGIES AND RELATED RESEARCH

Criteria for Rating Corporate Entities, updated February 2016
Criteria for Rating Public Entities, updated February 2016
ESCOM rating report, February 2016

RATING LIMITATIONS AND DISCLAIMERS

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S Corporates GLOSSARY

Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Economies Of Scale	Economies of scale are the cost advantages of an increase in output if the fixed costs of doing so, such as those for plant and equipment, remain the same. The marginal cost, or the cost of the last unit of production, falls as output is raised.
Gearing	With regard to corporate analysis, gearing (or leverage) refers to the extent to which a company is funded by debt and can be calculated by dividing its debt by shareholders' funds or by EBITDA.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
Interest Cover	Interest cover is a measure of a company's interest payments relative to its profits. It is calculated by dividing a company's operating profit by its interest payments for a given period.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long-Term Rating	A long term rating reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Margin	A term whose meaning depends on the context. In the widest sense, it means the difference between two values.
Net Profit	Trading/operating profits after deducting the expenses detailed in the profit and loss account such as interest, tax, depreciation, auditors' fees and directors' fees.
Operating Profit	Profits from a company's ordinary revenue-producing activities, calculated before taxes and interest costs.

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Short-Term Rating	A short term rating is an opinion of an issuer's ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.

SALIENT FEATURES OF ACCORDED RATINGS

GCR affirms that a.) no part of the rating was influenced by any other business activities of the credit rating agency; b.) the rating was based solely on the merits of the rated entity, security or financial instrument being rated; c.) such rating was an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

Electricity Supply Corporation of Malawi participated in the rating process via face-to-face management meetings, teleconferences and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible.

The credit rating/s has been disclosed to Electricity Supply Corporation of Malawi with no contestation of the rating.

The information received from Electricity Supply Corporation of Malawi and other reliable third parties to accord the credit rating(s) included:

- 2016 reviewed annual financial statement
- Four years of comparative audited financial statements
- Integrated strategic Plan 2015-2021
- Financial forecasting model
- Full details of planned and committed capex activity

The ratings above were solicited by, or on behalf of, the rated client, and therefore, GCR has been compensated for the provision of the ratings.