RATING REPORT

Razaque Steels (Private) Limited

REPORT DATE:
June 22, 2022

RATING ANALYST:
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RATING DETAILS		
Rating Category	**Latest Rating**	**Previous Rating**
Entity	**BBB-/A-3**	**BBB-/A-3**
Rating Date (Entity)	*June 22, 2022*	*May 24, 2021*
Rating Outlook	Stable	Stable

COMPANY INFORMATION	
Incorporated in 1963	**External auditors:** BDO Ebrahim & Co. Chartered Accountants
Private Limited Company	**Managing Director (MD):** Mr. Irshad Mowjee
Key Shareholders (with stake 5% or more):	
Mr. Irshad Mowjee – 50%	
Ms. Farhana Mowjee – 50%	

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

Razaque Steels (Private) Limited

OVERVIEW OF THE INSTITUTION

Razaque Steels (Private) Limited (RSPL) was incorporated on 18th July 1963 as a Private Limited Company under the Companies Ordinance 1984. The company is primarily engaged in the manufacturing and sale of steel bars and billets with its registered head office based in Karachi, Pakistan.

Directors' Profile

Mr. Irshad Mowjee has been associated with the family business as the Managing Director since 2006. He is a B.A (Hons) in Economics from City of London Polytechnic and also holds MBA degree from Imperial College, University of London.

Ms. Farhana Mowjee is the Director and has been associated with the company since 1991. Prior to joining RSPL; she has served as a Manager in Ernst and Young (UK). She holds a Bachelors of Arts (Hons) in Philosophy from University College London. She also completed her Chartered Accountancy Training

RATING RATIONALE

Rating Rationale:

The ratings assigned to Razaque Steels (Private) Limited (RSPL) take into account the business risk of long steel sector which is considered relatively high given its fragmented nature accompanied by prevailing competition and price sensitivity of raw material to exchange rate. On the other hand, the sector continues to be supported by strong sovereign protection through favorable tariff regime. The long-term demand outlook for steel products remains positive given Pakistan's low existing steel consumption per capita and ongoing strategic construction projects. However, short to medium term outlook is considered moderate in line with sudden change in political landscape coupled with escalating inflation and interest rates resulting in potential slowdown in construction and automobile industries.

As a result of favorable government policies and gradual economic recovery post pandemic crisis, RSPL posted significant growth in its topline during the outgoing year and onwards supported by the industry's ability to pass increase in raw material prices to end consumers. Due to the volatile nature of steel prices in the international market, margins showed improvement in FY21 in line with higher prices of end-products, high-capacity utilization leading to improved absorption of fixed cost components and inventory gains. However, margins in the ongoing year were impacted due to significant lead time between material ordering and delivery of finished product. Going forward, with the expected rise in finance cost, improvement in net margins is deemed essential to alleviate pressure on bottom line. In line with growth in business revenues, cash flows have improved; however, the same in terms of total borrowings still remained weak at end-HY22 owing to sizable working capital requirements. Moreover, financing is largely limited to utilization of short-term credit while long term debt is minimal, which translates in a comfortable DSCR. Further, the ratings factor in support extended to liquidity position by improvement of net operating cycle and maintenance of current ratio. The company has no plan of procuring long-term funding in the medium to long-term as no major capital expenditure is in the pipeline; any uptick in demand will be accommodated by the existing capacity. The leverage indicators are supported by interest free loan extended by the sponsors. Furthermore, the plan of discontinuation of billet manufacturing facility will result in tapering off half of the working capital requirement; therefore, the leverage indicators are expected to improve going forward. The ratings remain sensitive to downward trend witnessed in margins during HY22 owing to lead-lag in input-output pricing. In addition, the ratings remain dependent on improvement of business margins through operational efficiencies, prudent management of working capital cycle and maintenance of leverage indicators at manageable levels.

RSPL stands amongst the small-sized players in the long steel industry with the installed capacity of billets and reinforcement bars (rebars) at 50,000MTs and 48,000MTs, respectively. It is a family-owned business and has a strong track record of operations since its founding more than five decades ago. The company over the years has primarily remained focused towards catering to corporate clients. RSPL has two production facilities; Unit-A (Re-rolling Mill) and Unit-B (Billets facility acquired from Faizan Steel Group on a long-term operating lease) located at S.I.T.E-Karachi and Hub-Balochistan, respectively. Energy requirement of both facilities is met through dedicated feeders which ensure uninterrupted full load power supply. Capacity utilization of bars increased to 87% (FY20: 79%) in the outgoing fiscal year *and Qualification in 1988 in UK.*

on account of subsequent economic recovery and favorable outlook for construction industry. Going forward, management has planned to further improve capacity through eliminating production bottlenecks and gradual automation of the machinery.

