RATING REPORT

Shahmurad Sugar Mills Limited

REPORT DATE:
February 27, 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	*February 18, 2019*		*November 30, 2017*	

COMPANY INFORMATION

Incorporated in 1979	**External auditors:** Kreston Hyder Bhimji & Co., Chartered Accountants
Public Limited Company	**Chairman of the Board:**Mr. Ismail H. Zakaria
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:**Mr. Yusuf Ayoob
Al-Noor Sugar Mills Limited – 15.6%	
CDC-Trustee National Investment Trust Fund – 8.5%	
Employees Old Age Benefits Institution – 5.5%	

APPLICABLE METHODOLOGY(IES)

Applicable Rating Criteria: Industrial Corporates (May, 2016)
https://www.vis.com.pk/kc-meth.aspx

Shahmurad Sugar Mills Limited

OVERVIEW OF THE INSTITUTION

Incorporated in 1979, Shahmurad Sugar Mills Limited (SSML) is a public limited company and is listed on Pakistan Stock Exchange (PSX). The company operates under the umbrella of Al-Noor group, under which Al-Noor Sugar Mills Limited, Reliance Insurance Company Limited and Al-Noor Modaraba Management Company also operates.

RATING RATIONALE

Shahmurad Sugar Mills Limited (SSML) belongs to Al-Noor Group (ANG), involved in the manufacturing of sugar, rice, ethanol, power and board products along with presence in the financial sector. SSML is primarily engaged in the business of manufacturing and selling of sugar and ethanol. Production facilities of SSML include sugar and ethanol manufacturing units located at Jhok, District Sajawal in the province of Sindh. ANG has a share of around 3% is country's total production while SSML has a market share of around 10% in terms of country's total installed ethanol capacity.

Industry Dynamics

Sugar

Local demand supply dynamics projected to depict some improvement in MY19; slight upward pressure expected in local prices

Over the last two years excess supply of sugar has prevailed on the back of sugar production outpacing the overall consumption. Significant increase in production and lower allowable export quota set by the Government resulted in a sizeable increase in ending inventory at end-FY17. While production continued to outpace supply, higher export quota of 1.5m tons (with subsidy benefit by federal government and an additional subsidy by Sindh government for sugar mills in Sindh) has facilitated in reducing inventory levels which continued to remain at elevated levels at end-MY18. Decline in production for MY19 (expected to be significantly lower at around 6m tons but still higher than domestic consumption for MY19) along with export quota of 1.1m tons allowed is expected to improve local demand supply dynamics (resulting in lower ending inventory) and result in some upward pressure on prices. However, profitability of sugar mills will remain dependent on quantum of increase in domestic prices of sugar along with quantity of sugar exported. Subsidy allowed by Punjab Government is significantly lower vis-à-vis overall subsidy of prior year while no subsidy has been announced by the Federal and Sindh Government.

Mn Tons	MY16	MY17	MY18
Opening Inventory	0.849	0.777	2.326
Sugar Production	5.1	7.048	6.5
Sugar Available	5.949	7.825	8.826
Domestic Consumption	4.9	5.1	5.4
Exports	0.272	0.399	1.5
Ending Inventory	0.777	2.326	1.926

Global oversupply situation to persist; prices expected to remain under pressure in MY19

Baring two years (MY16 & MY17), global production of sugar has outpaced consumption over the last decade resulting in sizeable global sugar ending inventory. Resultantly, ending inventory has stood at over 50% of the total consumption over the last 5 years. The demand-supply dynamics have kept international sugar prices on the lower side during MY18 (Average sugar prices were $357.5/tonne in MY18 vis-à-vis $477.4/tonne in MY17). Going forward, global stock levels are projected to rise as higher production from India is expected to offset decline in production in Brazil and European Union. Resultantly, international prices are expected to remain bearish during

MY19 with exports for local producers being only profitable with subsidy support from government. India is forecasted to become the largest sugar producer (due to enhanced yields and increase in area under cultivation) in the world in MY19 overtaking Brazil for the first time in the last fifteen years. Other major sugar producers include Brazil, Thailand, China, USA, Mexico, and Pakistan.

