RATING REPORT

Sitara Chemical Industries Limited (SCIL)

REPORT DATE:
October 27, 2020

RATING ANALYSTS:

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RATING DETAILS

Rating Category	Latest Rating Long-term	Latest Rating Short-term	Previous Rating Long-term	Previous Rating Short-term
Entity	A+	A-1	A+	A-1
Rating Date	*Oct 27, 2020*		*Nov 08, 2019*	
Rating Outlook	Stable		Stable	

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 – 9.20%	
Bank, DFI & NBFCs – 9.13%	
Mutual Funds – 6.43%	

APPLICABLE METHODOLOGY

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

Sitara Chemical Industries Limited (SCIL)

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 is a business graduate from NUST Business School and has over 10 years of experience in relevant industry.

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-FY20: Rs. 10.5b; end-FY19: Rs. 10.1b; end-FY18: Rs. 9.5b

Assets: end-FY20: Rs. 26.4b; end-FY19: Rs. 26.8b; end-FY18: Rs. 19.8b

Net Sales: FY20: Rs. 11.8b; FY19: Rs. 12.7b; FY18: Rs. 12.3b

Profit After Tax: FY20: Rs. 299m; 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 the Chlor-alkali sector with the highest market share of around 45% along with strong sponsor support. The ratings incorporate moderate business risk profile having sizable revenues in a highly competitive operating environment. However, the revenues, margins and profitability position of the company took a dip owing to depressed economic activity amid ongoing pandemic. The ratings draw comfort from manageable financial risk appetite emanating from its low leveraged capital structure, sound liquidity profile and adequate debt service coverage. 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. Rising electricity and RLNG tariff, rupee devaluation and risk of resurgence of COVID-19 till the vaccine is developed remain key challenges.

The ongoing geopolitical scenario, global economic landscape and slowdown in domestic economic activity amidst the COVID-19 pandemic is likely to pose financial risk to the company impacting revenues, profitability, liquidity and debt repayment capacity. Therefore, the ratings incorporate significant dependence of caustic soda manufacturers on textile sector and highly competitive market dynamics. The company's ability to maintain scale of operations, improve profit margins and contain leverage indicators around current levels would be the key ratings sensitivities. Further, disruption in operations due to coronavirus outbreak was a major business risk factor; however SCIL took special approvals immediately to continue its operations while taking special measures to comply with all stipulated standard operating procedures. .

Key Rating Drivers:

Market leader in the oligopolistic sector: The chlor-alkali sector is oligopolistic in nature with three players operating in the country. Overall capacity utilization has continued to remain moderate owing to imbalance in the demand and supply of product leading to competition driven market. Moreover, the demand of caustic soda has declined during the outgoing period in line with spread of COVID-19 in export markets and subsequent lockdown in Pakistan. Domestic market is currently under flux and will take firmer direction once spread of COVID-19 is contained, local economic policies, macroeconomic indicators and other key variables have settled. The total volumetric caustic soda sales in local market (liquid and flakes) of the sector were recorded lower around 260,157MT (FY19: 293,253MT); similarly SCIL also reported slightly lower quantum sales of 117,635MT (FY19:124,652) during FY20. However, in terms of market share the company's position was cemented further during the outgoing year with SCIL comprising 45% (FY19:42.5%) of the county's caustic soda market. While the sector is power intensive, the companies have set up captive power plants to support the production process indigenously. 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. As per the management, the locally produced caustic soda flakes is estimated around Rs.79,500/ton while the imported product is priced at Rs. 100,000/ton. Business prospects of the caustic soda sector in the long run exhibit a positive trend underpinned by growing demand and sound margins; however in the short to medium term caustic soda market may experience some pressure on account of lower textile exports coupled with lower domestic demand.

