RATING REPORT

Procon Engineering (Pvt.) Limited

REPORT DATE:

May 22, 2024

RATING ANALYST:

Basel Ali Assad

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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*		*Negative*	
Rating Action	*Maintained*		*Maintained*	
Rating Date	*May 22nd, 2024*		*January 26th, 2023*	

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

Applicable Rating Criteria: Corporates

https://docs.vis.com.pk/docs/CorporateMethodology.pdf

APPLICABLE RATING SCALE(S)

VIS Issue/Issuer Rating Scale:

https://docs.vis.com.pk/docs/VISRatingScales.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 the manufacture of automotive seats for passenger and commercial vehicles, auto parts including cargo deck, chassis frame, and sheet metal/body parts and has also diversified into foam and synthetic (F&S) products. The ratings derive comfort from the strong sponsorship profile of the Master Group, one of the country's leading business conglomerates with diversified presence across various business sectors including mattresses, textile, automobiles and energy. The ratings also factor in the capacity enhancement efforts of the Company's synthetic division which include the addition of two new press lines over the rating review period. However, the overall business risk profile of the Company was elevated during the rating review period on account of steep inflation, currency depreciation, policy rate hikes and import restrictions which have significantly impacted demand for automobiles as well as supply-side operations.

Resultantly, the Company's topline decreased on a timeline basis; however, the F&S division has helped mitigate drop in revenue. Nonetheless, despite lower gross margins, profitability depicted improvement during the ongoing year vis-à-vis SPLY mainly owing to reduction in financing charges due to lower debt utilization. Consequently, cash flow coverages and debt repayment capacity have enhanced. Moreover, capitalization indicators depicted an improving trend with decline in debt levels coupled with expansion of the equity base due to internal capital generation. Going forward, the ratings will remain sensitive to improvement in profitability indicators, particularly given the ongoing challenges of the automobile sector, whilst maintaining coverages, liquidity and capitalization levels.

Rating Drivers

Elevated business risk on the back of depressed downstream demand for automobiles

The overall business risk of the auto-parts industry is considered to be in the high to medium category given appreciable cyclicality, historical volatility in gross margins, reliance on imported raw materials and notable exposure to exchange rate fluctuations. Over the rating review period, the Company's business risk has been elevated due to deterioration in the macroeconomic environment which has seen unprecedented levels of inflation and currency depreciation that have diminished disposable incomes of consumers as well as raised vehicle prices significantly. Additionally, the high policy rate environment coupled with restrictions on loan sizes and repayment durations by the State Bank of Pakistan (SBP) further discouraged car leasing activity. Consequently, demand for automobiles has dropped notably in FY23 and HY24 with total vehicle sales during half-year ended-Dec'23 amounting to 605,318 (FY23: 1,354,350, FY22: 2,162,521), forcing automobile manufacturers to shut down operations repeatedly. Moreover, on the supply-side front, import restrictions imposed by SBP to curb deterioration of the current account deficit hampered procurement of necessary raw materials thereby impacting production activity.

The ratings also take into consideration the diversification efforts of the Company through the expansion of the Foaming and Synthetic (F&S) division which is engaged in the production of non-woven fabric, foam seats, foam and spring mattresses, sheets and finished foam. Fabrics produced by the Company are also utilized in the production of pampers, face masks, safety gowns and agricultural activities. Moreover, consistent sponsor support in the form of interest-free loans to the Company is viewed positively. Furthermore, the ratings also take into account the strong market position of PEPL which is the sole supplier of seats to Honda Atlas Cars and fulfills around half of the supply of automotive items to two other major market players in auto industry; while the same results in concentration risk, the long-standing association with these clients provides comfort.

Sizeable contingent guarantees provided to related companies

The Company has provided a cross-company guarantee to the lenders of two associated companies, namely, Master Motor Corp (Pvt.) Ltd. and Foamco (Pvt.) Ltd. and the outstanding amount was Rs. 11.7b (FY22: Rs.

4.7b) at end-FY23; the same results in potential risk exposure to PEPL in case of default on loans by the associated entities.

