RATING REPORT

Sitara Chemical Industries Limited (SCIL)

REPORT DATE:
November 15, 2019

RATING ANALYSTS:
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RATING DETAILS

Rating Category	Latest Rating		Previous Rating	
	Long-term	Short-term	Long-term	Short-term
Entity	A+	A-1	A+	A-1
Rating Date	*Nov 08, 2019*		*Nov 14, 2018*	
Rating Outlook	Stable		Positive	

COMPANY INFORMATION	
Incorporated in 1981	**External auditors:** M/s Deloitte Yousuf Adil & Co Chartered Accountants
Public Limited Company	**Chairman of the Board:** Mr. Abdul Awal
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Mian Mohammad Adrees
Mian Mohammad Adrees – 63.64%	
General Public – 9.39%	
Bank, DFI & NBFCs – 9.13%	
Mutual Funds – 6.37%	

APPLICABLE METHODOLOGY

VIS Entity Rating Criteria: Corporates (May 2019)
https://www.vis.com.pk/kc-meth.aspx

OVERVIEW OF THE INSTITUTION

SCIL was incorporated in 1981 as a public limited company under Companies Act, 1913 (now Companies Act, 2017). The principal activities include operation of Chlor-Alkali plant and textile unit. The chemical division is engaged in the production of caustic soda & other auxiliary products while textile division is involved in production of different types of yarn and high quality men's fabric under the brand name 'Rajahs'. The company is listed on Pakistan Stock Exchange.

Profile of the Chairman

Mr. Abdul Awal, appointed as Chairman in 2019, is a business graduate from NUST Business School. He joined the Board in 2014 and was appointed as Chairman of Audit Committee during the same period.

Profile of the CEO

Mian Muhammad Adrees is a renowned businessman. He graduated from University of Punjab. He is also the CEO of Sitara Developers and Managing trustee of Aziz Fatima Trus.

Financial Snapshot

Core Equity: end-FY19: Rs. 10.1b; end-FY18: Rs. 9.5b

Assets: end-FY19: Rs. 26.8b; end-FY18: Rs. 19.8b

Net Sales: FY19: Rs. 12.7b; FY18: Rs. 12.3b

Profit After Tax: FY19: Rs. 0.9b; FY18: 1.1b

RATING RATIONALE

The ratings assigned to Sitara Chemical Industries Limited (SCIL) take into account its leading position in chlor-alkali sector and strong sponsor profile. The ratings draw comfort from increasing revenues and largely sustained gross margins despite economic slowdown. Moreover, sound coverages and comfortable gearing levels provide strength to the ratings. Meanwhile, the management's focus on improving operational efficiencies through BMR and planned diversification in revenue stream is expected to bode well for the company. However, the industry is faced with crucial challenges in terms of slack demand for caustic soda, increasing power related costs amidst higher interest rate scenario.

Key Rating Drivers:

Market leader in the oligopolistic sector: The chlor-alkali sector is oligopolistic in nature with three major players operating in the country. Overall capacity utilization has remained moderate owing to imbalance in the demand and supply of product leading to competition driven market. In line with overall decline in growth of Large Scales Manufacturing (LSM), the total volumetric caustic soda sales excluding export sales (liquid and flakes) of the sector were recorded lower at 293,253 MT (FY18: 299,478 MT). Accordingly, SCIL reported a lower sale quantity of 124,652 MT (FY18: 139,097 MT) in local market during FY19. While the sector is power intensive, the companies have setup captive power plants to support the production process indigenously. Nonetheless, the transformation of entire production technology to power efficient Ion Exchange Membrane (IEM) plants has enabled the companies to subside the impact of higher RLNG prices and escalated power tariff to some extent. In addition, the differential in the local and import prices of caustic soda due to import duty and freight charges has created a sustainable market for local players.

Industry demand dynamics leading to lower capacity utilization: Considering an overall slowness in manufacturing sector and contemplating lower demand, SCIL has reduced the gross production of caustic soda during FY19, which stood at 145,122 MT (FY18: 152,558 MT). Gross production of hydrochloric acid also decreased to 317,961 MT (FY18: 342,750 MT) during the same period. Meanwhile, the company plans to secure the margins and a sustainable growth in sales through diversification of revenue stream, continued BMR, and effective planning.

At the same time, capacity utilization of textile division stood lower during the year under review. However, lower production is attributable to impeded production on account of back process upgradation in textile division during the last quarter of FY19. SCIL has adjusted its power mix during FY19, with 55% (FY18: 52%) of total electricity need being met through Coal Fired Power Plant (CFPP), 21% (FY18: 1%) through WAPDA and 21% (FY18: 25%) through Gas Fired Power Plant (GFPP), while proportion of Sitara Energy has been reduced to 3% (FY18: 23%).

