RATING REPORT

Hi-Tech Lubricants Limited (HTL)

REPORT DATE:

September 20, 2019

RATING ANALYSTS:
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RATING DETAILS

	Latest Rating		Previous Rating	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	A	A-2	A	A-1
Rating Outlook	Stable		Stable	
Rating Date	*September 20,'19*		*February 18,'18*	

COMPANY INFORMATION

Incorporated in 1997	**External auditors:** M/s Riaz Ahmed & Co., Chartered Accountants
	Chairman of the Board: Mr. Shaukat Hassan
Public Limited Company	**Chief Executive Officer:** Mr. Hassan Tahir
Key Shareholders (with stake 5% or more):	
Shaukat Hassan & family – 31.1%	
Tahir Azam & family – 31.1%	

APPLICABLE METHODOLOGY(IES)

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

Hi-Tech Lubricants Limited

OVERVIEW OF THE INSTITUTION

Hi-Tech Lubricants Limited (HTL) was initially formed as a partnership firm in March, 1997. In 2011, the firm was converted into a private limited company by the name of Hi-Tech Lubricants (Pvt.) Limited and subsequently converted into a public unlisted company in the same year. In 2016, the company was listed on the Pakistan Stock Exchange (PSX).

Primary activity of HTL involves trading of lubricants imported from SK Lubricants, South Korea in Pakistan under the brand name 'ZIC'. Registered office of the company is located at 1-A Danepur Road, GOR-1, and Lahore.

The company association with SK Lubricants, South Korea extends since 1997. The arrangement is for a period of 2 years and is extendable for another 2 years and was last negotiated at the time of the IPO in 2014. Management expects to sign a 10 year agreement with SK lubricants in the ongoing year. SK group is one of the largest conglomerates in South Korea and was ranked 95 in fortune global 500 list of 2017.

RATING RATIONALE

The ratings assigned to Hi-tech Lubricants Limited (HTL) take into account the established footprint of the company entailing adequate brand recognition in the lubricant sector. The assigned ratings incorporate moderate business risk profile of the company underpinned by relatively favorable competitive landscape of the sector and further diversification in revenue stream owing to formulation of oil marketing company (OMC); however in terms of demand dynamics the company revenues are under pressure due to slump in the overall automobile and construction sectors. The ratings also factor in currently low, though increasing, financial risk of the company as depicted by low leveraged capital structure. The liquidity position of HTL is supported by investments in liquid avenues. However, the ratings are constrained by increasing intensity of forex exchange risk rending the management's initiatives to transfer the impact of devaluation of local currency into the final product readily ineffective; the same has resulted in drop in sale revenues, accumulation of inventory, suppressed margins and weak profitability and cash flow generation. The ratings will remain dependent on maintenance of leverage and liquidity indicators coupled with augmentation of topline on account of incremental sales generation from OMC operations.

HTL has been in the business of trading of lubricants imported from SK Lubricants, South Korea (SKL) for around two decades. HTL sells almost all of its lubricants under the brand name 'ZIC'. The company has also invested in a wholly owned subsidiary, Hi-Tech Blending (Pvt.) Limited (HTBL) to set up a state of the art blending plant which was completed in August'2016. The plant has the facility of blending, producing its own bottles/caps and filling lines for lubricant bulk import. Blending capacity of the plant is 30,000 MT per annum, whereas filling capacity of the plant is 90 bottles per minute. Process of manufacturing bottles and filling lubricants is almost entirely automated.

HTL's product portfolio includes diesel, gasoline and motor cycle engine oil. Product portfolio also caters to Underhoods (industrial oils, greases, hydraulics, gear oils, brake fluids and coolants). These products are further classified into two segments i.e. top-tier (synthetic) and mid-tier (semi-synthetic) segment. Around three-fourth of the company's total sales comprise top-tier (synthetic) oil sales. Gasoline engine oil is the major sales driver in the top-tier range comprising over two-third of total sales, while diesel and motorcycle engine oil represents over 90% sales in mid-tier range. Company's entire sales are made through distributors (over 150 distributors) with negligible institutional sales only constituting 3% of the total national sales, this area depicts room for improvement. Concentration in sales in term of top 20 distributors is on the higher side.