Key Rating Drivers

Business risk profile remains elevated as a combined outcome of multiple factors; however, mitigants for some are in place: Business risk for the sector is considered to be on the higher side due to its sensitivity to exchange rate and volatile nature of raw material prices. Given sizable rupee depreciation in terms of dollar in the ongoing year; the pressure on raw material cost is expected to build further. For bars and billets manufacturing, the core raw material is scrap metal comprising of around 60-65% of the manufacturing cost; around two-thirds of the scrap metal demand is met through imports. Shredded scrap prices remained at record high levels over the last 22 months with hike witnessed to $597/MT at end-Apr'22 as opposed $263/MT at end-June'20.

On the demand side, in terms of historical data industrial/construction operations picked up pace during FY21 as LSM index exhibited an improvement by 14.85%. With sudden shift in the political landscape followed by worsening of economic & financial indicators involving increase in inflation and delay in locking IMF deals for economic bailout is expected to put pressure on performance of steel sector as construction activities are likely to be slowed. Further, the significant increase in benchmark rates is also projected to slow down economic growth as the cost of doing business has increased sizably. On the flip side, given development/approvals of infrastructure projects is the forte of the incumbent government, the demand risk for steel sector is relatively mitigated. Moreover, the ongoing CPEC activity and construction of dams is likely to cater to foreseeable risk of demand compression. In terms of regulatory risk, the Government of Pakistan continues to offer protection to the sector from foreign suppliers by imposing 46% (5% Customs Duty (CD), 15% Regulatory Duty (RD), 2% Additional Customs Duty (ACD), and 24% Anti-Dumping Duty (ADD)) and 43% (11% CD, 30% RD, and 2% ACD) duty on the import of billets and bars from China.

Topline exhibited growth trend in line with volumetric growth and higher rebar prices:

The revenues of the company exhibited positive trajectory as a combined outcome of growth in volumetric sale of deformed bars (DBs) to 46,322 MT (FY20: 40,474 MT) coupled with increase in average price of the same to Rs. 105,455/MT (FY20: Rs. 93,518/MT) during FY21. RSPL's topline can be categorized into two products, DBs and Billets, with the latter being a semi-finished raw material product sold (when produced in excess) to other long steel producers for conversion to bars. DBs constituted 92% (FY20: 87%) of the revenue topline while the remaining was contributed by billet sales. The increased demand of DBs was primarily a function of positive outlook of the construction sector given steel industry is one the main beneficiaries of uptick in construction activities. Further, the gross margins of the company increased to 9.7% (FY20: 6.6%) owing to improvement in average selling price of DBs, inventory gains and jump in production volumes leading to better absorption of fixed cost components of cost of sales.

The operating expenses, including administration and distribution expenses, increased to Rs. 126.6m (FY20: Rs. 105.4m) mainly as a result of increased contribution to workers' participation fund in line with significant improvement in bottom line during FY21. Further, other income also stood higher at Rs. 9.1m (FY20: Rs. 1.8m) owing to income amounting to Rs. 4.8m (FY20: nil) booked from trading activities. In addition, despite utilization of borrowings remaining largely unchanged, the finance cost decreased to Rs. 92.2m (FY20: Rs. 187.6m) on account of sharp dip in benchmark interest rates during the period under review. As a result of positive momentum in revenues, improvement in margins and curtailment of interest expense, RSPL reported substantial profit of Rs. 185.9m during FY21 as opposed to negative bottom line of Rs. 2.9m in the preceding year.

Notable growth was manifested in 1HFY22 with RSPL's net sales recorded at Rs. 3.6b on account of growth in quantum sales to 24,956 MT along with significant increase in retail prices of DBs to Rs. 142,503/MT. The growth in volumes is a function of exogenous factors involving amnesty scheme, which had been offered till Dec'20 and later extended for another six months to facilitate those intending to invest their untaxed money in construction projects along with construction package introduced by the Prime Minister in April'19. However, the gross margins declined to 6.1% due to increase in average raw material prices, primarily imported scrap, in line with deprecation of rupee against dollar. The operating expenses in absolute terms largely remained at prior year's level at Rs. 62.4m during HY22; however, the same represents rationalization of expenses if analyzed in terms of growth in revenues. On the flip side, finance cost increased to Rs. 53.0m as a combined outcome of increase in utilization of short-term borrowings along with escalation of benchmark rates during HY22. As a result of dip in margins despite growth in revenues, the company recorded lower profit after tax amounting to Rs. 61.1m during HY22. The management has projected to close FY22 at Rs. 5.5b; the same is considered realistic and achievable given the current performance of the company.