Onslaught of COVID-19 pandemic resulting in low industry demand and capacity utilization: Given overall sluggishness in the manufacturing sectors and contemplating lower demand amidst COVID-19 pandemic , SCIL's production of caustic soda was reported lower at 115,770 MT (FY19: 133,015 MT) during FY20. Production of hydrochloric acid also decreased to 96,672 MT (FY19: 109,127 MT) during the same period. However, the trend is expected to be rescued given there is recovery in textile sector exports during the ongoing year. In addition, the performance of the textile sector was most severely hit by the pandemic with a decline of 2.6% during FY20; therefore owing to slash in export orders, capacity utilization of SCIL's textile division stood lower at 69% (FY19: 82%) during the year under review. SCIL has adjusted its power mix with increased focus on indigenous sources, Coal Fired Power Plant (CFPP) during FY20 produced 73% (FY19: 55%) of total electricity need followed by Sitara Energy at 13% (FY19: 3%) and Wapda at 7% (FY19: 21%). The proportion of electricity supply from Gas Fired Power Plant (GFPP) has been reduced to 7% (FY19: 21%).

Drop in sale; profitability slashed sizably owing to decline in margins and finance cost escalation: Over the last four years, sales of the company have grown at a CAGR of around 5%; however, during the outgoing year the revenue declined by 7% to Rs. 11.8b (FY19: Rs. 12.7b) primarily in line with decline in volumetric sales owing to onslaught of corona virus pandemic. The chemical sector remains the major revenue driver meanwhile textile segment continues to supplement the revenue stream. The contribution of chemical division sales to the gross sales of the company increased to 84.6% during the review period (FY19: 83.85%). The decline in sales revenue reported by textile division is primarily attributable to decrease in the number of bags sold during the year. Caustic soda is the flagship product of the company accounting for almost four-fifths of the total revenue base. Incremental revenue from brick making unit, which started operations in FY18 was recorded higher at Rs.35.5b (FY19:Rs. 25.5m) during FY20.

The gross margins declined to 19.3% (FY19: 21.7%) during FY20 as a combined impact of increase in average cost of production caustic flakes and fabric relative to increase in output prices coupled with higher depreciation charge for the year. The increase in cost of production was an outcome of higher electricity prices, RLNG tariff, coal prices and higher cotton bales prices. Another contributing factor of increased input cost was a change involving costing of RLNG; for 1HFY19 industrial tariff was available at a combination of natural gas and RLNG tariff which was later changed to RLNG only. RLNG is pegged to crude oil prices in US$ resulting in considerable appreciation to input cost of gas during the year under review. Although the prices of caustic liquid and flakes increased to Rs.65,000MT (FY19: Rs. 61,000MT) and Rs.79,500MT (FY19:Rs. 78,875MT) respectively during FY20 to compensate against the incremental cost of production; however the same could not fully be offset due to prevalent economic conditions of the sector being not conducive enough to warrant such decision. In addition, the higher depreciation charge was attributable to accelerated depreciation calculated on investment of Rs. 1.9b in plant and machinery during FY19; the capex majorly involved installation of Electrolyzers (Rs. 500m), renovation of plant (Rs. 315m), overhauling of gas engines (Rs. 135m), harmonic filters (Rs. 145m) and purchase of equipment for brick making plant (Rs. 70m). Meanwhile, textile division majorly underwent back process upgradation, involving replacement of blow room lines, and card machines along with civil work. In addition, revaluation adjustments on fixed assets during the outgoing year also contributed to higher depreciation expense.

The distribution cost declined primarily as a result of reduced freight expense owing to dip in the overall scale of operations and no avenues of export availed. Further, administrative expenses were also recorded lower at Rs. 626.2m (fY19: Rs. 660.2m) owing to decline in the value of donations made. The employee related expenses largely remained at prior year's level. The other expenses also stood lower at Rs. 86.3m (FY19: Rs. 190.6m) given loss amounting to Rs. 106.2m was booked on disposal of property and equipment in FY19. Finance cost has depicted an increasing trend in line with higher average benchmark rate and higher utilization of short-term borrowings. Other income, mainly comprising unwinding of discount on deferred consideration receivable was recorded slightly higher at Rs. 102.5m (FY19: 97.7m) during FY20. Subsequently, in line with decline in quantum sales, drop in margins and higher finance cost the bottom line of the company was recoded lower at Rs. 298.8m during FY20 as compared to Rs. 885.5m in the preceding year.