Oil Marketing Company (OMC)

HTL is in process of diversifying in the OMC business and expects to start commercial operations in the first half of 2019. The company plans to open 360 fuel stations in the first five-year of operations with memorandum of understanding already signed for over 86 pumps. The company has received approval for opening of 27 petrol pumps in Punjab; the same are expected to become operational by end-FY20; however the remaining 58 will be opened in FY21. The new fuel station will offer full range of services to customers and will be a combination of dealer and mixed financed pumps. The company's existing distributor network for lubricant business will also facilitate in retail footprint expansion. Progress has also been made in terms of expansion of storage infrastructure with storage facility at at

Sahiwal completed; meanwhile, storage facility at Tarujabba is in its completion phase. Further, feasibility study of Mehmoodkot has been completed; once the aforementioned facility is constructed the company will be able to improve its penetration in the Southern market as well. Storage infrastructure is also being enhanced through hospitality arrangements in Punjab and KPK. VIS believes that the company's brand strength and recognition in lubricant business will facilitate HTL in establishing its footprint in the OMC business. In this regard, strong focus on service quality, as planned by the management, is considered important, particularly post deregulation in High Speed Diesel (HSD) business. Given the increased competitive landscape of the OMC sector with aggressive capex plans of existing (significant storage capacities coming online of Hascol, APL and PSO over the next two years) and new OMCs (Admore), progress against planned initiatives and projected financial targets will be an important rating driver, going forward. While increasing trend in international oil prices and rupee depreciation may partly impact demand growth, VIS expects the company to hold on to its sales momentum owing to increased transit activity as CPEC projects near completion.

Sector Dynamics

Lubricant industry in the country is dominated by multinational players, Shell Pakistan Limited (SPL) and Chevron Pakistan Limited (CPL), due to their perceived better product quality. Other major players include Pakistan State Oil Limited and HTL who also enjoy sizeable market share. Cumulatively, these four players represent over two-third of the lubricant market share. Remaining demand is catered to by multiple smaller players and other OMCs including Hascol Petroleum Limited and Total Parco Pakistan Limited. Share of smuggled products has witnessed a declining trend given the crack-down by the government on smuggled products in order to improve revenues. Lubricant business in the country is subject to high taxes and duties including custom duty of 22, sales tax of 20% besides income tax.

Pakistan's lubricant oils market demand is dominated by the transport segment with over four-fifth share, followed by industrial and then power sector. Within transportation segment, heavy duty diesel engine oil represents the major chunk of consumption followed by passenger cars and industrial oils. Lubricant business is deregulated and offers higher margin vis-à-vis conventional fuels (MOGAS and HSD) sold by OMCs

Going forward, demand growth for lubricant business is expected to continue to be driven by the transportation sector. However, owing to significant increase in automobile prices as an outcome depreciation of rupee in terms of dollar, sales of automobile segment have dwindled. In addition, with increase in fuel prices together with compressed purchasing power owing to inflationary pressure, the consumer demand patterns have been negatively impacted. As per the external survey conducted by HTL, the end consumers have made lubricant change less frequent to mitigate the cost increase. Further, OMCs, as part of the retail expansion strategy are aggressively targeting to increase market share in the lubricant business (through value added services like oil change facilities), which can result in significant price competition going forward. In the backdrop of rupee depreciation, margins of industry players are also expected to witness pressure unless cost increases are passed on to customers.

