## RATING REPORT

# International Steels Limited

**REPORT DATE:**
April 14, 2023

**RATING ANALYST:**
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| RATING DETAILS | | |
|---|---|---|
| **Rating Category** | **Latest Rating** | **Previous Rating** |
| **Entity** | **A+/A-1** | **A+/A-1** |
| ***Rating Date*** | *April 14, 2023* | *May 23, 2022* |
| **Rating Outlook** | *Rating Watch-Developing* | *Stable* |
| ***Outlook Date*** | *April 14, 2023* | *May 23, 2022* |
| ***Rating Action*** | Maintained | *Reaffirmed* |

| COMPANY INFORMATION | |
|---|---|
| **Incorporated in 2007** | **External auditors:** A.F. Ferguson & Co., Chartered Accountants |
| **Public Limited Company** | **Chairman:** Kamal A.Chinoy |
| **Key Shareholders (with stake 5% or more):** | **Chief Executive Officer:** Mr. Yousuf H. Mirza |
| International Industries Limited - 56.3% | |
| Sumitomo Corporation – 9.07% | |

| APPLICABLE METHODOLOGY(IES) |
|---|
| **VIS Entity Rating Criteria *Corporates (August 2021)*** <br> ***https://docs.vis.com.pk/docs/CorporateMethodology202108.pdf*** |

# International Steels Limited

| OVERVIEW OF INSTITUTION | RATING RATIONALE |
|---|---|

*International Steels Limited (ISL) was incorporated in 2007 and is currently Pakistan's premium producer of flat steel products with an annual production capacity of 1,000,000MT. The primary activity of the company is manufacturing of cold rolled steel coils (CRC), hot dipped galvanized coils (HDGC), and color coated coils. Major shareholders of the company are International Industries Ltd. (IIL) and Sumitomo Corporation with a shareholding of 56.3% and 9.1% in ISL respectively. The remaining shareholders include directors, financial institutions, mutual funds, foreign companies, and general public.*

**Corporate profile**

International Steels Limited (ISL) was incorporated in 2007 and is one of the country's leading producers of flat steel products. The company is primarily engaged in the production of Cold Rolled Steel Coils (CRC), Hot Dipped Galvanized Coils (HDGC), and Color Coated Coils and has a total production capacity of 1m MT. ISL is a subsidiary of International Industries Ltd. (IIL) which has a shareholding of 56.3% while its associated company, Sumitomo Corporation, has a shareholding of 9.1%. In-house co-generation plant with an installed capacity of 19MW is in place that is sufficient to cater to ISL's power related needs, while excess power is sold to K-Electric Limited.

**Elevated business risk on the back of significant macroeconomic challenges**

The flat steel industry is characterized by moderate to high business risk mainly due its cyclical nature, high fixed operating costs and price volatility of raw materials. The price of hot-rolled coils (HRC), which is the primary raw material for flat steel products, exhibited notable volatility reaching an all-time high of $1,100MT in September 2021, but has since declined to about $508/MT in December 2022. The decrease was due to reduced demand caused by China's zero-COVID policy, a downturn in the real estate construction industry, and global restrictive monetary policies. Additionally, the energy crisis in Europe resulting from the Russia-Ukraine conflict negatively impacted industrial activities. Spot prices of SS400 grade hot-rolled coil remained within $600-$670/MT FOB China levels between January and February'23.

The local flat steel industry is oligopolistic in nature, dominated by ISL and Aisha Steel Mills Ltd. (ASML). The average consumption of steel per capita in the country is only 46kg, which is significantly lower than the global average of 233kg suggesting considerable growth opportunity. Demand for flat steel products is largely derivative of the output from the automotive, construction, pipes and consumer durable sectors. However, the challenging macroeconomic conditions brought upon by import restrictions, currency depreciation, rising inflation, soaring power costs and high policy rates have dampened demand outlook for the overall steel sector. This downturn is evident through the decline in the large-scale manufacturing (LSM) index by 4.4% YoY during Jan'23 and decrease in total automotive unit sales by 47.55% YoY in 8MFY23. However, ratings factor in ISL's ability to navigate through these restrictions due to its export proceeds, albeit, the quantum of raw materials procured was subdued owing to lower business activity. Additionally, during FY22, anti-dumping duties for cold-rolled coils (CRC) were extended for another five years while anti-dumping duties for galvanized coils are under review by the National Tariff Commission (NTC) and will expire by end-FY23 for color-coated coils.

