RATING REPORT

Deharki Sugar Mills (Private) Limited

REPORT DATE:

May 17, 2023

RATING ANALYST:

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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	Reaffirmed		Upgrade	
Rating Date	*17th May'23*		*15th April'22*	

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DSML was incorporated as a private limited company in July, 2010 under the Companies Ordinance 1984 *(Repealed with the enactment of Companies Act 2017)*. The registered office of the company is located at 17, Abid Majeed Road, Lahore Cantt. And the manufacturing unit is located at KLP Road, Mauza Kamoo Shaheed, Taluka Ubauro, Mirpur Mathelo, Ghotki Sindh.

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

Business Risk & Sector Update: Pakistan is the seventh-largest producer and the fifth-largest consumer of sugar. According to the Economic Survey of Pakistan, sugar industry is the country's second-largest agro-based business after the textile industry. In terms of sugarcane production, Punjab produces 67% of the sugarcane, followed by Sindh (25%), Khyber Pakhtunkhwa (KPK) (8%), and Baluchistan (less than 1%). Its production contributes 0.8% to GDP and 3.7% to agriculture's value addition. The country has the capacity to raise production by 4.0 million tons and export USD 2.0b worth of sugar and USD 500m worth of ethanol by using the same land but raising yields by 40 to 50 percent. According to the data collected by Ministry of Food Security, through September 30, 2022, at least 5.3 million metric tons (MT) of sugar has been removed from inventories or has been consumed. The volume of sugar consumed each day is around 15,980 tons. More than 1.7m MT surplus sugar was available at the start of crushing season MY23. Additionally, exporting this surplus sugar would have generated USD 1.0b in foreign currency. During CY22, almost 33% of the 22 million hectares of total cultivable land were inundated by flood while damage to the sugarcane crops resulted in a loss of USD 273m. On aggregate, direct losses from rice, cotton, and sugarcane were USD 1.30b (rice: USD 543m, cotton: USD 485m, and sugarcane: USD 273m).

The inherent cyclicality in crop yields and raw material prices is believed to have a substantial impact on the business risk profile of the sugar sector. Furthermore, there is a noticeable difference in pricing mechanisms, with the price of the end product, granulated sugar, being set by market forces whereas sugarcane cost being regulated by the government. A typical sugarcane crop has a 3- to 5-year production cycle, with government assistance to farmers and crop productivity playing a major role. In 2022-23 season.

According to the most recent USDA semi-annual sugar report published on October 3, 2022, due to the damage brought on by the flood, the estimated harvested area is to contract by 4.7% to 1.23 million hectares. As a result, the forecast for sugarcane output in 2022–2023 has decrease to 82.4 million tons (2021-22: 89 million tons-2020-21: 81 million tons). Sugar output in 2022–2023 is expected to be reduced to 6.657 million tons (MT). Meanwhile, due to population growth and demand from the developing food processing industry, sugar consumption is projected to rise by around 3% to 6.1 MT in 2022–2023. In view of accumulating sugar stocks, the Govt. has so far allowed 250,000 tons of sugar in the ongoing year. Recently, sugar prices have shown rising trend in line with inflationary pressure, which would benefit the industry players in realizing inventory gains and increase in gross margins. However, elevated markup rates would likely to suppress bottomline of companies with high leveraged capital structure.

Operating Performance: The crushing season 2022-23 started on Nov 27, 2022 (2021-22: Nov 21, 2021). The crushing season lasted for 106 days as compared to 136 days in the preceding season owing to reduction in cane yield due to floods. Accordingly, total cane crushed stood lower at 1.6m MT (2021-22: 1.93m MT; 2020-21: 1.27m MT) during the 2022-23 season. However, sucrose recovery rates improved to 10.43% (2021-22: 10.06%; 2020-21: 9.90%) while sugar production decreased to 165.4K MT (2021-22: 192.9K MT; 2020-21: 125.8K MT). Molasses production amounted to 70.1K MT (2021-22: 90.4K MT; 2020-21: 60K) with a lower recovery rate of 4.42%

(2021-22: 4.76%; 2020-21: 4.63%). The comparison of production related information for three seasons is also presented below:

Crushing Season	2020-21	2021-22	2022-23
Season days	110	136	106
Cane Crushed (MT)	1,270,152	1,932,090	1,585,515
Capacity Utilization (%)	65.14%	99.08%	81.31%
Sugar Production (MT)	125,757	192,910	165,410
Recovery Ratio (%)	9.90%	10.06%	10.43%
Molasses Produced (MT)	60,000	96,603	70,147
Molasses Recovery (%)	4.72%	4.76%	4.42%

Property, plant and equipment stood at Rs. 3.0b (MY22: Rs. 3.0b; MY21: Rs. 3.2b). The company make investment in balancing, modernization and replacement (BMR) from time to time to ensure efficient production. The value of investment property representing agriculture land in Rahim Yar Khan has remained unchanged at Rs. 539m (MY22 & MY21: Rs. 539m) at end-1Q'MY23.

