RATING REPORT

Frontier Foundry Steel (Private) Limited

REPORT DATE:
February 11, 2019

RATING ANALYSTS:
Maimoon Rasheed
maimoon@jcrvis.com.pk

Asfia Aziz
asfia.aziz@jcrvis.com.pk

RATING DETAILS

Rating Category	Initial Rating	
	Long-term	Short-term
Entity	A-	A-2
Rating Outlook	Stable	
Rating Date	*February 11, 2019*	

COMPANY INFORMATION

Incorporated in 1986	**External auditors:** Rafaqat Babar & Co. Chartered Accountants
	Chairman of the Board: Mr. Nauman Wazir Khattak
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Mr. Zarak Khan
Zarak Khan	
Nauman Wazir Khattak	

APPLICABLE METHODOLOGY(IES)

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

Frontier Foundry Steel (Private) Limited

OVERVIEW OF THE INSTITUTION

Frontier Foundry Steel (Private) Limited (FFSPL) was incorporated as a Private Limited Company in 1986. The company's core business relates to manufacturing of rebars with the production plants situated in Peshawar and Lahore.

Shareholding pattern of the company demonstrates that it's a family owned business with major shareholding resting with Senator Nauman Wazir Khattak (16.51%) and Mr. Zarak Khan (80.16%) who are the Chairman and Chief Executive Officer of FFSPL, respectively. Mr. Nauman Wazir Khattak graduated as an Aeronautical Engineer in 1977 and holds directorship in SNGPL, Pakhtunkhwa Energy Development Organization, FATA Development Authority, Engineering Development Board, Water and Sanitation Services Peshawar, City University Peshawar and Sarhad University of Science and Technology, Peshawar.

RATING RATIONALE

Frontier Foundry Steel (Private) Limited (FFSPL) deals in manufacturing of rebars. At end-December'2018, the company had an installed capacity of rebars at 322,000MT which comprises 72,000MT capacity of Peshawar plant and 250,000MT capacity of Lahore plant. FFSPL commenced operations of its Lahore plant in April'2018. FFSPL's utilization levels have been increasing on a timeline basis and were reported on the higher side. In order to cater to rising demand, FFSPL is in the process of expanding its capacity simultaneous to transforming its mills from a rerolling mill to a direct rolling mill that will import scrap and manufacture billets which will be utilized in-house to produce rebars.

Sector Dynamics

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, and thus resulting in improved pricing power of industry players. While dumping margins have reduced given significant rupee depreciation, risk of dumping from China is considered moderate given supply constraints due to ban on use of induction furnace.

Post expansion, top-tier integrated players (undergoing capacity expansion) will benefit from significantly lower cost of production vis-à-vis smaller non-integrated players and therefore will be relatively better positioned. Going forward, JCR-VIS expects demand growth to remain subdued in the short-term in line with slower economic growth in the backdrop of increasing interest rates and sizeable current account deficit. However, demand outlook over the medium to long-term is expected to remain healthy given focus of the government on construction of dams and housing units.

Expansion Plans

Following are the details of expansion plans of the company:

1. Lahore Project Phase I: This project has commenced operations in April'2018 with an installed rebar capacity of 250,000MT per annum. The project has been entirely financed through equity.
2. Peshawar Project: This project comprises BMR of rerolling mill to enhance rerolling capacity from 72,000MT to 120,000MT and installation of melting unit with an installed capacity of 140,000MT at Hayatabad, Peshawar. The project is being funded through a mix of debt and equity. Expected COD for this project is July'2019.
3. Lahore Project Phase II: This plan comprises installation of melting units at the Lahore mill to transform it into an integrated mill with billets capacity of 250,000MT per annum. The total cost of the project is expected to be financed through a mix of debt and equity. Work on this project will commence post the completion of the aforementioned Peshawar project and will require around six months to come online.

Besides increased sales volume, the expansion will also benefit the company on the back of various efficiencies. These include lower power, re-heating and labor cost.

Sales and Market Penetration

Sales mix of the company entirely comprises corporate and institutional sales (builders and contractors). During FY18, sales revenue of the company witnessed a substantial increase of around 50% on the back of higher sales volumes due to the 2.5 month impact of commencement of Lahore plant operations. Moreover, sizeable growth has also been observed during 1HFY19. FFSPL's market position is stronger in the Northern market with increased penetration planned in the Southern region. The same is considered important in the backdrop of sizeable capacities coming online. In addition, growth in retail sales will also be pursued for mitigating the likely adverse impact of concentration in sales. JCR-VIS expects growth in retail sales to materialize overtime given the company's initiatives of setting up sales offices across Pakistan.

Profitability

Profit after tax of the company has grown by 33% and by around 4 times during FY17 and FY18, respectively. Increase in profitability is a function of improved volumetric off-take and improving gross margins. Gross Margins (GM) of the company have been increasing since FY17 on the back of volumetric growth and higher average selling prices. During FY18, GMs improved to 10.8% (FY17: 4.5%) on account of better plant efficiency. Going forward the management projects margins to improve further through installation of an efficient plant providing power savings and inclusion of retail clients in the sales mix offering higher margins. Moreover, profitability is expected to increase on the back of higher volumetric sales, improved sales prices and tax benefits by GoP.