Mn Tons	MY16	MY17	MY18
Opening Inventory	96.40	91.21	88.06
Sugar Production	164.20	168.30	179.44
Sugar Available	260.60	259.51	267.50
Consumption	169.09	171.40	174.40
Import Demand	66.00	60.04	57.40
Exports	66.30	60.10	61.09
Ending Inventory	91.21	88.06	89.41

Existing pricing dynamics are a drag on the profitability of the sector. Based on current international prices and existing exchange rate, international prices are still at a discount to local prices

Local retail prices which are driven by market forces have remained depressed on account of surplus supply of sugar. Higher fixed sugarcane prices (including the impact of quality premium which is estimated to range between Rs. 5 to Rs. 12 per mound for mills in Sindh) set by the government to facilitate growers and farmers coupled with depressed retail prices have compressed margins for the industry. Based on current sugar cane prices announced by the government and assuming average recovery ratio for the industry, cost of production of sugar is slightly higher vis-à-vis local prices. Given the expected increase in sugar prices, this trend is expected to reverse in MY19 with retail prices expected to be higher vis-à-vis cost of production. However, margins and profitability are expected to remain depressed. On the export front, current international prices (assuming exchange rate of 140) translate into a 10%discount vis-à-vis local prices. Break even international prices accounting for freight and sales tax advantage at existing exchange rate are $370 vis-à-vis existing prices of $339.

Per Kg Prices	MY14	MY15	MY16	MY17	MY18
Average Local Prices (Rs)	54.8	58.91	63.77	61.43	53.57
Average International Prices (USD)	0.459	0.377	0.461	0.474	0.358

<u>**Ethanol**</u>

Industry Profile: It is estimated that Pakistan currently has an installed production capacity of over 700,000 metric tons for Ethanol with around 20 distilleries in operation. Pakistan ethanol exports were recorded at an all-time high of 742m liters (2017: 580m liters; 2016: 450m liters) and increased by 28%. Increase in exports was facilitated by new ethanol capacities coming online and excess availability of molasses given elevated levels of sugar production. Top 5 players account for over 50% of the total exports. Premier group is the largest player in the segment followed by Madina, Shakarganj, Shahmurad and Tandlianwala Sugar Mills. The biggest buyers were Alcotra with 230m liters followed by Kolmar and Mitsubishi. Major markets for ethanol exports include China, South Korea, EU and Philippines. Going forward, with lower forecasted sugar and resulting molasses production, ethanol exports are expected to witness some decline from existing levels.

Globally, the world's leading ethanol producers include USA and Brazil who cumulatively account for 84% of the total production. Expansion in global ethanol supply is expected on the back of higher sugarcane crop being diverted towards ethanol production in Brazil along with a higher build up in USA ethanol inventory as a result of a substantial tariff imposed by China on USA ethanol imports. Apart from its prevalent use as a motor gasoline around the world, ethanol is also used in ink cartridges, perfumes, medicines and sanitizers.

Profitability was supported by availability of molasses at competitive rates in MY18. Going forward, profitability would remain dependent on ethanol export prices and availability of molasses at competitive rates

Profitability of ethanol exports is dependent on international prices of ethanol, efficiency in operations and availability of molasses at competitive rates. Having significant environmental advantages, ethanol is considered one of the cheapest sources of octanes. However, these have been susceptible to some downfall in global price trend due to higher global supply which is expected to persist going forward. Distilleries in Pakistan have enjoyed superior margins as high availability of molasses had pulled down cost of producing ethanol while global ethanol prices witnessed a mild descent in MY18. The expected decline in sugar production in MY19 has limited the availability of molasses driving up prices significantly and hence increasing cost of producing ethanol. This is however expected to be partly offset by benefit of rupee depreciation that industry players will enjoy.