**Lower capacity utilization due to compressed supply and demand**

During the outgoing year, overall production output decreased by 11.4% YoY to 441,013MT (FY21: 498,037MT) owing primarily to decreased demand led by challenging operating environment. Additionally, capacity utilization decreased for the company's two main product lines, cold-rolled coils (CRC) and galvanized coils, while utilization for color coated coils segment witnessed a marginal increase. Breakdown of historical capacity utilization can be seen below:

| | FY20 | FY21 | FY22 |
|---|---|---|---|
| **Cold Rolled Steel Strip** | | | |
| Installed Capacity (MT) | 1,000,000 | 1,000,000 | 1,000,000 |
| Production (MT) | 424,355 | 498,037 | 441,013 |
| **Utilization (%)** | **42%** | **50%** | **44%** |
| **Galvanizing** | | | |
| Installed Capacity (MT) | 462,000 | 462,000 | 462,000 |
| Production (MT) | 230,023 | 279,678 | 213,200 |
| **Utilization (%)** | **50%** | **61%** | **46%** |
| **Color Coated Coils** | | | |
| Installed Capacity (MT) | 84,000 | 84,000 | 84,000 |
| Production (MT) | 21,166 | 15,478 | 17,037 |
| **Utilization (%)** | **25%** | **18%** | **20%** |

The company has completed capital expenditure pertaining to a rewinding line with an electrolyte cleaning section to help resolve bottlenecks in the production of cold-rolled sheets. Estimated project cost was around Rs 1.2b and was funded by Temporary Economic Refinance Facility (TERF) and Long-Term Financing Facility (LTFF) at concessionary rates by the State Bank of Pakistan (SBP). Additionally, new Purlin machines have been commissioned at the company's service center which is mainly engaged in shaping flat rolled steel into various forms ready for industrial and construction use. The strategic location of the service center at Port Qasim Area also helps encourage just-in-time production capability, according to management.

**Increase in topline during FY22 attributable to higher prices, however, subdued local and export demand resulted in significant decrease in net revenues during HYFY23; pressure witnessed on both gross and net margins**

The company's net revenues witnessed a 31% YoY uptick in FY22, amounting to Rs. 91.4b (FY21: Rs. 69.8b), primarily due to increase in prices as total volumetric sales for galvanized products and cold-rolled products, the two main product lines, decreased by 18.1% and 7.3%, respectively. Moreover, about 20.4% of net sales pertained to exports amounting to about Rs. 18.7b (FY21: Rs. 11.9b), a 57.4% increase YoY. Primary export markets include North and South America as well as Asia, constituting about 10% and 7% of total net sales, respectively (FY21: 7.4%, 7.1%). Moreover, contribution from the company's recently established service center almost doubled to Rs. 9b during FY22 (FY21: Rs. 4.6b).

Gross margin declined to 13.5% (FY21: 19.3%) in FY22 primarily on the account of significant volatility in international prices of key raw materials, mainly hot-rolled coils (HRC), as well as currency depreciation. Moreover, net margins were squeezed to 5.9% (FY21: 10.7%) owing largely to higher financing charges of Rs. 1.3b (FY21: Rs. 812m) in line with increase in policy rate, higher selling and distribution costs amounting to Rs. 1.6b (FY21: Rs 1.1b) due to jump in global rates for freight expenses and impact of super tax of Rs. 716.3m. Additionally, administrative expenses witnessed a decrease to Rs. 340m (FY21: Rs. 361.5m) due to cost rationalization whereas other income and expenses stood at Rs. 1.3b and Rs. 201m, respectively (FY21: Rs. 1.3b, Rs. 316m).