Sales and Profitability: During MY22, net revenues posted a growth of ~19% primarily led by higher molasses and sugar sales. Net sales of sugar were recorded higher at Rs. 9.0b (MY21: Rs. 8.2b) in line with 10.8% increase in quantity sold while average sugar prices were marginally lower during the outgoing year. Molasses sales almost doubled to Rs. 2.0b (MY21: Rs. 990.0m) on the back of 61% increase in volumetric sales along with around 26% increase in average selling prices. Sale of agri inputs include fertilizers, seeds, agri implements being sold to farmers. Other by-products included bagasse and mud sale. Breakdown of sales in volume sold and average selling prices is tabulated below:

	MY21		MY22	
Quantity in Metric Tons	QTY	Avg. Selling Prices Rs./Unit	QTY	Avg. Selling Prices Rs./Unit
Sugar (MT)	114,386	71,943	126,790	71,332
Molasses (MT)	60,000	16,494	96,603	20,720
Agri Inputs (MT)	81,916	4,020	124,522	3,916
Mud (MT)	44,729	1,192	63,593	1,264
Bagasse (MT)	121,086	3,843	101,343	3,452
Net Revenue	Rs. 10,066.9m		Rs. 11,963.7m	

During MY22, the company generated Rs. 1.8b (MY21: Rs. 1.4b) in gross profits while gross margins increased to 14.7% (MY21: 13.6%) primarily as a result of economies of scale and improvement in sucrose recovery rates. While support prices of sugarcane in Sindh were higher at Rs. 250/maund (2020-21: Rs. 202 per maund) for 2021-22 crushing season, average procurement cost of sugarcane was slightly lower at Rs. 256/maund (MY21: Rs. 258/maund) owing to relatively less premium paid over and above the support price amidst higher crop yield. Other components of cost of sales increased largely in line with inflationary pressure and scale of operations. Administrative expenses were largely rationalized with inflationary pressure. Other income decreased to Rs. 73.8m (MY21: Rs. 259.1m) as no markup income was recognized on advances to holding company during the outgoing year (MY21: Rs. 145.7m). Selling expenses amounted to Rs. 13.0m (MY21: Rs. 107.5m), increase in last year was due to one-off expenses related to a promotional campaign for PSL cricket team.. Finance cost augmented to Rs. 906.5m (MY21: Rs. 416.1m) due to sharp rise in markup rates and higher average short-term borrowings. Accounting for tax credit during the outgoing year, the company recorded net profit of Rs. 380.5m as compared to loss of Rs. 175.0m, with net margin of 3.2% (MY21: n.m.).

During 1QMY23, the company generated higher net revenue of Rs. 6.1b vis-à-vis Rs. 2.9b in CPLY mainly on account of higher quantity of sugar sold amounting 75,732 tons as compared to 27,839

MT in the CPLY. Average selling prices remained subdued at Rs. 80.94 per Kg (1QMY22: Rs. 102.7/Kg) owing to excessive sugar stock available in the country. Resultantly, gross margins took a dip in 1Q'MY23 to 9.30% as compared to 24.4% in same period last year. Meanwhile, after the Government decision to allow exports by end of Nov'22, sugar prices started to stabilize in the following month *(circular for allowing export of sugar was issued on Jan 20, 2023).* Sugarcane was also procured at a higher rate as compared to previous season in line with higher support price. Administrative expenses increased mainly due to higher legal and professional charges along with increase in donations. Other income was recorded slightly lower mainly due to no scrap sales. Other expenses were lower due to lower provisions for employee related fund contributions. Finance cost, on the other hand, increased substantially in line with elevated markup rates and higher average borrowings. Resultantly, Despite lower tax charge vis-à-vis CPLY, net profit amounted to Rs. 106.7m (1QMY22: Rs. 313.9m) while net margins declined to 1.80% (1QMY22: 10.8%).