Given the company's plan of revenue diversification through induction of new product lines along with continued BMR on economically efficient operations, the declining trend in revenues and margins is expected to be rectified. Further, in line with outbreak of COVID-19 pandemic, the government has taken number of measures including reduction in policy interest rate and provision of term loans to industry at subsidized rates to spur economic growth; the same measures have boded well with SCIL's investment strategies along with reduction in finance cost. In addition after lifting of lock down in the country, the company has witnessed some recovery in the sales both in chemical division and in textile division.

Diversification to support sales growth and profitability: The company has embarked upon a strategy of revenue diversification through production and sale of soap noodles. The project cost is estimated to be around Rs. 1.85b which would be financed through a mix of debt and equity ratio of 80:20 with equity contribution amounting to Rs. 350m. LCs of plant and machinery have been opened with banks, meanwhile, the civil works are also being carried out. The shipments of major equipment are expected to reach in Dec'20. As per the management, the project is projected to come online by end-March'21; expected payback period is 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 FY19, 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.

In June'20, the company approved setting up of Linear Alkyl Benzene Sulphonic Acid (LABSA) plant having a production capacity of 30,000MT/annum. The project cost is estimated at Rs. 775m out of which financing agreement of Rs. 500m is under negotiation; the remaining Rs. 275m will be sponsor contribution. Commercial negotiations with foreign vendor are underway.

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.

Albeit slight decline, liquidity profile and debt service ability remained largely remained intact: Given a decline in scale of operations, slash in margins and sizable increase in finance cost, Funds from Operations (FFO) declined during the year under review. As a result decline in FFO, FFO to total debt declined on a timeline basis. Conversely, owing to overall decline in debt levels on account of timely repayment of long-term obligations, FFO to long-term remained unchanged at prior year's level; the same is sizable at 0.63x. Further, debt service coverage was also recorded slightly lower during the outgoing year as a result of decline in FFO; however DSCR is still considered adequate. Going forward, VIS will critically monitor SCIL's liquidity position in terms of projected debt obligations to be cleared during the rating horizon; any adverse variation in the same may lead to revision in ratings.

As per the agreement SCIL inked with Sitara Developers (Pvt.) Limited for sale of investment property at an aggregate price of Rs. 2.2b, an advance, representing 20% of the total agreed sale price, amounting to Rs. 438m was received in FY18. Meanwhile, the remaining balance of about Rs. 1.8b will be received over a period of six years in five equal annual installments. During the year SCIL received Rs. 175m; both parties have agreed to defer the remaining consideration by one year.

Loans and advances majorly comprised advance tax of Rs. 1.3b (FY19: Rs. 1.3b), advances extended to suppliers and contractors of Rs. 541.7m (FY19: Rs. 706.5m) and letter of credit fee margin and expenses of Rs. 168.5m (FY19: Rs. 520.9m) at end-FY20. Stock in trade was recorded higher by end-FY20, as the company has higher raw material inventory, the same includes imported cotton amounting to Rs. 680m procured prior to onslaught on pandemic. In line with slowdown in textile exports, the orders were not processed. However, now given the textile sector has picked momentum the carryover inventory will get streamlined. Trade debts were largely maintained at last year's level, aging profile of receivables is satisfactory as around 89% of receivables fall due in less than 180 days bracket. Meanwhile, allowance for bad debts has increased to Rs. 187.8m (FY19: Rs. 175.3m) by end-FY20. The company holds investment property amounting to Rs. 3.3b (FY19: Rs. 3.3b) comprising freehold land, residential plots and building proportions for purpose of of capital appreciation and earning rental income. The rental income received amounted to Rs. 33.6m during FY20 as compared to Rs. 30.2m in the preceding year. The fair value of investment property is estimated to be equivalent to its carrying value. As per the management, SCIL will continue to hold the aforementioned properties for the foreseeable future; however in case of any severe liquidity stress the properties can be liquidated. Other financial assets involve investments in mutual funds acquired principally for the sale in the near term.

