RATING REPORT

Frontier Foundry Steel (Private) Limited

REPORT DATE:
February 22, 2023

RATING ANALYSTS:
Muhammad Tabish
muhammad.tabish@vis.com.pk

Basel Ali Assad
basel.ali@vis.com.pk

RATING DETAILS				
Rating Category	**Latest Rating**		**Previous Rating**	
	Long-term	**Short-term**	**Long-term**	**Short-term**
Entity	A	A-1	A	A-1
Rating Date	*Feb 22, 2023*		*Nov 01, 2021*	
Rating Outlook	Stable		Stable	

COMPANY INFORMATION	
Incorporated in 1986	**External Auditors:** Yousuf Adil, Chartered Accountants
Private Limited Company	**Chairman:** Mr. Nauman Wazir Khattak
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Mr. Zarak Khan
Zarak Khan ~80.2%	
Nauman Wazir Khattak ~16.5%	

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

Frontier Foundry Steel (Private) Limited

OVERVIEW OF THE INSTITUTION

Frontier Foundry Steel (Private) Limited (FF Steel) was incorporated as a Private Limited Company in 1986. The company's core business relates to manufacturing of rebars with the production units situated in Peshawar and Lahore. In addition, an export-oriented production unit of copper ingots is located in Gujranwala.

Profile of Chairman

Mr. Nauman Wazir Khattak, a sitting senator, 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.

Profile of CEO

Mr. Zarak Khan has an undergraduate degree in mechanical engineering from Ghulam Ishaq Khan Institute of Engineering Sciences & Technology. He was awarded a gold medal in his bachelor's degree for his academic achievement.

RATING RATIONALE

Corporate Profile

Frontier Foundry Steel (Private) Limited (FF Steel), with over 37 years of operations, is a medium-sized producer of long steel, specializing in the production of rebars and billets with presence in north and central regions of Pakistan. Based on capacity, FF Steel holds market share of approx. 4-5%. It is a family-owned business, with majority ownership distributed between two members. Product line includes deformed steel bars in grades 60 and 80. FF Steel holds multiple ISO certifications and has a workforce of over 900 employees. Present power capacity is 82MW and entire requirement is met through national-grid.

Operating Performance

The company has two production sites for steel bars, with present capacities of 400 and 700 metric tons per day located in Peshawar and Lahore, respectively. The utilization of resources remained low despite a slight increase in production level in the outgoing fiscal year, as a result of both previous melting unit project being underway leading to shortage of raw materials (billets) for the company and a recent drop in market demand.

Figure: Annual Capacity & Production Data – Rebars (in MTs)

	FY21	FY22	HY'23
Production Capacity	**396,000**	**396,000**	**198,000**
- Peshawar Plant	144,000	144,000	72,000
- Lahore Plant	252,000	252,000	126,000
Actual Production	**185,543**	**188,345**	**83,204**
Utilization	***46.9%***	***47.6%***	***42.0%***

Vertical integration project at Lahore plant and diversification of business mix through venturing into non-ferrous segment.

The Lahore plant completed its BMR project (Phase II) in Nov'22, enabling in-house billet production while vertical integration has eliminated the need to buy and reheat billets for the rolling process leading to an estimated yearly cost savings of ~Rs. 4K per ton. The project cost stood at Rs. 1.8b, which was primarily funded through TERF facility. As per management, both plants have now been integrated vertically, and entire production needs can be fulfilled through in-house billets. Moreover, management planned to establish a plant in southern region in the medium term to benefit from geographical diversification, however, this has been postponed due to present unfavorable macroeconomic environment.

As part of its strategy to diversify into non-ferrous products, the company recently established an export-oriented production unit for copper ingots in Gujranwala, which began operations in June'22. Management intends to scale up operation with an aim to increase revenue contribution to a range of 10-15% in the future.

Key Rating Drivers

Industry Update – Present supply side constraints and rising input costs has led to unprecedented price hikes of rebar and slowdown in market demand. Steel sector is likely to undergo consolidation, going forward.

Pakistan's steel sector has been facing significant challenges recently due to supply-side issues resulting from the restrictions on obtaining Letters of Credit (LCs) for importing key raw materials such as scrap steel, which has primarily been due to dwindling foreign exchange reserves in the country. In addition to this, sizeable rupee depreciation during the year combined with high international scrap prices (peaked at around $700/MT in Mar'22) and rising fuel and electricity costs have resulted in unprecedented hikes in steel bars prices, which currently stand at over Rs. 300K per ton as of Feb'23. Furthermore, duty structure for the imported raw material includes 2% additional custom duty, 5% regulatory duty, 17% sales tax, 2% income tax, and 1.25% ETO Cess, which further adds to the costs of steel production. Total scrap steel imports noted a decline of ~41% YoY between July-Oct'22, leading to a shortage of raw materials in the market. Consequently, steel companies have increased focus towards procurement of local scrap.

