RATING REPORT

Agha Steel Industries Limited

REPORT DATE:
October 21, 2019

RATING ANALYSTS:
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RATING DETAILS		
Rating Category	**Latest Rating**	**Previous Rating**
Entity	**A-/A-2**	**A/A-1**
Sukuk	**A**	**A+**
Rating Date (Entity)	*October 18, 2019*	*March 01, 2019*
Rating Outlook	Stable	Stable

COMPANY INFORMATION	
Incorporated in 2013	**External auditors:** Haroon Zakaria and Company Chartered Accountants
	Chairman of the Board: Mr. Iqbal Hussain Agha
Key Shareholders:	**Chief Executive Officer:** Mr. Hussain Iqbal Agha
Mr. Iqbal Hussain Agha	
Mr. Raza Iqbal Agha	
Mr. Hussain Iqbal Agha	
Ms. Shazia Iqbal Agha	

APPLICABLE METHODOLOGY(IES)
Applicable Rating Criteria: Industrial Corporates (May, 2016) http://www.vis.com.pk/kc-meth.aspx

Agha Steel Industries Limited

OVERVIEW OF THE INSTITUTION	RATING RATIONALE

OVERVIEW OF THE INSTITUTION

Agha Steel Industries (ASIL) was established in FY12 as a partnership concern (AOP). ASIL operated as an AOP till May 31st, 2017. On June 1st 2017, Agha Steel Industries Limited (ASIL) took over the Net Assets of ASI (AOP) leaving no business behind with AOP. ASIL was incorporated in Pakistan on November 19, 2013 as a private limited company. On April 7, 2015 ASIL converted itself into a public limited company.

The board comprises 7 members and is chaired by Mr. Iqbal Hussain Agha. Mr. Iqbal belongs to one of the leading industrial powerhouses in Pakistan. He possesses deep-rooted industrial experience across different industries, particularly in the steel and textile sectors. He has been involved in several successful ventures, including Abbas Textiles and Denim International.

RATING RATIONALE

Agha Steel Industries Limited (ASIL) stands amongst the top-tier players in the long steel sector with installed capacity of billets and reinforcement bars (rebars) at 450,000MT and 250,000MT, respectively. ASIL's electric arc furnace for melting is a competitive advantage vis-à-vis peers. Going forward, the company plans to further increase its rolling capacity by 400,000MT through installation of Danieli's direct rolling mill (Mi.DA® Plant). The enhanced capacity of rebars is expected to come online in the second quarter of FY20 and is also projected to provide cost and competitive advantage over competitors. Cost advantages include lower power, re-heating and labor cost. The total cost for Phase II has been estimated at around Rs. 3.5b, two-fifth of which has already been funded through company's internal cash flows while the remaining will be financed on supplier's credit which will have a bullet payment after 2 years from the arrival of machinery.

Capacity utilization level of bars was reported on the lower side at 50% (FY18: 82%) during FY19 on account of the plant being shut down for BMR in 1QFY19. During 1QFY20, capacity utilization of bars was reported at around 69%. However, capacity utilization of billets continued to be on the lower side. Management expects capacity utilization of billets to improve in the ongoing year through direct sales of billets particularly for wire rod manufacturing which requires utilization of high quality billets.

Sector dynamics have weakened due to slowdown in demand and sizeable capacities coming online. Industry consolidation to support of sales of top-tier players as smaller non-integrated and inefficient players (ungraded sector) players exit the industry.

Overall sectoral risk is considered high given the fragmented and cyclical nature of industry, expected increase in competition post capacity expansion by established existing and new players and significant reliance on duty protection. However, local players enjoy ~ 39% (RD of 15%; ADD of 24%) and ~ 49.5% (RD of 30%, ADD of 19.15%) duty protection on Chinese imported billets and rebars, respectively. However, despite duty protection, pricing power of industry players weakened in the outgoing year on account of significant rupee devaluation and decline in international steel prices.

Going forward, demand growth is expected to remain subdued in the short-term in line with slower economic growth, sizeable fiscal deficit (lower PSDP spending) and further contraction expected in large scale manufacturing in FY20 (LSM contracted by 3.4% in FY19). However, industry consolidation due to exit of smaller non-integrated and inefficient players (ungraded sector) players is expected to support sales. Demand outlook over the medium to long-term is expected to improve once work on construction of dams and government's housing schemes picks pace. Industry margins and profitability are expected to remain under pressure due to higher finance cost and increasing competition as additional capacities come online. VIS expects pressure on financial performance of non-integrated and inefficient players (ungraded sector) to be more pronounced vis-à-vis top-tier players.

Market position has weakened in the outgoing year. In the backdrop of sizeable increase expected in finance cost projected in FY20 due to full year impact of higher interest rates, achieving projected sales volumes for billets and bars while maintaining gross margins is considered important to improve profitability profile. Installation of Mi.DA plant to result in some relief to profitability indicators over the medium term.

Sales revenue of the company witnessed a decline of 2% during FY19 on account of lower volumetric sales in FY19. Besides weak demand, lower volumetric sales were a function of plant closure during the first quarter for BMR expansion. Given the lower volumes vis-à-vis peers, market position of the company weakened in the outgoing year. ASIL's market position is relatively stronger in the Southern market with increased penetration planned in the Northern region. The same is considered important in the backdrop of sizeable capacities coming online.

Despite declining on a timeline basis, gross margins (GMs) of the company remained on the higher side as compared to peers during FY19 and were reported at 20.5% (FY18: 25%). GMs declined in the outgoing year primarily on account of inability to pass on higher cost of production to the consumers led by significant rupee depreciation. Going forward, despite expected in power cost due to increase in tariff management expects GMs to maintain at similar levels due to significant power cost savings post completion of expansion and declining scrap prices (although risk of inventory losses on existing stock remains). Net profitability of the company witnessed attrition largely due to higher finance charges. In the backdrop of sizeable increase expected in finance cost projected in FY20 due to full year impact of higher interest rates, achieving projected sales volumes for billets and bars while maintaining gross margins is considered important to improve profitability profile.

