RATING REPORT

Procon Engineering (Pvt.) Limited

REPORT DATE:

January 26, 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	*Negative*		*Stable*	
Rating Action	*Maintained*		*Maintained*	
Rating Date	*January' 26, 2023*		*October'21, 2021*	

COMPANY INFORMATION

Incorporated in 1988	**External Auditors:** Rao & Company Chartered Accountants
Private Limited Company	**Chairman:** Mr. Nadeem Malik
Key Shareholders (with stake 5% or more):	**CEO:** Mr. Nadeem Malik
Mr. Nadeem Malik- 33.3% M/s N. M Holding (Pvt) Ltd – 33.3% M/s Najeeb Holding (Pvt) Ltd – 33.3%	

APPLICABLE METHODOLOGY(IES)

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

Procon Engineering (Pvt.) Limited

OVERVIEW OF THE INSTITUTION

Procon Engineering (Pvt.) Limited was incorporated on 13th October, 1988 as a private limited company. The company is engaged in manufacturing of automotive parts and components.

Profile of Chairman and CEO:
Mr. Nadeem Malik is a seasoned businessman with extensive experience in the automobile and foam products industry. Mr. Nadeem has been associated with Master group for past three decades and is currently serving as Chairman of various associate companies. He holds a Bachelor's degree in Business Administration from the University of Southern California.

RATING RATIONALE

Procon Engineering (Pvt.) Limited ('PEPL' or 'the Company') is engaged in manufacturing of automotive seats for passenger and commercial vehicles, along with auto parts including cargo deck, chassis frame, and sheet metal/body parts. PEPL is part of Master Group, which has diversified presence across various business sectors ranging from mattresses, textile, automobiles and energy sectors. PEPL has three production plants; two are located in Karachi and one in Lahore. The Company also has an underlying subsidiary Master Auto Engineering (Pvt) Ltd (MAE) and associated company Master Wind Energy Ltd., comprising 6.2% of the asset base as of Jun'22.

Business Update - PEPL:

Sales & Operations

Table 1: P&L (Extract)

	FY21	*FY22*	*Q1'FY23**
Net Sales (PKR Million)	13,748.7	24,964.5	4,810.0
Gross Margin (%)	*11.4%*	*13.6%*	*15.7%*
Operating Margin (%)	*6.2%*	*9.2%*	*8.9%*
Net Margin (%)	*4.6%*	*6.4%*	*2.2%*

**Unaudited*

- PEPL posted strong growth (82%) in top line in FY22, which was mainly driven by volumetric growth in sales of seats of four wheelers, sheet metal parts, non-woven fabrics, welded parts and roof head linings, which cumulatively comprise 71% of the Company's top line.
- As an auto-part manufacturer, the Company operates on pre-determined profit margins, wherein increase in procurement costs is passed on to end-consumers. The improvement in gross margin is broadly attributed to higher volumetric offtake.
- Given higher production during the period and rise in prevailing inflation, administrative overheads were up 62% in FY22. The average staff strength during FY22 was 3,506 vis-à-vis 2,473 during FY21.
- The finance cost incurred during FY22 amounted to Rs. 576m, notably increasing from Rs. 152m in the preceding year. Cost of funding, calculated on the basis of two-point average, rose from 3.1% to 5.8%. The finance cost of the Company is notably lower than the prevailing benchmark rates mainly because 17% of the financing is under subsidized financing scheme, while an additional Rs. 3b (Jun'21: Rs. 2.6b) is an interest free loan provided by related parties.
- The share of profit from Master Wind Energy Limited increased from Rs. 182.6m to Rs. 347.5m during FY22, and the actual dividend inflow also doubled from Rs. 60.5m to Rs. 120.3m.
- Given strong growth in top line, improvement in gross margins, controlled uptick in overheads and finance cost and higher income from associate portfolio, the Company managed to grow its bottom line by 1.5x to Rs. 1,592m (FY21: Rs. 638m).
- The Company's offtake so far in FY23 has remained lacklustre, which is mainly a result of slower offtake in automobile industry. In 5M'FY23, overall vehicle offtake was lower by 39%, with offtake of Pickups, Jeeps and Passenger Cards being lower by 67%, 18% and 39% respectively.
- Sales outlook for FY23 is viewed to be depressed, mainly as PEPL's downstream i.e. automobile sector is likely to post adverse offtake numbers, with sales likely to be remain lower on account of affordability concerns, given sizable uptick in automobile prices and high prevailing leasing cost.
- Nevertheless, medium to long term outlook for the Company is supported by a projected uptick in localization level of automobiles. Given import restrictions, requests for new part designs have increased notably YoY, which is expected to bear dividends starting FY24.

Cash Flow Coverages

Table 2: Cash flow Coverage Indicators

	FY21	***FY22***	***Q1'FY23****
FFO (PKR Million)	**891**	**1,552**	**227**
FFO/Total Debt (x)	13.8%	11.6%	6.8%**
FFO/LTD (x)	51.1%	58.5%	29.5%**
Debt Service Coverage (x)	5.83	2.26	1.31**
(Stock in Trade + Trade Debts) / STB (x)	1.24	0.99	1.10
Current Ratio (x)	1.16	1.09	1.12

**Unaudited*

***Annualized*

- Given the uptick in debt, the Company's cash flow coverage indicators have come under stress, with both cash flow coverage of debt and debt service coverage ratio contracting during Q1'FY23.
- Given likely elongation of slower offtake into Q2&Q3'FY23 and further increase in benchmark rate in Nov'22 and Jan'22, the debt service coverage ratio is expected to come under further stress during the ongoing year.
- Short-term borrowings of the Company are adequately covered by a sizable inventory and stock of trade debts. Overall credit risk on trade debts is viewed to be low, given that counterparties comprise large to medium-sized auto assemblers.