Demand for steel and allied products has also taken a hit owing to lower industrial output as reflected by a contraction in the Large-Scale Manufacturing (LSM) Index by 3.6% between July-Nov'22 YoY. This decrease in demand is precipitated by the far-reaching effect of import restrictions across industries, rising policy rate, impact of recent floods and economic/political uncertainty, all leading to noticeable reduction in infrastructure development projects and overall construction sector demand.

Going forward, macroeconomic indicators suggest further reduction in demand, with World Bank projecting GDP growth to fall to 2%. Additionally, given uncertainty surrounding the imposition of import restrictions, as well as existing macroeconomic and sector-specific challenges, the industry is likely to undergo consolidation as rising manufacturing costs may force the closure or suspension of operations amongst smaller industry players and in turn existing medium and large-sized players will have more room to expand their presence.

Revenue growth is driven by price hikes of rebars while volumetric offtake stood at around previous year level.

Net sales revenue, following a 1.6x growth in the previous year given increased capacity and dispatches, surpassed the Rs. 29b mark in FY22. The year-on-year uptick of ~44% was primarily driven by increase in rebar prices, while overall volumetric off-take stood at around previous year level. The dispatches in the ongoing fiscal year have noted a slight contraction with a drop in market demand impacted by flood damages and slowdown in construction sector; net sales during 7M'FY23 amounted to ~Rs. 18.5b. Management projects full-year sales to exceed Rs. 35b with expectations to cover up for the lost sales in subsequent quarters.

In terms of client mix, majority of revenue continues to emanate from corporate customers, followed by distributors and direct online sales to households. Client concentration risk is low as demonstrated by top ten clients accounting for ~10% of revenue base.

Profitability margins were impacted by rising input costs combined with significant financial charges. Maintaining satisfactory margins will be crucial from a ratings perspective.

Profitability margins, both gross and net, have trended downwards over time. However, during the review period, margins experienced a notable decline due to sharp increase in international scrap metal prices, high freight and energy costs, and sizeable rupee depreciation. Financial charges also rose considerably due to an increase in debt levels and hikes in policy rates during the year. Despite drop in margins, bottom-line noted a modest increase in absolute terms, due to strong topline growth.

Despite increase in debt levels, cash flow coverage metrics remained sound and aligned with peer median.

Improved earnings have led to a positive trend in funds flow from operations (FFO) over the past three fiscal years, reaching Rs. 2.4b (FY21: Rs. 1.7b; FY20: Rs. 0.7b) in FY22. However, cash flow coverage metrics though remains satisfactory have noted a dip in the review period due to considerable increase in debt levels, as reflected in FFO to long-term debt and FFO to total debt of 0.95x (FY22: 1.21x; FY21: 3.15x) and 0.16x (FY22: 0.32x; FY21: 0.44x), respectively as at end-1H'FY23. Similarly, debt servicing coverage ratio dropped to 2.90x (FY22: 5.64x; FY21: 5.73x)

Stretched working capital cycle may lead to build up of liquidity pressures going forward.

Liquidity has remained satisfactory, with a current ratio consistently reported above 1.3x, and adequate coverage of short-term borrowings in relation to trade debts and inventory. However, stock levels have nearly doubled during 1H'FY23, reaching Rs. 6.9b (FY22: Rs. 3.6b; FY21: Rs. 3.3b), owing to a shift in raw material from billets to scrap steel with the start of billet production at the Lahore plant, as well as management's decision to hold finished goods inventory due to rapid price escalation during the review period.

In line with industry phenomenon, recent uptick in inventory holdings and debtor days has resulted in an extended cash conversion cycle. Trade debts have also noted a sizeable increase in line with revenue growth, and the ageing profile remains sound with ~4% receivables outstanding for more than a year. However, the proportion of receivables due for more than 180 days increased to ~39% (FY21: ~15%) in FY22, which may lead to build up of liquidity pressures going forward.

Retained profits continue to support capitalization levels; leverage indicators have trended upwards.

