RATING REPORT

EMCO Industries Limited (EMCO)

REPORT DATE:
December 7, 2021

RATING ANALYSTS:
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RATING DETAILS				
	Latest Ratings		Previous Ratings	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	A-	A-2	A-	A-2
Rating Date	7th December, 2021		*27th October, 2020*	
Rating Action	Reaffirmed		Initial	
Rating Outlook	Stable		Stable	

COMPANY INFORMATION	
Incorporated in 1954	External Auditors: M/s Crowe Hussain Chaudhury & Co. Chartered Accountants
Public Limited Company	Managing Director/Chief Executive Officer: Mr. Tariq Rehman
Key Shareholders (with stake 5% or more):	
ICC. (Pvt) Limited – 8.4%	
Mr. Munaf Ibrahim – 7.1	
Mr. Javaid Shafiq Siddiqi – 6.9%	
Mr. Pervaiz Shafiq Siddiqi – 6.9%	
Mr. Ahsan Suhail Mannan – 6.4%	
Mr. Suhail Mannan – 6.2%	
Mr. Muhammad Zulqarnain Mahmood Khan – 5.7%	
Associated Engineers (Pvt.) Limited – 5.7%	
Mrs. Ayesha Noorani – 5.3%	
Mr. Usman Haq – 5.2%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Corporates (August 2021)
https://docs.vis.com.pk/docs/CorporateMethodology202108.pdf

OVERVIEW OF THE INSTITUTION

EMCO Industries was established in 1954 and is involved in production and sale of porcelain based insulators, and substation products used in power sector

Profile of the CEO

Mr. Tariq Rehman holds a Bachelor's degree in Electrical Engineering and Master's degree in Ceramic engineering. He has an experience in the relevant industry for over 5 decades.

Financial Snapshot

Tier-1 Equity: end-FY21: Rs. 768.7m; end-FY20: Rs. 547.4m; end-FY19: Rs. 408.0m

Assets: end-FY21: Rs. 3.5b; end-FY20: Rs. 2.7b; end-FY19: Rs. 2.5b

Profit After Tax: FY21: Rs. 201.9m; FY20: Rs. 117.8m; FY19: Rs. 144.5m

RATING RATIONALE

The ratings assigned to EMCO Industries Limited (EMCO) take into account the company's strategic market positioning due to provision of highly specialized products; high voltage porcelain insulators. The ratings derive strength from reliance of the power sector on the company's products used during transmission, at grid stations and for distribution of electricity. The ratings derive comfort from steady demand of company's products from securing contracts from government, semi-government and premium private sector electricity generation companies in Pakistan, as well as with a handful of large-scale energy sector contractors and transformer manufacturers.

The ratings incorporate positive momentum in revenue on account of volumetric increase coupled with higher average prices. The company sustained gross margins in the outgoing year while net margins increased in line with rationalized operating expenses, higher other income and lower finance cost. Liquidity has remained adequate in terms of cash flow coverages. The management has embarked upon enhancing operational efficiencies, optimizing production capacity of the existing plant and capex for a new product line. Leverage indicators are projected to increase on account of mobilization of additional long-term borrowing for capex, going forward. Meanwhile, the ratings factor in positive demand prospects of insulators in view of increasing per capita consumption of electricity, continued investment in power generation capacity of the country and export potential. Materialization of the intended capital expenditure while achieving projected revenue growth and keeping capitalization indicators at adequate level are the key rating sensitivities.

Nearly full capacity utilization whilst the company has planned to enhance capacity to meet higher local demand and expand export markets: Installed production capacity remained intact at 5,000 tons per annum in the outgoing year, with a higher capacity utilization of 96% (FY20: 84%). Depending on the product mix, the company has the capacity to produce 4,500 to 5,000 tons per annum and has been operating at nearly full capacity utilization for the past few years, except for in FY20 due to closure of operations amidst first wave of Covid-19.