Profitability

Given increase in volumetric sales of the company to 26.7m liters (FY17: 23.2 liters) the net sales were recorded higher at Rs. 9.3b (FY17: Rs. 7.5b) during FY18. The classification of HTL's product portfolio is done into two segments i.e. top-tier (synthetic) and mid-tier (semi-synthetic) segment. Both segments have their own sales team and are given separate annual sales targets. Around three-fourth of the company's total sales comprise top-tier (synthetic) oil sales, while remaining comprise mid-tier (semi-synthetic) oil sales. Gasoline engine oil is the major sales driver in the top-tier range comprising over two-third of total sales, while diesel and motorcycle engine oil comprises over 90% sales in mid-tier range. Sales of both top-tier and mid-tier range mostly takes place in central region followed by north region. There is still room for improvement in penetration in the South region. The gross margin slightly declined to 20.8% (FY17: 23.7%) primarily on account of increase in prices of imported raw material. The increase in selling and administrative expense was mainly a function of higher employee related expense as a result of annual salary adjustments and higher headcount in line with increase in scale of operations. Moreover, financial cost increased due to higher utilization of funding lines in the current period to meet higher working capital requirements along with increase in benchmark interest rates. HTL reported other income amounting to Rs. 108.5m (FY17: Rs. 95.8m); the income largely pertained to profit on term deposits and interest income on loans extended to subsidiary. The impact of low margins coupled with higher operating and finance cost resulted in a subdued profit generation for the company; the profit after tax stood at Rs. 554.4m during FY18 compared to Rs. 726.9m in the preceding year.

The profitability indicators of the company took a further downward turn with the company reporting an after tax loss of Rs. 472.7m during 9MFY19. The net loss was a combined outcome of drop in volumetric sales coupled with decline in margins. The demand of the company's products took a sharp hit during 2QFY19 as a result of HTL's transferring the price hike emanating from currency devaluation to end consumers; however, the margins dropped sizably during 3QFY19 given the company was not able to fully translate the incremental input cost into the final retail price during the ongoing year. As per the management, the final price adjustment to fully transfer the impact of rupee devaluation was made in 4QFY19; therefore recovery in margins is expected going forward. Moreover, to further ease the pressure on margins the company has increased the procurement of raw material from the company's own wholly owned subsidiary, Hi-Tech Blending (Pvt.) Limited (HTBL) to reduce forex related losses; HTL started purchasing 65% of the total raw material from HBTL from 2QFY19 as compared to 45% in preceding year. In addition, on account of changes in the economic and competitive landscape of the lubricant industry, the company has established its footprint in the economic tier whereby it caters to highly price sensitive consumer segment involving diesel-based lubricants. As per the management, given the base oil involved in the production of economic tier lubricant is extracted and refined locally the margins for this particular segment are relatively high at 35% as compared to other products in the existing product mix. HTL also incurred higher finance cost amounting to Rs. 165.3m during the 9MFY19 as compared to Rs. 60.9m in the corresponding period last year as a result of piled up inventory levels given depressed demand. Moreover, the increase in the benchmark interest rates also contributed to higher finance cost for the ongoing year. Going forward, VIS expects rescue of operating margins despite increasing competition and rupee depreciation on account of impact of various costs saving initiatives, higher proportion of blended plant in product mix and planned increase in prices. Given the volumetric growth in sales, profitability is projected to depict stable growth over the rating horizon.

Liquidity

Liquidity profile of the company exhibited weakening on account decline in profitability metrics owing to slump in demand patterns and depressed margins. Given the company reported loss during the ongoing year, funds flow from operations (FFO) turned negative. However, liquidity profile is supported by presence of sizeable liquid assets held on balance sheet; although the same is planned to be liquidated and utilized for incurring capital expenditure over the next 2 years. The company has invested in term deposit receipts amounting to Rs. 920.7m (FY18: Rs. 851.8m; FY17: Rs. 1.0b) at end-9MFY19 with maturity ranging between one to six months. The interest receivable on these securities is locked at 3.0% to 6.2% per annum. Further, working capital cycle increased on account of higher inventory accumulated for finished goods. As per management, the additional stock accumulated during the ongoing year on account of slackened demand arising from sharp increase was largely offloaded by end-FY19; therefore the management expects inventory days to remain at prior year's level. Trade debts in relation to sales have remained within manageable levels with majority of company's sales based on cash. Current ratio of the company was reported at 1.1x (FY18: 1.8x; FY17: 1.8x) at end-9MFY19. In line with negative FFO, debt servicing coverage ratio (DSCR) is currently negative; however the same is projected is projected to remain adequate once the margins return to normal levels.