Modest growth in sales led by higher average selling prices: The company's sales exhibit a CAGR of 9% over the last four years. However, net sales witnessed an increase of 3.53% during FY19. Revenue is majorly driven by chemical division, meanwhile textile division continue to supplement the revenue stream. Despite lower sales in volumetric terms, the company's revenue stood higher on the back of increase in average selling prices of both chemical and textile products. Exports sales stood lower at Rs. 380m (FY18: Rs. 556m) owing to unfavorable rates of caustic soda flakes in international market. Incremental revenue from brick making unit, which started operations in 3QFY18 amounted to Rs. 25.5m.

While average basic price per metric ton of caustic soda *liquid (flagship product) which prevailed during the year* has increased to Rs. 60,796/MT (FY18: Rs. 52,197/MT), the gross margins improved marginally to 21.7% (FY18: 21.5%), primarily due to higher cost related to fuel and power along with stores & spares. The contribution of chemical division net sales to the total net sales of the company has also decreased to 81.4% during the review period (FY18: 82.3%). The increase in sales revenue reported by textile division is attributable to increase in average selling price to Rs. 14,655/Bag (FY18: Rs. 12,136/Bag) during FY19, while the number of bags sold during the year decreased by 14.8%. Distribution cost stood higher in line with higher freight expenses owing to higher fuel prices. Further administrative expenses increased on a timeline basis due to inflationary pressure leading to annual salary adjustment. Additionally, loss on disposal of property, plant and equipment was recorded at Rs. 106.2m during FY19 (FY18: *Nil*). Finance cost has depicted an increasing trend in line with higher average benchmark rate and higher short-term and long term borrowings. Despite, increase in other income, mainly comprising unwinding of discount on deferred consideration receivable, net profit decreased to Rs. 885m (FY18: Rs. 1.1b) during FY19 owing to higher operating expenses, other expenses and elevated finance cost.

Diversification to support sales growth and profitability: The board has approved revenue diversification through production and sale of soap noodles. The project cost is estimated to be around Rs. 1.6b which would be financed through a mix of debt and equity ratio of 80:20. The said project is expected to be completed in 1.5 years and is expected to reap gross cash margins of 16%, with a payback period of 5 years. As per management, in the first year of its operations, it is expected to generate Rs. 2.75b of incremental revenue, with 50% capacity utilization. The management is anticipating to achieve 90% and 100% capacity utilization in the second and third year of operations.

The main raw material required for the production of soap noodle is RBD palm oil & RBD palm kernel oil, constituting around 83% of the total raw material mix; among other constituents, 5% caustic soda will also be utilized. Soap noodles market in Pakistan is approximately 200,000 MT. Since last year, the government has imposed heavy duties on import of soap noodles to encourage domestic production. Presently, demand of around 135,000 MT is being met by local players (Nimir Industrial Chemicals Limited: 90,000 MT; Gamalux Oleochemicals Limited: 10,000 MT; Others: ~35,000 MT). SCIL expects to partially meet the rest of the demand through an installed production capacity of 35,640 MT. Additionally, 3,135 MT of Grade A glycerin will also be produced as a by-product.

Extensive BMR to improve operational efficiencies: SCIL has incurred Rs. 2.05b of capital expenditure on chemical division and Rs. 446.7m on textile division during FY19. Expenditure incurred on chemical division majorly pertained to M-I plant, M-IV plant, CFPP and GFPP. Additionally, considerable electrical and installation work has been done to enhance operational efficiency. Meanwhile, textile division majorly underwent back process upgradation, involving replacement of blow room lines, and card machines along with civil work.

Liquidity profile and debt service ability remained largely intact: Albeit profit before tax declined during FY19, Funds from Operations (FFO) largely remained at prior year's level on account of higher non-cash adjustments, addition of non-operating loss and positive difference between incurred and paid finance cost. Conversely, in line with overall increase in debt levels, FFO to total debt and FFO to long-term debt decreased during the year under review. Debt service coverage ratio improved marginally on account of lower long-term repayments made during the year.

Given agreement made with M/s Sitara Developers (Pvt.) Limited for sale of its investment property worth Rs. 2.2b last year, SCIL has received advance of Rs. 438m (20% of total sale price) during FY18 while Rs. 350m has been recorded as current portion of deferred consideration on sale of investment property during FY19. The first installment related to the sale agreement is due in March'2020 and remaining four installments will be received in subsequent years, thereby supporting liquidity, going forward. Meanwhile, the company has acquired land worth Rs. 267.3m held as investment property for the purpose of capital gain.