EMCO remains the only porcelain insulator manufacturer in Pakistan and serves around 75% of the local demand. The company faces competition only from imports, which is also minimal given price differential. Some cottage industries are present which operate on a very small scale and cater to private clients only. The management intends to add a new product line of 'Instrument Transformers' in substation product category to cater to the local needs and also to enhance exports. Instrument transformer is an electrical device of high accuracy that is used to transform or isolate current/voltage levels. They are most commonly used for metering or operating instrument of high current/voltage circuits by isolating the secondary control circuitry safely in high currents/voltage. Total capex on the aforementioned is estimated at Rs. 275m. Letter of credits (LCs) for the import of machinery is planned to be opened in November' 21. Given the machinery is customized for the purpose, equipment is expected to arrive in May' 22 and start commercial operations in January'23 after passing required testing. While operating at full capacity, incremental revenue from instrument transformers is estimated at Rs. 800m. In addition, Balancing, Modernization and Replacement (BMR) of Rs. 500m is also in pipeline for the current year. This was expected to be completed in FY21, however, due to supply chain disruptions amid pandemic resulted in container unavailability and shipment cost crisis, the company had to inevitably delay the project. The BMR is related to enhanced automation and controls of existing plant to increase production yield and optimize production processes. This is expected to generate incremental revenue of about Rs. 400m. LCs for the machinery are expected to be opened by end-Dec'21 and machinery is expected to arrive by end-June' 22. Installation and commissioning is expected by end-Dec'22 while the commercial operations are intended in Feb'23.

Property, plant and equipment stood higher at Rs. 1.9b (FY20: Rs. 1.4b) by end-FY21. The company made additions of Rs. 209.5m in the outgoing year, out of which Rs. 169.4m pertained to plant and machinery and Rs. 32m is related to addition in building on freehold land. Revaluation adjustment in the value of PP&E amounting to Rs. 459.3m (FY20: Rs. 191.6m) was reported in FY21. PP&E also included installation of net metered based Solar Power setup for a capex of Rs. 80.5m. The company has a total power requirement of around 2.2 MW while operating at full capacity. The solar power setup is of 1 MW capacity which would cover around one-third of the company's electrical load demand, based on average solar output over the year and result in cost saving of approximately Rs. 21m per annum. EMCO has a sanctioned load from LESCO of 3 MW and the current utilization is approximately 1.1 MW. Being a continuous process industry, standby generator capacity of 1.2 MW is also in place. The company has a gas connection from Sui Northern Gas Pipelines Limited (SNGPL) of 2.4 mmcfd for gas kilns, which have power requirement of around 1.05 MW. As a backup source for these kilns, EMCO has a Synthetic Natural Gas (SNG) plant to counter any gas interruptions; SNG plant uses Liquefied Petroleum Gas (LPG) as feedstock. Existing power facilities ensure sufficient power availability to support additional capacities as well.

Two other projects namely, High Voltage Disconnector/Isolator Manufacturing (HVD/IM) and RTV Coating acquired certifications for commercial operations in November and December, 2020, respectively, after passing relevant tests; these were completed earlier in FY20. Presently, the company has orders in hand of worth Rs. 120m and Rs. 70m of HVD/IM and RTV coated insulators, respectively. In addition, orders worth Rs. 170m related to HVD/IM are currently under techno-commercial evaluation.

Growth in topline with largely intact gross margins: The company recorded net revenue of Rs. 2.0b (FY20: Rs. 1.6b) in FY21, with a growth of 27%. The growth in sales was driven by increase in volume sold of 4,982 tons (FY20: 4,193 tons) with higher average price per ton of Rs. 408,558 (FY20: Rs. 381,144). Around 93% (FY20: 96%) of the revenue comprised line insulators and the rest pertained to substation products. Sale of line insulators amounted to Rs. 1.9b (FY20: Rs. 1.5b) comprising around 93% (FY20: 96%) of the revenue, and the rest pertained to substation products sale of Rs. 138.6m (FY20: Rs. 52.8m) in FY21. Export sales continued to remain limited at Rs. 34.4m (FY20: 42.1m) due to capacity constraints. Owing to highly specialized nature of products offered, the company has limited customer base due to which client concentration has remained very high on timeline basis. A list of top ten customers constituting 88% of the topline is presented below:

Customer Name	PKR
Faisalabad Electric Supply Company	353,195,207
Lahore Electric Supply Company	209,126,852
K- Electric Ltd	198,878,564
Islamabad Electric Supply Company	188,620,111
Multan Electric Power Company	187,994,040
Peshawar Electric Supply Company	166,805,641
Quetta Electric Supply Company	160,367,611
Sukkur Electric Power Company	158,152,000
Gujranwala Electric Power Company	144,530,500
Hyderabad Electric Supply Company	33,500,000
Total	1,801,170,526

During FY21, the company generated higher gross profit of Rs. 485.5m (FY20: Rs. 379.6m) while margins remained at 23.9% (FY20: 23.8%). Cost of sales was recorded higher at Rs. 1.5b (FY20: Rs. 1.2b) in FY21 mainly due to increase in cost of raw material and packaging material consumed to Rs. 725m (FY20: Rs. 497.7m); proportion of the same in cost of goods manufactured has also increased to 48% (FY20: 40%). Out of this total cost Rs. 226.3m (FY20: Rs. 180.2m) is related to porcelain which is 65% (FY20: 77%) imported. Metal-based subcomponents of insulators costed

Rs. 456.4m (FY20: Rs. 336.7m), three-fourth of which are imported. Packing material cost amounted to Rs. 49.7m (FY20: Rs. 41.6m). Cumulatively, around two-third of the total raw material requirements are met through imports, which exposes the company to exchange rate risk. However, the management procures raw material around 3 to 5 months in advance. Moreover, the risk is largely mitigated given the company has been able to pass on the impact of higher cost for new tenders, as the devaluation of local currency is also reflected in cost of imported insulators. Salaries, wages and benefits increased to Rs. 314.3m (FY20: Rs. 294.6m) in line with inflationary adjustment. Meanwhile, power and fuel cost was lower at Rs. 195.0m in FY21 vis-à-vis Rs. 234.3m in the preceding year due to measures to increase efficiency of ignition system. Depreciation charge was also higher in the outgoing year. Administrative expenses were recorded at Rs. 87.4m (FY20: Rs. 78.7m) and were largely rationalized. Selling and distribution expenses amounted to Rs. 32.3m (FY20: RS. 30.9m) in FY21. Other expenses increased to Rs. 31.9m (FY20: Rs. 14.9m) due to higher expenses related to worker's profit participation fund of Rs.15.1m (FY20: Rs. 8.8m), provision for expected credit loss of Rs. 6.2m (FY20: Nil) and provision for stock obsolescence of Rs. 2.8m (FY20: Rs. 0.8m). Other income was also recorded higher at Rs. 33.4m (FY20: Rs. 5.4m) mainly on account of recording fair value gain on investment properties of Rs. 16.4m (FY20: Nil), rental income of Rs. 8.6m (FY20: Rs. 0.04m) along with amortization of government grant of Rs. 2.7m (FY20: Nil). Finance cost decreased to Rs. 87.5m (FY20: Rs. 97.4m) in line with lower average markup rates during FY21. Accounting for taxation, net profit was recorded higher at Rs. 201.9m (FY20: Rs. 117.9m) during FY21. Net margins increased to 9.9% (FY20: 7.4%) mainly on account of higher gross profit, rationalized operating costs and some decrease in finance cost.

Presently, the company has confirmed orders in hand of Rs. 1.2b while revenue of Rs. 540m would be booked for 1QFY22. As per management, topline is projections to grow at a CAGR of 24% over a period of three business cycles due to additional capacity and higher productivity from BMR coming online in FY23. Meanwhile, profit margins are expected to decrease slightly owing to competitive pricing by the company for its new product line to participate in export markets. Additionally, instrument transformers are relatively lower margin product due to higher cost of production.