Capitalization

Table 3: :Balance Sheet (Extract) (all figures stated in PKR' Millions, unless stated otherwise)

	Jun'21	***Jun'22***	***Sept'22****
Total Asset	**11,914.7**	**21,964.0**	**22,837.0**
Total Liabilities	**8,300**	**16,758**	**17,477**
Total Equity	**3,614**	**5,206**	**5,361**
Total Debt	**6,458**	**13,432**	**13,422**
- Long term Debt	1,741	2,655	3,086
- Short term Debt	4,717	10,777	10,336
Leverage (x)	**2.30**	**3.22**	**3.26**
Gearing (x)	**1.79**	**2.58**	**2.50**

**Unaudited*

- Despite strong growth in profitability, which was fully retained into the business, the relative increase in quantum of debt has been higher, as a result of which the Company's gearing ratio has increased on a timeline.
- It is pertinent to mention that the sponsors have invested Rs. 3b (Jun'22) into the Company as interest free short term borrowing, which increased from Rs. 2.6b as of Jun'21. The infusion of interest free debt from sponsors is viewed as an indication of strong sponsor commitment towards PEPL. However, as the debt is repayable on sponsors demand, it has been treated as debt for gearing ratio calculation.

Key Rating Drivers - PEPL:

The rating incorporates Sponsor Profile & Commitment, along with strong competitive market position

Assigned ratings incorporates sponsor support of Master group, a well-diversified conglomerate. Sponsor has from time to time exhibited support through extension of interest-free loans. Ratings also take into account strong market position of the Company; PEPL remains the sole supplier of seats to Honda Atlas Cars and fulfills around two-fourth of the supply of automotive items to two other major market players in auto industry. While this also exposes the Company to concentration risk, the track record of ongoing association with these customers provides comfort.

The assigned rating incorporates business risk profile of PEPL, as an auto parts manufacturer

VIS classifies business risk profile of PEPL in the high to medium category, given historical volatility in gross margins, which varies with volumetric offtake. Furthermore, the business risk profile also incorporates exchange rate risk, cyclicality in auto sales due to slow down in GDP growth and political uncertainty. The Company's bottom line is supported by continuous dividend income from Master Wind Energy, which has been incorporated.

The revision in outlook takes into depressed sales outlook of automobile sector

The revision in rating outlook takes into account depressed sales outlook for PEPL's downstream i.e. automobile sector, which is likely to post adverse offtake numbers in FY23Given import restrictions, requests for new part designs have increased notably YoY, which is expected to bear dividends starting FY24. Nevertheless, materialization of these revenues will depend on availability of raw material, majority of which is imported.

Cognizant of the significant dependence on automobile industry, the Company has diversified its business risk by getting into other product lines such as non-woven fabric, foam seats, foam and spring mattresses, sheets and finished foam. The Foaming & Synthetic (F&S) division is producing a fabric used in the making of pampers, face masks, and some agricultural activities as well as safety gowns used in health care. F&S division accounted for ~18% of gross sales in FY22 (FY21: 26%). As per management, with increased focus on F&S division, revenues are projected to notably increase in the ongoing year.

Given slower offtake in Q1'FY23, financial risk has depicted an increased

Given the uptick in debt, the Company's cash flow coverage indicators have come under stress, with both cash flow coverage of debt and debt service coverage ratio contracting during Q1'FY23. Given likely elongation of slower offtake into Q2&Q3'FY23 and further increase in benchmark rate in Nov'22 & Jan'22, the debt service coverage ratio is expected to come under further stress during the ongoing year. Despite strong growth in profitability, which was fully retained into the business, the relative increase in quantum of debt has been higher, as a result of which the Company's gearing ratio has increased on a timeline. As per management, gearing ratio will be brought down to 1.6x by end-FY23. VIS expects this to be a challenging task and accordingly will continue to monitor changes in the same on an ongoing basis.

ISSUE/ISSUER RATING SCALE &DEFINITIONS Appendix I

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 II
Name of Rated Entity	Procon Engineering (Pvt.) Ltd
Sector	Auto Parts
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		
26-Jan-2023	A	A-2	Negative	Maintained
21-Oct-2021	A	A-2	Stable	Maintained
21-May-2020	A	A-2	Rating Watch-Negative	Maintained
27-Aug-19	A	A-2	Stable	Reaffirmed
09-Apr-18	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.
Disclaimer	Information herein was obtained from sources believed to be accurate and reliable; however, VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. For conducting this assignment, analyst did not deem necessary to contact external auditors or creditors given the unqualified nature of audited accounts and diversified creditor profile.
Due Diligence Meetings Conducted	

S.No	Names	Designation	Date
1	Mr. Naveed Alam	Chief Financial Officer	December 15, 2022