RATING REPORT

Deharki Sugar Mills (Private) Limited

REPORT DATE:
April 15, 2022

RATING ANALYST:

Tayyaba Ijaz, CFA
tayyaba.ijaz@vis.com.pk

RATING DETAILS				
Rating Category	Latest Rating		Previous Rating	
	Long-term	Short-term	Long-term	Short-term
Entity	A	A-2	A-	A-2
Rating Outlook	*Stable*		*Stable*	
Rating Action	Upgrade		Reaffirmed	
Rating Date	*15th April'22*		*27th July'21*	

COMPANY INFORMATION	
Incorporated in 2010	**External auditors:** M/s Riaz Ahmad, Saqib, Gohar & Co., Chartered Accountants
Private Limited Company	**Chairman of the Board:** Mr. Jahangir Khan Tareen **Chief Executive Officer:** Mr. Raheal Masud
Key Shareholders (with stake 5% or more):	
JDW Sugar Mills Limited – 100%	

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

Deharki Sugar Mills (Private) Limited

OVERVIEW OF THE INSTITUTION

DSML was incorporated as a private limited company in July, 2010 under the Companies Ordinance 1984.

Profile of the CEO
Mr. Raheal Masud brings with himself vast experience of the manufacturing sector. He joined JDW Sugar Mills Ltd. as General Manager in 1991.

RATING RATIONALE

Deharki Sugar Mills (Private) Limited (DSML) is a wholly-owned subsidiary of JDW Sugar Mills Limited. The company is principally engaged in manufacturing and selling of crystalline sugar. Head office of the company is based in Lahore, whereas manufacturing unit is situated in Ghotki, Sindh.

Key Rating Drivers

Higher sugar production in line with better crop yield with no further decline in recovery rate expected: Sugarcane crop is a high value cash which is the second largest agro-industry sector after textile. Sugarcane production accounts for 3.4% in agriculture's value addition and 0.7% in the country's GDP. As per Pakistan Bureau of Statistics (PBS), during 2020-21, sugarcane crop was cultivated on 1,165K hectares as compared to preceding year's area of 1,040 hectares. The increase in area under cultivation was mainly on account of favorable weather conditions and higher economic returns. Total sugarcane cultivation area for 2021-22 is 1,271K hectares, ~9.1% higher than the previous year, while sugarcane production for the year is projected at 84,800K tons, ~11% higher than the last year production i.e. 76,360K tons. According to United States Department of Agriculture (USDA) semi-annual report, sugar production in 2021-22 is forecasted at 6.7 million tons, around 11% higher than the current year's estimate of 6.0 million tons while sugar consumption is also expected to increase slightly to 5.9 million tons (MY21: 5.8m MT). The increase in sugar production is expected to drive closing stocks to 2.8 million tons. However, despite sufficient supply, sugar prices witnessed an increasing trend over the last three years with prices in September 2021 were 92% higher than the prevailing prices in October 2018. To control prices, Government of Pakistan (GoP) imported more than 350,000 tons of sugar in 2020-21. The imports were meant to build stocks and not to be sold in the market, however, given current scenario of higher production, the imports may be discontinued. The average sugar prices in MY22 are also expected to remain lower than the previous year.

Risk profile of sugar sector is considered high given inherent cyclicality in the crop levels and raw material prices. Moreover, distortion in pricing mechanism of raw material prices and refined sugar also creates challenge for sugar mills. In efforts to regulate the sector, bring transparency and enhance tax collection, Federal Board of Revenue (FBR) has implemented Track & Trace System during Sep-Nov'21 across the country to ensure electronic monitoring of the production and sale of important sectors, including tobacco, fertilizer, sugar and cement sectors. Under the Track & Trace System, no bag of sugar can be taken out from the factory and manufacturing plant without stamp and individual identity mark. To ensure its implementation, Regional Enforcement hubs across Pakistan were tasked to conduct raids on the unstamped /non-tax paid sugar. These steps have also resulted in higher revenues reported by sugar firms.