Significant capital expenditure primarily geared towards expansion of foam division
PEPL has three production plants; two are located in Karachi and one in Lahore. The Company also has an underlying wholly-owned subsidiary, Master Auto Engineering (Pvt) Ltd (MAE), and associated company, Master Wind Energy Ltd., with shareholding of 15%; total investments in both these companies amounted to Rs. 1.9b at end-Dec'23 (FY23: Rs. 1.6b, FY22: Rs. 1.4b).

The capital expenditure undertaken by the Company during FY23 amounted to Rs. 1.3b which largely pertained to the upgradation of machinery in the auto parts and foam division as well as the installation of a new press line for synthetic products. Additionally, a solar energy plant was setup to reduce utility overheads that amounted to Rs. 256.2m. During the ongoing year, the Company has begun the installation of another press line in the foam division, costing about Rs. 618.2m. The overall capital expenditure was financed largely by debt. Going forward, the Company does not plan to incur any major capex.

Lower sales in conjunction with decline in automobile demand; a shift towards F&S products
The Company's topline depicted a timeline decrease over the rating period to Rs. 10.7b during 1HFY24 (FY23: Rs. 23.2b, FY22: Rs. 25.0b) largely on account of lower volumetric offtake of four-wheel seats and sheet metal in line with lower demand for automobiles. However, the business mix has witnessed a notable shift toward the F&S division with about 56.9% of the topline emanating from the same during the ongoing year (FY23: 40.4%, FY21: 20.7%), manifested mainly in non-woven fabric. Breakdown of the sales mix is tabulated below:

	FY22	FY23	1HFY24
Seat 4 Wheel	46.5%	30.2%	24.0%
Sheet Metal	17.3%	14.3%	9.4%
Non-Woven Fabric	8.2%	12.4%	32.9%
Spring Mattress	6.7%	11.2%	13.1%
Foam Mattress	5.8%	16.8%	10.9%
Seat 2 Wheel	4.5%	4.3%	4.1%
Roof Headlining	4.3%	3.2%	2.5%
Door Trim and Sun Visor	3.4%	5.0%	1.1%
Other	2.6%	2.1%	1.9%
Carpet	0.7%	0.7%	0.1%
Polyester Wadding and Pillow	0.0%	0.0%	0.1%
Total	**100.0%**	**100.0%**	**100.0%**

The Company's client concentration risk is high consisting largely of institutional customers, in line with dynamics of the auto parts industry, with about 54.8% of net sales emanating from top 10 clients during 1HFY24 (FY23: 63.1%, FY22: 77.2%); however, downward trend in client concentration was witnessed given lower sales to automobile manufactures. Nonetheless, the associated risk is moderated through the long-term nature of contracts with clients along with strong customer relationships. Going forward, given that automobile demand is expected to remain suppressed in the short to medium term, the management envisages the business mix to remain split evenly between the automobile and F&S divisions for the foreseeable future. The management projects the topline to touch Rs. 19-20b during FY24.

Adequate profitability performance
PEPL's gross margins depicted an uptick to 15.1% during FY23 (FY22: 13.6%) as the Company operates on pre-determined profit margins, allowing higher production costs to be passed on to customers. Additionally, as per management, raw materials pertaining to the F&S division are partially procured locally through

associated companies, providing further respite to gross margins levels through reduced exposure to foreign currency fluctuations. However, the net margin was squeezed to 2.2% (FY22: 6.4%) largely on account of higher finance costs of Rs. 1.2b (FY22: Rs. 575.6m) mainly owing to the high policy rate environment. Additionally, distribution expenses increased to Rs. 573.8m (FY22: Rs. 179.4m) mainly on the back of higher freight costs in line with inflationary pressure coupled with increase in advertising expenditure owing to marketing efforts related to the F&S division. Moreover, higher tax expense amounting to Rs. 678.7m (FY22: Rs. 380.9m) was incurred mainly due to one-off prior period taxation adjustment. The share of profit from associate amounting Rs. 337.2m (FY22: Rs. 347.5m) continues to support the bottom line. Net profit stood lower at Rs. 502m (FY22: Rs. 1.6b; FY21: Rs. 638m) in FY23.