Capitalization and Funding

Equity base of the company has declined during the ongoing year on account of net loses reported during 9MFY19. Dividend payout ratio has ranged between 43%-73% over the last three fiscal years. Debt matrix of the company is largely tilted towards short-term obligations with long-term debt only accounting for less than 5% of total borrowings. The entire long-term debt is expected to be paid off by end-Aug'19. Going forward, the management does not plan on acquiring any new long-term funding for the next three years. During FY20, the management plans on incurring capex amounting to Rs. 300m on infrastructure development of storage facilities for OMC in KPK; however the same is going to be met by internal sources. Total capex planned for the OMC project will be funded through a mix of debt (50%) and equity (50%). Expansion will initially be funded through liquidating TDRs on balance sheet and internal cash generation. Given, the increase in working capital requirement owing to higher piled up inventory levels gearing and leverage indicators increased on a timeline basis; however still remained at manageable levels. Even after accounting for debt planned to be raised for funding OMC project and higher borrowing to fund working capital requirement, gearing is projected to remain below 1(x) over the rating horizon.

Corporate Governance

Overall corporate governance framework is supported by adequate board composition and oversight. Board composition conforms to best practices with 3 independent and 1 women director (regulatory requirement). Senior management team has largely remained stable with experienced resources hired for successful execution of the OMC project. Internal audit function is outsourced to Ernst and Young Ford Rhodes, , Chartered Accountants with an internal HTL team possessing relevant experience also in place for effective liaison. The company uses Oracle based ERP with integrated modules for its IT related needs. During the review period, the company also procured business intelligence module. Governance framework is supported by strong financial planning process, documented policy & procedural framework along with focus on transparency as evident from detailed governance related disclosures in the annual report that provide important information for stakeholders.

Hi-Tech Lubricants Limited Appendix I

FINANCIAL SUMMARY *(amounts in PKR millions)*

BALANCE SHEET	JUN 30, 2017	JUN 30, 2018	MAR 31,2019
Fixed Assets	2,501.0	1,389.0	1,556.9
Short Term Investments	1,081.1	917.4	920.7
Stock-in-Trade	2,070.8	961.2	1,899.7
Trade Debts	179.6	236.9	207.3
Cash & Bank Balances	220.9	471.6	30.2
Total Assets	6,619.6	5,522.3	6,763.8
Trade and Other Payables	1,170.8	614.0	942.4
Long Term Debt *(*incl. current maturity)*	409.1	155.1	114.3
Short-term Debt	1,236.0	707.6	2,364.7
Total Equity	3,733.2	3,892.7	3,197.3
INCOME STATEMENT	**JUN 30, 2017**	**JUN 30, 2018**	**MAR 31,2019**
Net Sales	7,328.5	9,253.6	6,980.5
Gross Profit	1,930.6	1,928.3	693.1
Operating Profit/ (Loss)	1,059.6	959.1	(162.3)
Profit After Tax	744.0	554.4	(472.7)
RATIO ANALYSIS	**JUN 30, 2017**	**JUN 30, 2018**	**MAR 31,2019**
Gross margin (%)	23.7	20.8	9.9
FFO	711.4	612.1	(470.5)
FFO to Total Debt	0.43	0.71	-
FFO to Long-term Debt	1.74	3.90	-
Debt Leverage	0.77	0.42	1.12
Gearing	0.44	0.22	0.78
Current Ratio	1.75	1.84	1.10
DSCR	2.57	7.9	-
ROAA (%)	13.2	9.7	-
ROAE (%)	21.1	14.5	-

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	Hi-Tech Lubricants Limited
Sector	Oil & Gas
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				
Sep 12, '19	A	A-2	Stable	Downgrade
Feb 22, '18	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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