Typically, sugarcane production has a 3-to-5 year cycle, driven largely by government support for farmers and crop yield. For the ongoing crushing season 2021-22, notified prices of sugarcane were revised to Rs. 225 per 40 Kg from Rs. 200 per 40 Kg in Punjab and Rs. 250 per 40 Kg from Rs. 202 per 40 Kg in Sindh. Even after substantial increase in support prices by the Provincial Governments, the industry is procuring sugarcane at higher rates. However, as per management, due to higher supply of cane, the premium paid above support prices is relatively lower in MY22 than the previous season. Sucrose recovery rates are also expected to remain intact in the ongoing year with no further decline expected in the medium term.

Regulatory matter update related to imposed penalty: The ratings have incorporated the developments in relation to penalties imposed by Competition Commission of Pakistan (CCP) on selected sugar mills and the subsequent legal proceedings initiated by the subject company. The impact of the imposed penalty of Rs. 774.4m on DSML would be significant. However, according to the management, the case is weak and any final decision by the court of law in this regard may take several years. Given uncertainty and material effect of the outcome, VIS will continue to monitor further developments in this matter.

Operating Performance: Installed sugarcane crushing capacity of the company stands at 13,000 MT per day. Crushing season 2021-22 started on November 21, 2021 in Sindh. Total cane crushed amounted to 1.5m MT (MY21: 1.27m MT; MY20: 1.22m MT) up till February 28, 2022, in the ongoing season. Given higher availability of sugarcane, the ongoing crushing season is expected to last for 125 days resulting in notable increase in production. Sugar produced during current season stood higher at 144,915 MT (MY21: 125,757 MT; MY20: 122,831 MT) with a recovery rate of 9.89% (MY21: 9.90%; MY20: 10.06%). Molasses produced increased to 67,935 MT (MY21: 60,000 MT; MY20: 55,253 MT) with a recovery rate of 4.68% (MY21: 4.72%; MY20: 4.53%).

	MY20	MY21	end-Feb' MY22
Capacity per day (MT)	13,000	13,000	13,000
Crushing Period (Days)	99	110	100
Total Crushing Capacity (MT)	1,950,000	1,950,000	1,950,000
Cane Crushed (MT)	1,220,644	1,270,152	1,484,611
Capacity Utilization (%)	62.60%	65.14%	76.13%
Sugar Production (MT)	122,831	125,757	144,915
Recovery Ratio (%)	10.06%	9.90%	9.89%
Molasses Produced (MT)	55,253	60,000	67,935
Molasses Recovery (%)	4.53%	4.72%	4.68%

Property, plant and equipment amounted to Rs. 3.2b (MY20: Rs. 3.3b) at end-MY21. Investment property representing agriculture land in Rahim Yar Khan remained unchanged at Rs. 539m (MY20: Rs. 539m) at end-MY21.

Growth in topline with some improvement in gross margins, however, the company reported net loss on account of tax adjustments in MY21: During MY21, net sales were recorded higher at Rs. 10.1b (MY20: Rs. 8.9b) primarily due to better sugar prices which more than offset the decrease in quantity sold. Revenue from sugar sales increased to Rs. 8.2b (MY20: Rs. 7.0b) with lower volumetric sales of 114,386 MT (MY20: 120,408) at a higher average sugar price of Rs. 71.9/Kg (MY20: Rs. 58.4/Kg). Revenue from molasses increased to Rs. 989.7m (MY20: Rs. 819.5m) in line with increase in quantity sold and average prices. Bagasse sales were recorded lower at Rs. 465.3m (MY20: 656.5m) owing to decrease in quantity sold and average selling prices. Agri inputs generated net revenue of Rs. 329.3m (MY20: Rs. 379.6m) in MY21. Breakdown of sales in volume sold and average selling prices is tabulated below:

	MY20		MY21	
Quantity in Metric Tons	**QTY**	**Avg. Selling Prices Rs./Unit**	**QTY**	**Avg. Selling Prices Rs./Unit**
Sugar (MT)	120,408	58,395	114,386	71,943
Molasses (MT)	55,253	14,832	60,000	16,494
Agri Inputs (MT)	112,475	3,375	81,916	4,020
Mud (MT)	34,583	1,274	44,729	1,192
Bagasse (MT)	161,072	4,076	121,086	3,843
Net Revenue	Rs. 8,930.9m		Rs. 10,066.9m	