In 1HFY23, net revenues declined notably by 26% on an annualized basis to Rs. 33.9b due to lower demand and supply constraints. Gross margins decreased further to 8.8% as currency depreciation offset any potential gains from decline in international raw material prices. Additionally, net margins dipped notably to 0.2% due to higher financing charges amounting to Rs. 1.7b and exchange loss of about Rs. 1.2b. Ratings remain dependent on projected improvement in profitability profile through management's strategy of de-leveraging balance sheet to reduce the impact of elevated finance cost.

**Deteriorated liquidity position owing to weakened cash flow coverages**

Funds from Operations (FFO) declined notable to ~-Rs. 76m during 1HFY23 (FY22: Rs. 7.8b; FY21: Rs. 10.9b) owing largely to reduced operating cash flows and higher financing payments. Consequently, FFO to total-debt and FFO to long-term debt both reduced to ~-0.005x and ~-0.02x, respectively (FY22: 0.36x, 1.85x; FY21: 0.91x, 2.08x) in 1HFY23. Additionally, debt-service coverage ratio declined notably to 0.5x (FY22: 3.46x; FY21: 4.93x) in 1HFY23.

Stock-in-trade amounted Rs. 22.8b at end-Dec'23 (FY22: Rs. 30.2b, FY21: Rs. 17.1b). At end-June'22, total trade debts amounted to Rs. 1b (FY21: Rs. 939.9m) out of which Rs. 910m were receivable from entities other than related parties (FY21: Rs. 722.9m). Out of these, about 57.3% were not past due, 42.6% were due within 60 days while the remainder was past due 61 days. Moreover, current ratio and short-term borrowing coverage were both satisfactory at end-Dec'22, standing at 1.11x (FY22: 1.2x, FY21: 1.4x) and 1.88x (FY22: 1.8x, FY21: 2.7x), respectively. Net operating cycle also increased primarily on the account of lower inventory turnover in line with lower demand. As per management, significant reduction in working capital cycle and early repayment of debt has improved the liquidity profile of the company in 3QFY23. Materialization of the projected targets will be important to sustain the ratings.

**Lower debt levels resulting in improved capitalization indicators**

The company's Tier-1 equity decreased to Rs. 17.3b during 1HFY23 (FY22: Rs. 19.2b; FY21: Rs. 17.7b) due to lower internal capital generation and dividend payout. Total borrowings stood at Rs. 15.9b at end-Dec'22 (FY22: Rs.21.6b; FY21: Rs. 12b) out of which 78% constitutes of short-term borrowings amounting to about Rs. 12.5b (FY22: Rs.17.4b; FY21: Rs. 6.8b). Lower quantum of short-term debt is attributable to lower working capital requirements due to improved inventory management. Total long-term debt has witnessed a timeline decrease to Rs. 3.5b (FY22: Rs. 4.3b; FY21: Rs. 5.2b) and was primarily utilized for capital expenditure to enhance production capacity and efficiency. Additionally, about 46% of long-term financing pertained to Temporary Economic Refinance Facility (TERF) and long-term financing facilities (LTFF) for export-oriented projects which have concessionary interest rates. Moreover, gearing decreased to 0.92x at end-Dec'22 (FY22: 1.13x; FY21: 0.68x) owing to notably lower overall debt levels despite decline in equity base while leverage remained relatively stable at 1.81x (FY22: 1.79x; FY21: 1.29x). Going forward, the company's ability to improve internal capital generation whilst maintaining financial indicators in line with benchmarks for the assigned ratings will be important from a rating's perspective.