Adequate liquidity in terms of cash flow coverages: Funds from Operations (FFO) increased to Rs. 354.4m (FY20: Rs. 229.3m) in the outgoing year in line with higher profitability. Resultantly, FFO to total debt and FFO to long-term debt improved to 0.41x (FY20: 0.28x) and 1.66x (FY20: 0.81x), respectively. Debt Service Coverage Ratio (DSCR) also increased to 2.39x (FY20: 1.93x) in FY21.

Stock in trade stood slightly lower at Rs. 594.2m (FY20: Rs. 610.4m) at end-FY21, due to decrease in finished goods inventory. Trade receivables increased to Rs. 593.1m (FY20: Rs. 366.1m) by the end-FY21. All local sales to National Transmission & Dispatch Company (NTDC) and Distribution Companies (DISCOs) as well as exports are against contracts with defined payments terms on sight. However, there is a lag of two to three months for payment clearance from government clients owing to excessive documentation and formalities. For private clients, payments are generally made in advance or in few cases credit period of 30 to 60 days' is provided; private clients constitute less than 10% of total turnover. Outstanding receivables have decreased to Rs. 277.2m by end-Sep 23, 2021. Aging profile shows that 85% of these payments fall due within six months' credit bracket, 6% receivables fall in 6-12 months while around 8% of receivables were outstanding for more than a year. Advances, deposits, prepayments and other receivables stood at Rs. 70.7m (FY20: Rs. 83.4m) and largely comprised employee related advances and current portion of long-term prepayments. Income tax refundable from government stood at Rs. 84.0m (FY20: Rs. 91.1m). Cash and bank balance amounted to Rs. 40.6m (FY20: Rs. 43.9m). Current ratio remained at 1.36x (FY20: 1.40x) at end-FY21. In addition, coverage of short-term borrowings remained adequate at 1.82x (FY20: 1.78x). Overall liquidity of the company is projected to remain adequate on account of higher profit generation, going forward.

Decrease in leverage indicators on the back of higher equity base: Tier-1 equity increased to Rs. 768.7m (FY20: Rs. 547.4m) by end-FY21 mainly on account of profit retention. In addition, sponsors have continued to support capitalization by providing interest free loan, which remained unchanged at Rs. 115.7m (FY20: Rs. 115.7m). Total liabilities increased to Rs. 1.4b (FY20: Rs. 1.2b) by end-FY21 due to increase in short-term borrowings, long-term deferred liabilities and trade and other payables. Trade and other payables increased to Rs. 326.6m (FY20: Rs. 272.3m) by end-FY21 mainly on account of increase in trade creditors to Rs. 172.3m (FY20: Rs. 135.9m). The payment terms with major raw material suppliers is LC at sight for imported raw material and 60 to 70 days' credit for local suppliers.