Cash Flows

With increase in profitability during FY18, FFSPL's funds from operations (FFO) have increased to Rs. 505m (FY17: Rs. 63m) providing sufficient coverage to outstanding short term obligations. FFO in relation to outstanding obligations has witnessed noticeable improvement with debt servicing coverage being healthy at 9.8 (x) at end-December'2018.

Capitalization and Funding

Capitalization levels of the company have strengthened on a timeline basis on account of rise in equity base on account of profit retention. Equity base of the company grew at a 3-year (FY15-FY18) CAGR of 61% and was reported at Rs. 2.2b (FY17: Rs. 1.4b) at end-June'2018. The sponsors injected equity during FY17 and FY18 to finance Lahore Project Phase I. With stability in debt levels (largely comprising STD) and increase in equity base, leverage indicators are on the lower side. However, with increased short term borrowings at end-December'2018 due to higher working capital requirements, gearing and leverage ratio reported as at June'2018 were 0.79x (FY17: 0.25x, FY16: 0.52x) and 1.09x (FY17: 0.57x, FY16: 1.15x) respectively. With increase in debt levels to fund expansion, gearing and leverage indicators are expected to rise but are expected to remain within manageable levels with comfortable debt servicing ability supported through improved profitability and cash flows.

Corporate Governance

Regular board meetings are convened with discussions limited to regulatory approvals. Board oversight may be enhanced through greater discussion on future strategy and internal control framework of the organization. Given the company's status as a private limited company, there is significant room for improvement in board composition and oversight. Management is in the process of further improving its control framework through strengthening of internal audit function and change of external auditors. JCR-VIS will track progress against planned initiatives, going forward.

Frontier Foundry Steel (Private) Limited — Appendix I

FINANCIAL SUMMARY *(amounts in PKR millions)*

BALANCE SHEET	**FY15**	**FY16**	**FY17**	**FY18**	**1HFY19***
Fixed Assets	582	476	1,554	2,202	1,929
Stock-in-Trade	35	37	110	497	509
Trade Debts	423	355	401	1,162	1,366
Cash & Bank Balances	128	710	138	445	372
Total Assets	1,387	1,811	2,530	4,852	5,055
Trade and Other Payables	244	261	292	322	178
Long Term Debt	18	16	18	114	156
Short Term Debt	85	345	333	1,605	1,616
Total Debt	102	361	351	1,720	1,772
Total Equity	520	700	1,432	2,191	2,530
INCOME STATEMENT					
Net Sales	4,652	4,497	4,653	7,021	5,767
Gross Profit	160	151	210	757	586
Operating Profit	111	87	100	448	373
Profit Before Tax	86	94	99	414	326
Profit After Tax	47	51	68	261	325
RATIO ANALYSIS					
Gross Margin (%)	3.4%	3.4%	4.5%	10.8%	10.2%
Net Margin	1.0%	1.1%	1.5%	3.7%	5.6%
Net Working Capital	386	659	277	603	851
Trade debts/Sales	9%	8%	9%	17%	12%
FFO	82	72	63	505	449
FFO to Total Debt (%)	81%	20%	18%	29%	51%
FFO to Long Term Debt (%)	470%	454%	350%	441%	576%
Current Ratio (x)	2.0	2.0	1.4	1.3	1.5
Debt Servicing Coverage Ratio (x)	NA	12.9	10.2	27.5	9.8
Gearing (x)	0.20	0.52	0.25	0.79	0.70
ROAA (%)	3%	3%	3%	7%	7%
ROAE (%)	9%	8%	6%	14%	14%

** Management Accounts*

ISSUE/ISSUER RATING SCALE & DEFINITION

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: JCR-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.jcrvis.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.jcrvis.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.

'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.jcrvis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when JCR-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

<table>
<tr><td>Name of Rated Entity</td><td>Frontier Foundry Steel (Private) Limited</td></tr>
<tr><td>Sector</td><td>Steel Industry</td></tr>
<tr><td>Type of Relationship</td><td>Solicited</td></tr>
<tr><td>Purpose of Rating</td><td>Entity Rating</td></tr>
<tr><td>Rating History</td><td>
<table>
<tr><th>Rating Date</th><th>Medium to Long Term</th><th>Short Term</th><th>Rating Outlook</th><th>Rating Action</th></tr>
<tr><td colspan="5"><u>RATING TYPE: ENTITY</u></td></tr>
<tr><td>February 11, 2019</td><td>A-</td><td>A-2</td><td>Stable</td><td>Initial</td></tr>
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</td></tr>
<tr><td>Instrument Structure</td><td>N/A</td></tr>
<tr><td>Statement by the Rating Team</td><td>JCR-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.</td></tr>
<tr><td>Probability of Default</td><td>JCR-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.</td></tr>
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