Meanwhile, in full year, profitability profile is projected to improve considerably on the back of augmentation in topline primarily in line with higher sugar prices. Profit margins are expected to improve on the gross level whereas elevated finance cost is likely to put a drag on bottomline.

Group Taxation: The Holding Company has filed an application in Dec'21 to Securities and Exchange Commission of Pakistan (SECP) for Group Taxation under regulation 8 of the Group Companies Registration Regulations 2008. The above mentioned application has been considered by SECP in dec'21 and issued a designation letter to JDWS for the group taxation of the Holding Company and DSML. Resultantly, the Group will be taxed as one fiscal unit from the tax year 2023 and onwards. Further, as per relevant clauses of the Income Tax Ordinance, 2001, any income derived from inter-corporate dividend and applicability of relevant section of the Ordinance on inter-corporate profit on debt within the group companies entitled group taxation is exempt from tax subject to the condition that return of the Group has been filed for the tax year.

Current and deferred income taxes are recognized by each entity within the group, regardless of who has the legal rights for recovery of the tax. However, current tax liability/receivable is shown by the company as its legal obligation/right of recovery of tax upon submission of group annual tax return. Balances among the group entities as a result of group taxation is shown under tax recoverable/payable to respective group entity. Any adjustments in the current and deferred taxes of the company on account of group taxation are credited or charged to statement of comprehensive income in the year in which they arise.

Stressed liquidity profile in terms of cash flow coverages: Funds from operations (FFO) decreased to Rs. 365.7m (MY21: Rs. 443.2m) mainly owing to lower interest income received in MY22. This, along with increase in short-term borrowings led to decrease in FFO to total debt to 0.06x (MY21: 0.11x). Debt service coverage fell below one i.e., 0.90x (MY21: 1.30x) owing to increase in finance cost paid along with higher principal repayments (MY22: Rs. 487.2m; MY21: Rs. 228.2m). Meanwhile, cash flow coverages are projected to improve in full year on the back of higher profitability.

The auditors have presented a qualified opinion on the audited financials of the year ending Sep 30, 2022. Basis for qualified opinion entails that the with reference to note 5.1.1 and 35.7 to the financial statements, the management has obtained syndicate long-term financing under Common Terms Agreement dated Jan 10, 2020. In accordance with the terms of agreement, the company is required to comply with certain financial covenants. As per independent audit report, the company was in compliance with all relevant covenants except for debt service coverage as defined in the agreement. Pursuant to non-compliance of above mentioned covenant, the company has not classified non-current maturity of such loan as current liability under the requirement of International Accounting Standards 1 'Presentation of Financial Statements' which constitute a departure from IFRSs. The company's accounting record indicate that had management classified its long-term liabilities as current liabilities pursuant to breach of covenant, total current liabilities has been increased by Rs. 1,282m as at reporting date.

Stock in trade augmented to Rs. 5.8b (MY21: Rs. 1.6b) on account of build-up of carryover sugar inventory by the end-MY22. The company had 25,905 tons (MY: 14, 543 tons) of carryover sugar stock by the end-MY22. Nearly all industry players reported higher stocks in tandem with surplus sugar available in the country amidst no export allowed to the sector. Trade receivables amounted to Rs. 576m (MY22: Rs. 523.3m), out of which nearly 40% pertained to net carrying amount receivables from growers against sale of agri inputs. The receivables against bagasse sale amounting Rs. 207.3m (MY21: Rs. 222.3m) are due from the holding company; these were past due one month as at reporting date. Sugar sale is generally made in cash or advance basis while credit sales to institutional clients are normally cleared within a month period. Advances, deposits and other receivables stood lower at Rs. 155.6m (MY21: Rs. 1.7b) due to nil outstanding balance (MY21: Rs. 1.6b) of short-term advances/loans to its Holding & associated companies. Cash and bank balances stood at Rs. 150.2m (MY21: Rs. 35.1m). Trade and other payables increased to Rs. 752.8m (MY21: Rs. 387.2m) by the end of the outgoing year primarily due to accumulation of sales tax payable and payable to the holding company. The latter represented amount payable to JDWS under group taxation, after netting off advance tax paid. Meanwhile, payable to growers amounted to nil (MY21: nil) as of reporting date. Given increase in short-term borrowings and trade and other payables, current ratio decreased to 1.18x (MY21: 1.57x). Net operating cycle extended to 129 days (MY21: 44 days) owing to slower inventory turnover during the outgoing year. However, coverage of short-term borrowings via stock in trade and trade debts improved to 1.67x (MY22: 1.51x). Going forward, improvement in debt service coverage and working capital management are considered key rating sensitivities.