During the ongoing year, while the gross margin decreased to 12.6% as rising costs were not fully passed on, the net margin witnessed an uptick to 4.7%. The same is largely an outcome of lower financing costs owing to drop in debt levels. Additionally, income from associate amounting to Rs. 311m supported net income. Going forward, given that the Company intends to rely solely on interest-free directors' loans for working capital requirements coupled with the concessionary interest rates on long-term debt, financing costs are expected to decline which will support the bottom-line. The Company's ability to improve profitability metrics, particularly by ensuring that higher production costs are effectively absorbed by customers, will be an important rating consideration, going forward.

Healthy liquidity position

Funds from Operations (FFO) witnessed an increase to Rs. 903.7m during 1HFY24 (FY23: Rs. 1.3b, FY22: Rs. 1.6b) on the back of increased profitability coupled with lower debt repayments. Consequently, cash flow coverages improved notably with FFO-to-total debt and FFO-to-long-term debt standing at 34.4% and 71%, respectively (FY23: 17%, 48.5%; FY22: 11.6%, 58.5%). Additionally, debt-service coverage ratio also increased to 2.44x (FY23: 1.61x, FY22: 2.26x) in 1HYFY24.

The overall liquidity profile depicted notable improvement over the rating review period with the current ratio and short-term borrowing coverage increasing to 1.18x and 2.94x, respectively (FY23: 1.17x, 1.76x; FY22: 1.09x, 0.99x). The same is largely an outcome of decline in short-term borrowings due to lower working capital requirements as the inventory stockpile was utilized. Moreover, trade debts amounting to Rs. 1.9b at end-Dec'23 (FY23: Rs. 1.9b, FY22: Rs. 1.6b) depicted healthy aging with the majority due within 2 months; the overall credit risk of the same is considered low given that counterparties mainly comprise large to medium-sized auto assemblers. On the other hand, trade and other payables increased notably to Rs. 5.3b (FY23: Rs. 3.5b, FY22: Rs. 2b) mainly due to higher advances from customers and mobilization advances from PEPL's original equipment manufacturer (OEM) against import of equipment and initiation of new projects. Going forward, given declining debt levels coupled with the concessionary interest-rates on long-term financing, liquidity indicators are expected to remain range bound.

Improvement in leverage indicators owing to internal capital generation

The Company's total equity augmented on a timeline basis to Rs. 6.3b (FY23: Rs. 5.8b, FY22: Rs. 5.2b) on the back of profit retention. The equity base also consists of interest-free long-term loans from directors (payable at the discretion of the Company) amounting to Rs. 1.2b (FY23: Rs. 1.1b, FY22: Rs. 1.1b). The overall debt profile witnessed a notable decline during the ongoing year mainly owing to decrease in short-term borrowings (including interest-free director's loan payable on demand) to Rs. 2.7b (FY23: Rs. 4.8b, FY22: Rs. 10.8b) on account of lower working capital requirements in view of adequate available inventory. Long-term borrowings, which also decreased slightly to Rs. 2.5b by end-1HFY24 (FY23: Rs. 2.6b, FY22: Rs. 2.7b), comprised majorly of financing obtained under the SBP's Temporary Economic Refinance Facility (TERF) at concessionary rates. Consequently, capitalization levels exhibited improvement with gearing and leverage decreasing to 0.83x and 1.87x, respectively (FY23: 1.27x, 2.15x; FY22: 2.58x, 3.22x). Going forward, the management plans to settle short-term running finance facilities through utilization of current inventories and rely solely on interest-free directors' loans to meet working capital requirements for the foreseeable future. Consequently, capitalization indicators are expected to improve further, moving forward.

REGULATORY DISCLOSURES	Annexure I
Name of Rated Entity	Procon Engineering (Pvt.) Ltd
Sector	Auto Parts
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings
Rating History	see table 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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Due Diligence Meetings Conducted	see table below

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
22-May-2024	**A**	**A-2**	**Stable**	**Maintained**
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

Due Diligence Meetings Conducted

S.No	Names	Designation	Date
1	Mr. Naveed Alam	Chief Financial Officer	March 21, 2024