Augmentation in equity on a timeline basis on back of profit retention: Equity base has been fortified in line with profit retention. The surplus on revaluation on property, plant and equipment was recorded lower at Rs. 4.2b (FY19: Rs. 4.5b) at end-FY20 on account of adjustment made for related deferred tax liability. For the year ended-FY19, the company paid 100% final dividend amounting Rs. 214.3m. In addition, SCIL has also recommended a final cash dividend of 100% for year ended-FY20. Despite increase in short-term borrowings, total borrowings decreased in line with repayments of long-term obligations. Leverage and gearing ratios decreased to 1.12x (FY19: 1.21x) and 0.68x (FY19: 0.70), respectively, by end-FY20. Although, the company plans on mobilize additional long-term funding during FY21, leverage and gearing are expected to remain at current levels or just increase slightly owing to sizeable repayments scheduled coupled with internal capital generation, going forward.

Sitara Chemical Industries Limited — Appendix I

FINANCIAL SUMMARY *(amounts in PKR millions)*

BALANCE SHEET	Jun 30, 2017	Jun 30, 2018	Jun 30, 2019	Jun 30, 2020
Property, Plant and Equipment	9,413	9,572	15,516	14,935
Stock-in Trade	1,194	951	1,328	2,327
Trade Debts	1,164	1,138	1,176	1,201
Loans and Advances	3,603	3,763	3,954	3,331
Stores and Spares	644	744	950	860
Investment Property	2,927	3,034	3,296	3,316
Cash & Bank Balances	131	80	103	82
Other Financial Assets	274	352	336	197
Other Assets	175	163	168	182
Total Assets	19,525	19,797	26,827	26,431
Trade and Other Payables	2,537	2,293	2,416	1,991
Short Term Borrowings	2,976	3,525	4,333	4,984
Long-Term Borrowings (incl. current maturity)	3,015	2,020	2,776	2,100
Other Liabilities	1,146	1,322	2,682	2,663
Paid Up Capital	214	214	214	214
Tier-1 Equity	8,625	9,473	10,106	10,455
Surplus on revaluation on PPE	1,226	1,165	4,514	4,238
Total Equity	9,851	10,637	14,620	14,693

INCOME STATEMENT	Jun 30, 2017	Jun 30, 2018	Jun 30, 2019	Jun 30, 2020
Net Sales	10,074	12,265	12,698	11,793
Gross Profit	2,312	2,633	2,760	2,279
Operating Profit	1,459	1,642	1,540	1,221
Profit Before Tax	1,180	1,312	1,065	410
Profit After Tax	1,166	1,086	885	299
Funds from Operations	1,500	1,799	1,738	1,332

RATIO ANALYSIS	June 30, 2017	Jun 30, 2018	Jun 30, 2019	Jun 30, 2020
Gross Margin (%)	22.95	21.47	21.73	19.33
Net Margins	11.58	8.86	6.97	2.53
Current Ratio	0.88	0.84	0.88	0.88
Net Working Capital	(762)	(1,076)	(888)	(977)
FFO to Total Debt (x)	0.25	0.32	0.24	0.19
FFO to Long Term Debt (x)	0.50	0.89	0.63	0.63
Debt Leverage	1.10	0.97	1.21	1.12
Gearing	0.69	0.59	0.70	0.68
Debt Servicing Coverage Ratio (x)	1.70	1.56	1.69	1.29
ROAA (%)	6.24	5.52	3.80	1.12
ROAE (%)	12.45	10.60	7.01	2.04

(Stock in Trade+ Trade Debt) to Short-Term Borrowing Ratio	0.79	0.59	0.58	0.71

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	See table below
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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Due Diligence Meetings Conducted	See table below

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
10/27/2020	A+	A-1	Stable	Reaffirmed
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

Due Diligence Meetings Conducted

Name	Designation	Date
Mr. Zakir Hussain	CFO	14-Oct-2020