Satisfactory Operating Performance

Sugar

Capacity Utilization: Despite higher number of days in operations vis-à-vis last year (MY18: 126; MY17: 111), crushing volume of sugarcane was recorded at 744,578 MT during MY18 vis-à-vis 672,747 MT last year due to water shortage.

Recovery Rates: An improvement in recovery rate was noted for a second consecutive year (MY18: 11.06%; MY17: 10.82%; MY16: 10.6%). Effective production oversight and monitoring by the management has helped improve recovery rate of sugar. Sugar production exhibited a growth of 13% with total quantity produced recorded at 82,366 MT in MY18 vis-à-vis 72,755 MT in MY17.

Ethanol

Capacity Utilization: The Company has 2 lines operational for ethanol production with a capacity of 100 tons per day each respectively operating at near full capacity. Capacity utilization of Line 1 has remained on the higher side and stood at near 100% (MY17: 95%; MY16: 95%). Line 2 came online in the later part of the outgoing year which was operational for 132 days and operated at a utilization level of 98% during MY18. Total production for the year stood at 47,204MT vis-à-vis 30,564MT during MY17. Higher operating days for the new line would translate into improved production and sales revenue during MY19.

Power Generation: The Company generates a total of 7.5 MW of power via bagasse out of which 2 MW is required for ethanol production while the remaining is utilized for catering to the needs of sugar division.

Financial Profile

Sales Mix

Sugar: Sales of sugar contributed 49% (MY17: 53%) to the overall revenue mix of the company during MY18. Local sales constituted 35% of total sales while the remaining sales comprised exports due to extension in export quota provided by the Government (exports included subsidy by both federal and provincial government). Resultantly a significant jump of 32% in sugar sales was recorded. Given the absence of subsidy on export quota allowed, proportion of local sales in sales mix is projected to increase, going forward.

Ethanol: Contribution of ethanol in the overall sales mix has increased from 47% in MY17 to 51% in MY18. Historically, sales of ethanol almost entirely comprise export sales. Ethanol sales have increased at a healthy growth rate of 52% during the outgoing year which primarily emanated from better volumes sold (due to new line becoming operational) and the positive impact of PKR devaluation. Despite a conservative outlook for ethanol global prices, the recent extension in ethanol capacity would enable the company to offload higher ethanol volumes which would bode well for ethanol division sales going forward.

Improved profitability of ethanol division offset persistent trend in losses from sugar division translating into significant jump in overall profitability. Overall profitability expected to post double digit growth in MY19 on the back of improved revenues from the ethanol segment

Net sales recorded an increase of 43% in MY18. Growth in sales was a function of 32% higher revenues from the sugar division while revenues from the ethanol division jumped by 52% in MY18. While overall margins remained around prior year level, the company recorded negative margins in the sugar segment. However, gross margins witnessed noticeable improvement in the ethanol division given availability of molasses at competitive rates. Given current market prices and in the absence of subsidy, VIS expects export of sugar to be a drag on margins while local margins are projected to show case some improvement due to expected increase in local sugar prices. Within the ethanol division, the company has hedged the potential risk of unavailability of molasses (due to lower production) through advance procurement of molasses. Going forward, sizeable rupee depreciation, advance accumulation of molasses and enhancement in ethanol capacity would support ethanol division's revenues and margins.

On account of higher ethanol and sugar exports, the company had booked significant export freight charges resulting into higher operating expenses in MY18. However export subsidy booked in other income uplifted profit before tax for the company. Finance cost increased to Rs. 235m (MY17: 203m) due to higher average borrowings mobilized during MY18 vis-à-vis MY17. Going forward, significant monetary tightening is expected to have limited impact to the bottom line profitability as limited portion of the total borrowings mobilized comprise KIBOR based borrowings. The company posted a net profit of Rs. 601m (MY17: 7m) during the outgoing year.