Cash flow coverage of outstanding debt has declined while debt servicing coverage has weakened. Working capital management has room for improvement given the significant jump in stock in trade and trade debt despite stagnant sales.
Liquidity profile of the company has weakened on a timeline basis as evident from lower cash flow coverage of outstanding debt. FFO to Total Debt and FFO to Total Long Term Debt declined to 7% (FY18: 14%) and 19% (FY18: 38%), respectively. Decline was on account of lower cash flows and higher debt for expansion and working capital requirements. Debt servicing coverage ratio also declined to 1.3x (FY18: 2.1x). Long term debt of the Sukuk primarily comprises a Sukuk. Given the grace period on Sukuk there are limited repayments of long-term debt due till January 2021. Trade debts in relation to sales have witnessed a jump from 28% at end-FY18 to 33% at end-FY19 while stock in trade represented 72% (FY18: 48%; FY17: 26%). At end-June 2019, stock in trade in relation to trade debts represented 108% (FY18: 103%) of outstanding short term borrowings.

Elevated leverage profile due to sizeable borrowings undertaken
During October 2018, the company issued a Sukuk to replace its existing long term debt. However, despite issuance of replacement debt, debt levels of the company have increased significantly since the past two years on account of elevated short term borrowings to fund stock and trade debts. Going forward, the company plans to undertake supplier's credit in FY20 to fund the remaining portion of second phase of expansion (Mi.DA® Plant). Structure of the same entails bullet repayment after two years from the date of shipment arrival (repayment expected in FY23). With increase in equity base, leverage indicators are projected to gradually reduce over the rating horizon with material reduction expected to happen once majority debt repayment commences.

Agha Steel Industries Appendix I

FINANCIAL SUMMARY (Rs. in m)					
BALANCE SHEET	**FY15**	**FY16**	**FY17**	**FY18**	**FY19**
Fixed Assets	3,864	4,061	4,698	8,552	10,666
Stock-in-Trade	3,967	3,163	2,633	5,171	7,520
Trade Debts	1,212	1,714	1,957	2,977	3,413
Cash & Bank Balances	7	1	0	34	243
Total Assets	9,616	10,106	11,517	19,492	24,509
Trade and Other Payables	797	833	301	531	424
Long Term Debt	2,541	2,106	1,881	4,470	5,770
Short Term Debt	4,311	3,956	3,871	7,944	10,111
Total Debt	6,852	6,063	5,752	12,414	15,881
LTD/TD	37.1%	34.7%	32.7%	36.0%	36.3%
STD/TD	62.9%	65.3%	67.3%	64.0%	63.7%
Total Equity*	1,836	3,113	4,699	5,480	6,966
INCOME STATEMENT					
Net Sales	8,477	8,768	9,943	10,688	10,461
Gross Profit	1,575	2,037	2,713	2,693	2,142
Finance Cost	(678)	(477)	(418)	(419)	(921)
Profit After Tax	670	1,292	1,515	1,456	811
RATIO ANALYSIS					
Gross Margin (%)	18.6%	23.2%	27.3%	25.2%	20.5%
Net Margin	7.9%	14.7%	15.2%	13.6%	7.8%
Net Working Capital	93	567	315	1,036	2,253
Trade debts/Sales	14%	20%	20%	28%	33%
FFO	807	1,349	1,944	1,702	1,085
FFO to Total Debt (%)	12%	22%	34%	14%	7%
FFO to Long Term Debt (%)	32%	64%	103%	38%	19%
Current Ratio (x)	1.0	1.1	1.1	1.1	1.2
Debt Servicing Coverage Ratio (x)	1.5	2.0	2.3	2.1	1.33
Gearing (x)	3.73	1.95	1.22	2.27	2.28
ROAA (%)	7%	13%	14%	9%	4%
ROAE (%)	44%	52%	39%	29%	13%

** Equity includes loan from directors*

ISSUE/ISSUER RATING SCALE & DEFINITION 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	Agha Steel Industries Limited
Sector	Steel Industry
Type of Relationship	Solicited
Purpose of Rating	Entity and Sukuk Rating

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
18-Oct-2019	A-	A-2	Stable	Downgrade
01-Mar-2019	A	A-1	Stable	Reaffirmed
05-Dec-2017	A	A-1	Stable	Initial

Rating Date	Medium to Long Term	Rating Outlook	Rating Action
RATING TYPE: SUKUK			
18-Oct-2019	A	Stable	Downgrade
01-Mar-2019	A+	Stable	Reaffirmed
24-Aug-18	A+	Stable	Final
25-Apr-18	A+	Stable	Preliminary

Instrument Structure

Value of the Sukuk is Rs. 5b (inclusive of a green shoe option of Rs. 1b). The tenor of the instrument will be 6 years inclusive of a grace period of 2 years. Security structure of the Sukuk entails formation of a collection account through which 70% of the inflows of the company will flow through designated collection accounts maintained with collection banks. Moreover, a debt payment account (DPA) will be maintained (which will be filled through collection account) with the agent bank which will be build up with 1/3rd of the upcoming installment each month by the 10th day such that the entire upcoming installment is deposited in the DPA by the 10th day of the 3rd month.

The security structure also includes first pari-passu charge over present and future fixed assets (with a margin of 25%) and lien over and set-off rights in respect of all transaction accounts. The Sukuk shall be listed on the OTC market.

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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