Cost of sales increased to Rs. 8.7b (MY20: Rs. 7.8m) mainly due to the impact of higher average sugarcane procurement prices (MY21: Rs. 258.3/maund; MY20: Rs. 215.1/maund). Administrative expenses were recorded notably higher at Rs. 672.1m (MY20: Rs. 278.4m) mainly on account of increase in salaries, wages and benefits to Rs. 589.4m (MY20: Rs. 175.6m) in line with inclusion of salaries and benefits to a director (previously *nil*), inflationary adjustments and increase in headcount of executives. Selling expenses increased to Rs. 107.5m (MY20: Rs. 5.7m) which according to the management was due to one-off expense related to a promotional campaign for a cricket team in Pakistan Super League. Other income amounted to Rs. 259.1m (MY20: Rs. 304.5m) which largely constituted markup on loans to holding company and a related party. Other operating expenses decreased to Rs. 33.3m (MY20: Rs. 131.9m) largely due to no charge against allowance for expected credit losses related to sugar export subsidy (MY20: Rs. 90m). Despite increase in average borrowings, finance cost was recorded lower at Rs. 416.1m (MY20: Rs. 598.3m) on account of lower average markup rates. In MY21, tax charge increased notably to Rs. 572.9m (MY20: 273.5m) mainly as an outcome of reversal of tax credits under final tax regime. Resultantly, the company reported net loss of Rs. 175.0m (MY20: Rs. 160.9m) in MY21.

During 1QMY22, the company generated net revenue of Rs. 2.9b (1QMY21: Rs. 2.6b) led by volumetric sales of sugar of 27,839 MT and higher average selling prices of Rs. 102.7/Kg. Gross margins also increased to 24.4% (1QMY21: 19.9%) with gross profit of Rs. 710.4m (1QMY21: Rs. 514.1m). The increase in gross margins was driven by higher closing stocks of sugar dispatched at prevailing higher average selling rates. The company procured cane at an average cost of Rs. 257.7/40Kg in 1QMY22. Despite higher tax charge of Rs. 145.7m (1QMY21: Rs. 55.8m), net profit was recorded higher at Rs. 313.9m (1QMY21: Rs. 242.3m). In MY22, the company projects net sales of Rs. 13.0b on back of higher quantity of sugar and molasses sold in line with higher production.

Overall liquidity remained adequate in MY21; meanwhile, higher profitability is expected to support cash flow coverages in the ongoing year: Funds from operations (FFO) amounted to Rs. 419.6m (MY20: Rs. 460.1m) in MY21. Given some increase in borrowings, FFO to total debt and FFO to long-term decreased marginally to 0.11x (MY20: 0.13x) and 0.17x (MY20: 0.19x) respectively. Meanwhile, debt service coverage ratio has improved to 1.30x (MY20: 0.50x) owing to lower long-term repayments made during the outgoing year (MY21: Rs. 228.2m; MY20: Rs. 1.6b) in line with deferment of principal repayment of long-term loan for a year under Covid relief provided by SBP.

Stock in trade stood higher at Rs. 1.6b (MY20: Rs. 723.7m) mainly on account of higher sugar inventory at end-MY21. Stock in trade accumulated to Rs. 3.5b by end-1QMY22, largely as a result of buildup of sugar and bagasse stocks in the ongoing crushing season. Trade receivables increased to Rs. 523.3m (MY20: Rs. 290.8m) owing to Rs. 222.2m (MY20: Nil) due from the holding company, which were subsequently recovered. Trade receivables decreased to Rs. 103.4m by end-1QMY22. Advances, deposits, and other receivables declined to Rs. 1.7b (MY20: Rs. 3.4b) primarily on account of reduction in advance to related parties including JDW and JK Sugar amounting to Rs. 1.6b (MY20: 3.2b) and lower advances to suppliers amounting to Rs. 13.9m (MY20: Rs. 149.5m). Cash and bank balances decreased to Rs. 35.1m (MY20: Rs. 187.7m) by end-MY21. Net operating cycle remained manageable at 44 days (MY20: 36 days). With better working capital management, current ratio has improved steadily on a timeline basis (MY21: 1.57x; MY20: 1.35x). In addition, coverage of short-term borrowings via stock in trade and trade receivables remained adequate at 1.51x (MY20: 1.02x). Cash flow coverages improved notably by the end-1QMY22, in line with higher profitability. Liquidity profile is projected to strengthen on back of higher cash flow generation.