Liquidity profile has witnessed improvement due to enhanced cash flow coverage and increase in debt servicing ability. Working capital requirements remain on the higher side

Funds Flow from Operations increased to Rs. 658m (MY17: 16m; MY16: 268m) in MY18 translating into FFO to long term debt of 0.35x (MY17: 0.009x; MY16: 0.286x). Moreover, debt service coverage ratio increased to 2.25(x) (MY17: 0.99(x); MY16: 1.47(x)). However, sizeable subsidy receivable on exports and increase in loans and advances has resulted in higher utilization of short-term borrowing. Inventory levels have witnessed a noticeable decline as at end-1QMY19. Stock in trade and receivable (trade debt and subsidy receivable) represented 101% (MY17: 103%) of total borrowings at end-MY18. Current ratio was reported at 1.02 (MY17: 1.16) at end-MY18.

Elevated leverage indicators vis-à-vis rating benchmarks but are projected to improve going forward

Equity base of the Company has increased to Rs. 2.1b (MY18: Rs. 1.75b; MY17: Rs. 1.1b) at end-1QMY19 on account of internal capital generation. Dividend payout ratio was reported at 25% for MY18. The company has utilized sizeable short term borrowings (MY18: 3.4b) to finance its inventory and fund receivables. Despite the recovery in profitability, capitalization indicators still remain elevated as gearing stood at 3.5x (MY17: 3.92; MY16: 1.21) while debt leverage for the company stood at 3.76x (MY17: 4.42; MY16: 1.95). An expected trim down in inventory levels would push down utilization of short term borrowings which along with healthy internal generation is expected to result in improvement in capitalization indicators, going forward.

Shahmurad Sugar Mills Limited Appendix I

FINANCIAL SUMMARY *(amounts in Rs. in millions)*			
BALANCE SHEET	**SEP 30, 2016**	**SEP 30, 2017**	**SEP 30, 2018**
Fixed Assets	2,549	3,140	5,390
Investments	3	3	2
Stock-in-Trade	992	2,360	2,568
Trade Debts	31	455	388
Cash & Bank Balances	57	38	45
Total Assets	3,957	6,677	9,919
Trade and Other Payables	563	325	1,013
Long Term Debt *(*incl. current maturity)*	936	1,714	1,893
Short Term Debt	452	2,723	3,453
Total Equity	1,148	1,131	1,751
INCOME STATEMENT	**SEP 30, 2016**	**SEP 30, 2017**	**SEP 30, 2018**
Net Sales	5,910	5,056	7,220
Gross Profit	670	584	810
Operating Profit	333	106	(117)
Profit After Tax	125	7	601
RATIO ANALYSIS	**SEP 30, 2016**	**SEP 30, 2017**	**SEP 30, 2018**
Gross Margin (%)	11.34	11.55	11.22
Net Working Capital	(20.86)	80	(396)
FFO to Total Debt (x)	0.19	0.0035	0.12
FFO to Long Term Debt (x)	0.029	0.01	0.35
Debt Servicing Coverage Ratio (x)	1.47	0.99	2.25
Gearing	1.21	3.92	3.05
Leverage	1.95	4.42	3.76
ROAA (%)	6.33	0.14	7.25
ROAE (%)	21.80	0.64	41.27

ISSUE/ISSUER RATING SCALE & DEFINITIONS — Appendix II

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	Shahmurad Sugar Mills Limited
Sector	Sugar
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	
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.
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Rating History:

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
02/27/2019	A-	Stable	A-2	Reaffirmed
11/30/2017	A-	Stable	A-2	Reaffirmed
4/28/2016	A-	Stable	A-2	Reaffirmed
2/11/2015	A-	Stable	A-2	Upgrade
11/25/2013	BBB+	Stable	A-2	Reaffirmed
8/30/2012	BBB+	Stable	A-2	Reaffirmed