Healthy internal capital generation and all-out retention with its conversion into paid up capital continue to reinforce capital buffers, wherein net equity (excluding revaluation surplus) nearly doubling since FY20, reaching Rs. 7.3b at end-1H'FY23. Debt profile comprises a mix of long-term financing (including TERF facility and syndicated term finance) and short-term debt for working capital requirements. Total interest bearing liabilities increasing to Rs. 12.4b (FY22: Rs. 7.5b; FY21: Rs. 3.9b) at end-1H'FY23, with ~83% representing short-term debt. Given such sizeable increase in debt utilization, leverage indicators have trended upwards over time.

Room for improvement exists in terms of corporate governance; no segregation between ownership and management.

Corporate Governance (CG) lags behind similar rated listed counterparts due to the company's status as a private limited company. Currently, there is no segregation between

	ownership and management and board structure lacks subcommittees; both would add to supervisory oversight. The change of external auditor to Yousaf Adil, which is categorized as an 'A' firm on the SBP's panel of auditors, is being viewed positively. The planned IPO remains on the forefront of management agenda; however, it has been postponed due to current unfavorable economic environment.

Frontier Foundry Steel (Private) Limited **Annexure I**

FINANCIAL SUMMARY				*(amounts in PKR millions)*
BALANCE SHEET	**FY20**	**FY21**	**FY22**	**1H'FY23**
Non-Current Assets	3,267	7,537	8,484	8,015
Receivables	1,343	2,285	5,835	5,984
Stock in Trade	2,726	3,274	3,556	6,918
Advances, Deposits & Prepayments	976	1,614	2,058	2,225
Store, Spares	108	64	160	449
Cash & Bank Balance	477	294	803	2,435
Total Assets	**8,896**	**15,068**	**20,896**	**26,026**
Trade & Other Payables	425	1,482	2,110	1,957
Short-Term Borrowings	3,434	3,356	5,572	10,327
Long-Term Borrowings (*Incl. current maturity*)	556	542	1,978	2,064
Deferred Tax	231	1,416	1,387	1,438
Other Liabilities	378	74	228	300
Total Liabilities	**5,024**	**6,870**	**11,274**	**16,086**
Paid-up Capital	2,891	3,631	4,931	4,931
Total Equity (*Excl. revaluation surplus*)	**3,639**	**5,043**	**6,817**	**7,259**
INCOME STATEMENT				
Net Revenue	7,878	20,517	29,497	15,653
Gross Profit	1,053	2,335	2,935	1,527
Profit Before Tax	**451**	**1,484**	**1,445**	**389**
Profit After Tax	**453**	**1,346**	**1,423**	**321**
FFO	697	1,711	2,392	985
RATIO ANALYSIS				
Gross Margin (%)	13.4%	11.4%	9.9%	9.8%
Net Margin (%)	5.7%	6.6%	4.8%	2.0%
Net Working Capital	1,330	2,440	4,334	5,353
Current Ratio (x)	1.31	1.48	1.54	1.42
Short-term Borrowing Coverage Ratio (x)	1.18	1.66	1.69	1.25
FFO to Long-Term Debt (x)	1.26	3.15	1.21	0.95
FFO to Total Debt (x)	0.17	0.44	0.32	0.16
Debt Servicing Coverage Ratio (x)	4.63	5.73	5.64	2.90
ROAA (%)	6.1%	11.2%	7.9%	2.7%
ROAE (%)	12.4%	22.3%	16.0%	6.6%
Gearing (x)	1.10	0.77	1.11	1.71
Debt Leverage (x)	1.38	1.36	1.65	2.22
Net Operating Cycle (days)	131	63	68	111

ISSUE/ISSUER RATING SCALE & DEFINITIONS Annexure 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					**Annexure III**
Name of Rated Entity	Frontier Foundry Steel (Private) Limited				
Sector	Steel Industry				
Type of Relationship	Solicited				
Purpose of Rating	Entity Ratings				
Rating History	**Rating Date**	**Medium to Long Term**	**Short Term**	**Rating Outlook**	**Rating Action**
	RATING TYPE: ENTITY				
	02/22/2023	A	A-1	Stable	Reaffirmed
	01/11/2021	A	A-1	Stable	Upgrade
	24/08/2020	A-	A-2	Positive	Maintained
	11/05/2019	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. Copyright 2023 VIS Credit Rating Company Limited. All rights reserved. Contents may be used by news media with credit to VIS.				
Due Diligence Meeting Conducted	**Name**	**Designation**	**Date**		
	Mr. Fayyaz Ahmad Jarral	Executive Director	February 7, 2023		
	Mr. Ali Ahmad Minhas	CFO			
	Mr. Abrar Wasim	Head of Accounts			
	Mr. Khurram Ali	Head of Finance			