Loans and advances majorly comprised advance tax of Rs. 1.3b (FY18: Rs. 880m), advances extended to suppliers and contractors of Rs. 706.5m (FY18: Rs. 815.0m) and letter of credit fee margin and expenses of Rs. 520.9m (FY18: Rs. 678.1m) at end-FY19. Stock in trade stood higher mainly as a result of stacked finished goods inventory. Stores and spares increased by the end-FY19 mainly on account of overhauling conducted at CFPP during June'19. Receivables aging is considered to be satisfactory as around three-fourth of receivables fall due less than 180 days. Meanwhile, allowance for bad debts has increased to Rs. 175.3m by the end-FY19 from Rs. 93.3m in the preceding year. The increase is mainly due to implementation of IFRS 9 which has resulted in appropriating an allowance for expected credit losses of Rs. 56.2m at end-FY19 (FY18: *Nil*). Current liabilities stood higher with trade and other payables increasing to Rs. 2.4b (FY18: Rs. 2.3b) at end-FY19. Current ratio, though still low, improved marginally to 0.88x by end-FY19 (FY18: 0.84x).

Augmentation in equity on a timeline basis on back of profit retention: Equity base has been fortified in line with profit retention. The company also recorded surplus on revaluation on property, plant and equipment amounting Rs. 4.5b (FY18: 1.2b) at end-FY19. Given that SCIL has carried out major capex, long-term loan mobilized through financial institutions *(including current maturity*) stood higher at Rs. 2.8b (FY18: Rs. 2.0b). Effective rate of profit for the year on these diminishing musharika facilities ranges from 7.41% to 13.97% (FY18: 7.13% to 7.92%) per annum. Conforming to higher working capital requirements, short-term borrowing have also increased to Rs. 4.3b (FY18: Rs. 3.5b) by the end-FY19; all of these short-term funding comprised Islamic financing facilities, rates on which ranges from 6.90% to 13.82% (FY18: 6.81% to 7.78%). Given higher level of short-term and long-term debt, leverage and gearing indicators have increased to 1.21x and 0.70x (0.97x and 0.59x), respectively, by end-FY19. While the company may acquire debt of around Rs. 1.35b for the upcoming project, gearing is likely to remain around the current level on back of growth in equity, going forward.

FINANCIAL SUMMARY *(amounts in PKR millions)*

BALANCE SHEET	Jun 30, 2017	Jun 30, 2018	Jun 30, 2019
Property, Plant and Equipment	9,413	9,572	15,516
Stock-in Trade	1,194	951	1,328
Trade Debts	1,164	1,138	1,176
Loans and Advances	3,603	3,763	3,954
Stores and Spares	644	744	950
Investment Property	2,927	3,034	3,296
Cash & Bank Balances	131	80	103
Other Financial Assets	274	352	336
Other Assets	175	163	168
Total Assets	19,525	19,797	26,827
Trade and Other Payables	2,537	2,293	2,416
Short Term Borrowings	2,976	3,525	4,333
Long-Term Borrowings (incl. current maturity)	3,015	2,020	2,776
Other Liabilities	1,146	1,322	2,682
Tier-1 Equity	8,625	9,473	10,106
Surplus on revaluation on PPE	1,226	1,165	4,514
Total Equity	9,851	10,637	14,620
Paid-up Capital	214	214	214

INCOME STATEMENT	Jun 30, 2017	Jun 30, 2018	Jun 30, 2019
Net Sales	10,074	12,265	12,698
Gross Profit	2,312	2,633	2,760
Operating Profit	1,459	1,642	1,540
Profit After Tax	1,166	1,086	885
Funds from Operations	1,500	1,799	1,738

RATIO ANALYSIS	June 30, 2017	Jun 30, 2018	Jun 30, 2019
Gross Margin (%)	22.95	21.47	21.73
Net Margins	11.58	8.86	6.97
Current Ratio	0.88	0.84	0.88
Net Working Capital	(762)	(1,076)	(888)
FFO to Total Debt (x)	0.25	0.32	0.24
FFO to Long Term Debt (x)	0.50	0.89	0.63
Debt Leverage	1.10	0.97	1.21
Gearing	0.69	0.59	0.70
Debt Servicing Coverage Ratio (x)	1.70	1.56	1.69
ROAA (%)	6.24	5.52	3.80
ROAE (%)	12.45	10.60	7.01
(Stock in Trade+Trade Debt) to Short-Term Borrowing Ratio	0.79	0.59	0.58

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix II

VIS Credit Rating Company Limited

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

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	Sitara Chemical Industries Limited

Sector	Chlor-alkali (Chemical Sector Sub-set)
Type of Relationship	Solicited
Purpose of Rating	Entity Rating

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
11/08/2019	A+	A-1	Stable	Maintained
11/14/2018	A+	A-1	Positive	Reaffirmed
11/17/2017	A+	A-1	Positive	Maintained
06/07/2016	A+	A-1	Stable	Reaffirmed
12/31/2014	A+	A-1	Stable	Reaffirmed
3/07/2013	A+	A-1	Stable	Reaffirmed
2/22/2012	A+	A-1	Stable	Maintained
5/3/2011	A+	A-1	Negative	Downgrade

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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