| FINANCIAL SUMMARY | *(amounts in PKR millions)* | | | | |
|---|---|---|---|---|---|
| **BALANCE SHEET** | **FY19** | **FY20** | **FY21** | **FY22** | **1HFY23** |
| PPE | 19,862 | 20,638 | 19,180 | 20,750 | 20,442 |
| Stock-in-Trade | 14,648 | 15,132 | 17,081 | 30,197 | 22,847 |
| Trade Debts | 868 | 1,016 | 940 | 1,034 | 574 |
| Cash & Bank Balances | 403 | 106 | 293 | 896 | 1,699 |
| Total Assets | 39,762 | 42,861 | 41,720 | 55,905 | 51,089 |
| Trade and Other Payables | 5,612 | 8,921 | 6,588 | 6,470 | 9,221 |
| Long Term Debt | 7,277 | 6,585 | 5,216 | 4,263 | 3,533 |
| Short Term Debt | 10,191 | 11,520 | 6,796 | 17,360 | 12,457 |
| Total Debt | 17,468 | 18,105 | 12,012 | 21,623 | 15,990 |
| Paid-up Capital | 4,350 | 4,350 | 4,350 | 4,350 | 4,350 |
| Total Equity (excl. Surplus) | 11,590 | 11,472 | 17,667 | 19,185 | 17,333 |
| | | | | | |
| **INCOME STATEMENT** | **FY19** | **FY20** | **FY21** | **FY22** | **1HFY23** |
| Net Sales | 57,484 | 48,082 | 69,796 | 91,424 | 33,926 |
| Gross Profit | 6,449 | 4,213 | 13,492 | 12,381 | 2,975 |
| Admin exp | 284 | 263 | 362 | 340 | 153 |
| Selling & Distribution | 702 | 894 | 1,063 | 1,612 | 148 |
| Profit Before Tax | 3,679 | 442 | 10,295 | 8,001 | (32) |
| Profit After Tax | 2,664 | 495 | 7,466 | 5,412 | 61 |
| | | | | | |
| **RATIO ANALYSIS** | **FY19** | **FY20** | **FY21** | **FY22** | **1HFY23** |
| Gross Margin (%) | 11.2% | 8.8% | 19.3% | 13.5% | 8.8% |
| Net margin (%) | 4.6% | 1.0% | 10.7% | 5.9% | 0.2% |
| FFO | 3,876 | 1,017 | 10,874 | 7,759 | (76) |
| FFO to Total Debt (x) | 0.22 | 0.06 | 0.91 | 0.36 | (0.005) |
| FFO to Long Term Debt (x) | 0.53 | 0.16 | 2.08 | 1.85 | (0.02) |
| DSCR (x) | 2.14 | 1.03 | 4.93 | 3.43 | 0.50 |
| ROAA (%) | 7.1% | 1.2% | 17.7% | 11.1% | 0.1% |
| ROAE (%) | 23.7% | 4.3% | 51.2% | 29.7% | 0.3% |
| Leverage (x) | 2.32 | 2.63 | 1.29 | 1.79 | 1.81 |
| Gearing (x) | 1.51 | 1.58 | 0.68 | 1.13 | 0.92 |
| Current Ratio (x) | 1.09 | 0.94 | 1.38 | 1.20 | 1.11 |
| Stock+ Trade Debt/STB | 152.2% | 140.2% | 265.2% | 179.9% | 188.0% |
| CCC (days) | 72 | 71 | 59 | 83 | 114 |

# 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.

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**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** | International Steels Limited | | | | |
| **Sector** | Steel | | | | |
| **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** | | | | |
| | **14-April-23** | A+ | A-1 | Rating Watch-Developing | Maintained |
| | **23-May-22** | A+ | A-1 | Stable | Reaffirmed |
| | **12-Mar-21** | A+ | A-1 | Stable | Maintained |
| | **20-Oct-20** | A+ | A-1 | Rating Watch-Negative | Maintained |
| | **21-Jun-19** | A+ | A-1 | Stable | Reaffirmed |
| | **04-Apr-18** | A+ | A-1 | Stable | Reaffirmed |
| | **13-Jan-17** | A+ | A-1 | 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** | | |
| | **Mr. Mujtaba Hussain** | CFO | March 22, 2023 | | |
| | **Mr. Yousuf H. Mirza** | CEO | March 22, 2023 | | |