Manageable leverage Indicators: Equity base of the company decreased to Rs. 2.7b (MY2: Rs. 2.9b) due to net losses in MY21. Total borrowings of the company increased to Rs. 3.9b (MY20: 3.4b) mainly due to higher short-term financing (MY21: 1.4b; MY20: Rs. 992.3m) to meet working capital requirements. Long-term borrowings including current portion amounted to Rs. 2.5b (MY20: Rs. 2.4b) at end-MY21. Trade and other payables decreased to Rs. 387.2m (MY20: Rs. 569.0m) mainly due to lower general sales tax payables. Advances from customers decreased notably to Rs. 344.2m (MY20: Rs. 1.8b) due to decrease in taxes payables to Govt. authorities in respect of consideration received against sales of sugar and lower advance consideration from customers against sugar sales. Deferred tax liabilities of Rs. 482.9m (MY20: Rs. 56.2m) were outstanding at end-MY21.

Core equity increased to Rs. 3.0b on the back of profit retention in 1QMY22. However, with increase in short-term borrowing to fund elevated working capital requirement amidst crushing season, debt leverage and gearing increased to 2.11x (MY21: 1.90x; MY20: 2.05x) and 1.59x (MY21: 1.44x; MY20: 1.18x) by end-1QMY22. With decrease in long-term borrowings in line with scheduled long-term repayments and augmentation in equity base due to profit retention, capitalization indicators are projected to improve notably, going forward.

Deharki Sugar Mills (Private) Limited — Annexure I

FINANCIAL SUMMARY *(amounts in PKR millions)*			
BALANCE SHEET	**MY20**	**MY21**	**1QMY22**
Property Plant and Equipment	3,338	3,165	3,125
Investment Property	539	539	539
Stock-in-Trade	724	1,615	3,470
Trade Debts	291	523	103
Advances, Deposits, and Other Receivables	3,426	1,654	1,312
Short-Term Investment	12	14	14
Cash & Bank Balances	188	35	592
Other Assets	312	364	293
Total Assets	**8,829**	**7,910**	**9,448**
Trade and Other Payables	569	387	604
Advances from Customers	1,837	344	429
Long-Term Debt *(including current maturity)*	2,429	2,492	2,400
Short-Term Debt	992	1,418	2421
Total Debt	3,421	3,910	4,821
Other Liabilities	103	544	555
Total Liabilities	5,930	5,185	6,409
Tier-I/Total Equity	**2,900**	**2,725**	**3,038**
Paid Up-Capital	1,050	1,050	1,050
INCOME STATEMENT	**MY20**	**MY21**	**1QMY22**
Net Sales	8,931	10,067	2,907
Gross Profit	1,144	1,368	710
Admin Expenses	278	672	187
Selling & Distribution Expenses	6	107	3
Other Income	304	259	44
Finance Cost	598	416	72
Profit Before Tax	434	398	460
Profit (Loss) After Tax	161	(175)	314
FFO	460	420	486
RATIO ANALYSIS	**MY20**	**MY21**	**1QMY22**
Gross Margin (%)	12.8	13.6	24.4
Net Profit Margin (%)	1.8	n.m	10.8
Net Working Capital	1,291	1,531	1,710
Current Ratio (x)	1.35	1.57	1.42
Cash Conversion Cycle (Days)	36	44	95
FFO to Long-Term Debt (x)	0.19	0.17	0.81*
FFO to Total Debt (x)	0.13	0.11	0.40*
Debt Servicing Coverage Ratio (x)	0.50	1.30	3.23
Gearing (x)	1.20	1.46	1.60
Leverage (x)	2.05	1.90	2.11
Inventory plus Receivables/Short-term Borrowings	1.02	1.51	1.48

**Annualized*

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	Deharki Sugar Mills (Private) Limited
Sector	Sugar
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
04/15/2022	A	A-2	Stable	Upgrade
07/27/2021	A-	A-2	Stable	Reaffirmed
04/27/2020	A-	A-2	Stable	Reaffirmed
03/13/2019	A-	A-2	Stable	Downgrade
04/13/2017	A	A-2	Stable	Upgrade
06/08/2016	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
Mr. Ali Saeed	Sr. GM Accounts	March 10, 2022
Mr. Muhammad Jafar	Sr. Manager Accounts	March 10, 2022