Increase in leverage indicators due to elevated short-term borrowings amidst higher working capital requirements at end-MY22: Tier-1 equity increased to Rs. 3.1b (MY21: Rs. 2.7b) on account of internal capital generation. However, gearing and debt leverage increased to 1.88x (MY21: 1.44x) and 2.49x (MY21: 1.90x), respectively, primarily as a result of increase in short-term borrowings by end-MY22. Long-term loan inclusive of current portion stood lower at Rs. 2.0b (MY21: Rs. 2.5b) on account of principal repayments. Increase in leverage indicators at end-1Q'23 is due to seasonal nature of sugar segment, the same are expected to recede by the year end. The capitalization profile of the company is projected to strengthen on account of expansion in equity base and lower financing requirement due to offload of sugar inventory.

Regulatory matter update related to the 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 amounting Rs. 774.4m on DSML would be significant. However, the company has filed an appeal before the Competition Appellate Tribunal against the order of CCP. The Appellate Tribunal has restrained the CCP from adopting any coercive measures against the company for recovery of the fine. The company also challenged the same order of CCP before the Lahore High Court (LHC) in a writ petition. The operation of the said order has been suspended and CCP has been restrained from recovering penalty imposed in terms of the order of the LHC dated Oct 18, 2021. The matter is pending adjudication before the LHC. Given uncertainty and materiality of the outcome, VIS will continue to monitor further developments in this matter.

Deharki Sugar Mills (Private) Limited — Annexure I

FINANCIAL SUMMARY *(amounts in PKR millions)*			
BALANCE SHEET	**MY21**	**MY22**	**1QMY23**
Property Plant and Equipment	3,165	3,037	2,998
Investment Property	539	539	539
Stock-in-Trade	1,615	5,773	5,001
Trade Debts	523	576	516
Advances, Deposits, and Other Receivables	1,654	156	1,735
Short-Term Investment	14	14	14
Cash & Bank Balances	35	150	2,463
Other Assets	364	578	760
Total Assets	**7,910**	**10,824**	**14,026**
Trade and Other Payables	387	753	1,576
Advances from Customers	344	774	3,329
Long-Term Debt *(including current maturity)*	2,494	2,031	1,915
Short-Term Debt	1,418	3,796	3,772
Total Debt	3,912	5,827	5,687
Other Liabilities	541	365	223
Total Liabilities	5,185	7,718	10,814
Tier-I/Total Equity	**2,725**	**3,105**	**3,212**
Paid Up-Capital	1,050	1,050	1,050
INCOME STATEMENT	**MY21**	**MY22**	**1QMY23**
Net Sales	10,067	11,964	6,094
Gross Profit	1,368	1,762	566
Admin Expenses	672	718	216
Selling & Distribution Expenses	107	13	2
Other Expenses	33	17	15
Other Income	259	74	28
Finance Cost	416	907	168
Profit Before Tax	398	181	193
Profit After Tax	(175)	380	107
FFO	417	366	-9
RATIO ANALYSIS	**MY21**	**MY22**	**1QMY23**
Gross Margin (%)	13.60	14.70	9.30
Net Profit Margin (%)	n.m	3.20	1.80
Net Working Capital	1,531	1,084	1,071
Current Ratio (x)	1.57	1.18	1.11
Cash Conversion Cycle (Days)	44.00	129.00	78.00
FFO to Long-Term Debt (x)	0.17	0.18	n.m.
FFO to Total Debt (x)	0.11	0.06	n.m.
Debt Servicing Coverage Ratio (x)	1.30	0.90	0.70
Gearing (x)	1.44	1.88	1.77
Leverage (x)	1.90	2.49	3.37
Inventory plus Receivables/Short-term Borrowings	1.51	1.67	1.46

**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	see 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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Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
05/17/2023	A	A-2	Stable	Reaffirmed
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

Due Diligence Meetings Conducted

Name	Designation	Date
Mr. Ali Saeed	Sr. GM Accounts	April 6, 2023
Mr. Muhammad Jaffar	DGM Accounts	April 6, 2023