Debt profile of the company largely comprised short-term borrowings which have increased to Rs. 650.6m (FY20: Rs. 547.2m) by end-FY21 in line with working capital requirements. These borrowings also include amount of Rs. 54.3m (FY20: Rs. 92.8m) provided by sponsors as unsecured interest free loan to meet working capital requirements. Long-term loans (including current maturity) stood lower at Rs. 213m (FY20: Rs. 283.6m) at end-FY21. The company has outstanding loan of Rs. 40.7m (FY20: Rs. 35.2b) against term finance facility under refinance scheme of State Bank of Pakistan for payment of wages and salaries. The company has a history of restructuring; short-term facility was converted into long-term financing in March'17. As per revised repayment schedule in July' 18, remaining loan is to be repaid in 48 equal monthly installments of Rs. 1.4m for DF-I and Rs. 0.4m for DF-II. The outstanding value of this loan stood at Rs. 24.1m (FY20: Rs. 46.1m) and will be fully repaid by end-FY22. Another loan, amounting to Rs. 41.5m (FY20: Rs. 60.8m), was restructured first in June'13 and then in May'15. Under the restructuring agreement, the outstanding principal of Rs. 109.0m is repayable in quarterly staggered installments over a period of five years. The outstanding markup payable and accrued after restructured agreement shall be paid after the principal amount has been fully repaid; deferred markup as at reporting date amounted to Rs. 41.5m (FY20: Rs. 55.8m). The facility carries a markup at 3M-KIBOR and will be fully repaid by Feb'23. The company has not only been adhering to its repayment obligations since restructuring, but has also made early repayments of partial loans. A long-term loan amounting Rs. 25m (FY20: Rs. 24.2m) has been obtained from Associated Engineers (Pvt.) limited (an associated company) and is interest free. The terms of repayment have not been formalized, however, it is not repayable within next 12 months. In accordance with the requirements of IFRS 9, amortization and unwinding have been carried out and the relevant difference is charged to the profit and loss statement. Lease liabilities amounted to Rs. 2.2m (FY20: Rs. 4.8m) by end-FY21. Gearing and leverage decreased to 1.12x (FY20: 1.52) and 1.83x (FY20: 2.22x) owing to higher equity base. Adjusting for short-term working capital provided by sponsors, gearing reduces to 1.05x (FY20: 1.35x).

Capitalization indicators may come under pressure owing to mobilization of additional long-term borrowing and higher short-term financing to meet working capital requirements, going forward. However, scheduled repayment of long-term borrowings and internal capital generation are expected to keep leverage indicators at manageable level.

EMCO INDUSTRIES Limited (EMCO) Appendix I

FINANCIAL SUMMARY *(amounts in PKR millions)*			
BALANCE SHEET	**June 30, 2019**	**June 30, 2020**	**June 30, 2021**
Non-Current Assets	1,233	1,416	2,009
Stock-in-Trade	450	610	594
Stores & Spares	80	81	84
Trade Debts	534	366	593
Advances, Prepayments and other Receivables	78	83	71
Cash & Bank Balances	5	44	41
Other Assets	77	91	84
Total Assets	**2,457**	**2,691**	**3,476**
Trade and Other Payables	272	272	327
Short Term Borrowings	614	547	651
Long-Term Borrowings (Inc. current maturity)	304	284	213
Paid Up Capital	350	350	350
Tier-1 Equity	408	547	769
Total Equity	1,166	1,474	2,071
INCOME STATEMENT	**June 30, 2019**	**June 30, 2020**	**June 30, 2021**
Net Sales	1,386	1,598	2,035
Gross Profit	348	380	485
Operating Profit	250	270	366
Profit Before Tax	139	163	280
Profit After Tax	145	118	202
FFO	243	229	354
RATIO ANALYSIS	**June 30, 2019**	**June 30, 2020**	**June 30, 2021**
Gross Margin (%)	25.1	23.8	23.9
Net Working Capital	228	364	387
Current Ratio (x)	1.23	1.40	1.36
FFO to Long-Term Debt(x)	0.80	0.81	1.66
FFO to Total Debt (x)	0.26	0.28	0.41
FFO to Total Debt (x)*	0.34	0.31	0.44
Debt Servicing Coverage Ratio (x)	1.90	1.93	2.39
ROAA (%)	6.0	4.6	6.5
ROAE (%)	54.2	24.7	30.7
Gearing (x)	2.25	1.52	1.12
Gearing (x)*	1.75	1.35	1.05
Debt Leverage (x)	3.12	2.22	1.83
(Stock in Trade+ Trade Debts) to Short-term Borrowings (x)	1.60	1.78	1.82

**Adjusted for Short-term sponsor loan*

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	EMCO Industries Limited
Sector	Electrical Equipment
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				
December 7, 2021	A-	A-2	Stable	Reaffirmed
October 27, 2020	A-	A-2	Stable	Initial

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

	Name	Designation	Date
1	Mr. Salem Rehman	Executive Director	21-Sep-2021
2	Mr. Riaz Ahmad	CFO	21-Sep-2021