Going forward, the management plans on discontinuing the billet manufacturing at Hub and revert fully to purchase of billets from open market. In that regard the lease agreement of the manufacturing facility scheduled to be renegotiated on 30th June, 2022 might not be signed; however, final decision on the same has not yet been made. The discontinuation of billets production is expected to reduce the working capital requirements of the company to half or even a quarter. On the other hand, in order to rationalize working capital requirements RSPL will deal with procurement of 3,000 MT of billets per month from the local billet producers as opposed to Hub facility producing 4,500MT billets per month; the same is likely to result in 25% reduction in volumetric sale going forward. However, as per the management the volumetric decline will be offset by increase in retail price of DBs.

Improvement in liquidity position in line with FFO turning positive coupled with reduction in cash conversion cycle:

Liquidity profile of the company has exhibited positive trajectory with improvement during the outgoing year in line with growth in scale of operations, margins and profitability indicators. Funds from Operations (FFO) were recorded sizable at Rs. 224.6m during FY21 as opposed to negative in the preceding year owing to growth in scale of operations and enhancement of margins. However, the positive momentum in FFO growth slightly slowed down during the outgoing year on account of reduction in margins. As a result, FFO to total debt and FFO to long-term debt were recorded higher at 0.19x (FY20: negative) and 10.85x (FY20: negative) at end-FY21. On the other hand, with decline in FFO during the ongoing year coupled with higher utilization on short-term credit, FFO to total debt was lower at 0.05x at end-HY22. FFO to long-term debt has continuously seen an improving trend during the rating review period given RSPL has almost negligible reliance on long-term funding.

Stock in trade increased on a timeline basis to Rs. 1.1b (end-FY21: Rs. 906.3m; end-FY20: Rs. 615.1m) at end-HY22 owing to sizable raw material inventory held to meet forecasted demand; the same is linked with growth in scale of business operations. Further, trade debts also increased on a timeline owing to increase in revenues; the aging of receivables is considered sound as no receivable was overdue for more than six months while 90% of receivables pertained to less than three-month bracket. Provision amounting to Rs. 18.3m (FY21: Rs. 14.5m; FY20: Rs. 12.2m) was booked for expected credit losses during HY22; however, the amount in terms of total receivables is meager; the same trend of provisioning recorded for 1-2% of receivables is expected to continue in the future. The loan and advances also increased on a timeline to Rs. 248.2m (FY21: Rs. 152.2m, FY20: Rs. 20.9m) primarily on account of advance against imports for raw material; the same are part of normal course of business and do not carry any interest. The liquidity of the company is impacted due to sizable sales and income tax refunds aggregating to Rs. 307.9m (FY21: Rs. 230.2m; FY20: Rs. 229.0m) due from government at end-HY22; the company is unable to rectify the situation given it is an exogenous factor and inherent in the local steel industry.

Given increase in inventory and receivables off set by increase in short-term borrowings, current ratio of the company largely remained range bound; the same has ranged between 1.31-1.34x since FY18. Further, RSPL's cash conversion cycle (CCC) improved slightly on a timeline basis to 82 days (FY21: 95 days; FY20: 112 days) at end-HY22 in line with improvement in inventory turnover on account of efficient order servicing post pandemic crisis. The improvement in CCC is also an outcome of relaxed payment terms negotiated with suppliers based on sound repayment track record of the company.

Conservative capital structure in line with minimal reliance on long-term borrowings; however low equity base and increased short-term debt utilization resulted in elevated leverage indicators.

The Tier-I equity base of RSPL increased slightly to Rs. 1.1b (FY21: Rs. 1.0b; FY20: Rs. Rs. 819.3m) by end-HY22 on account of internal capital generation. The debt matrix of the company still has notable tilt towards short-term credit owing to minimal reliance of the company on long-term borrowings. Short-term borrowings increased on a timeline in line with growth in scale in operations leading to higher working capital financing. At end-HY22, the company had a total short-term financing limit of Rs. 3.1b out of which Rs. 1.4b remained unutilized. On the other hand, the long-term borrowings increased slightly to Rs. 20.7m (FY20: Rs. 16.3m) at end-FY21; however, the quantum of long-term funding in terms of company's equity and scale of operations is insignificant. Further, the same was reported even lower at Rs. 12.4m at end-HY22 in line with periodic repayments of obligations made during the concerned period. No new long-term loan was procured during HY22. Further, to support the leverage indicators, the directors have extended an interest free unsecured loan amounting to Rs. 205.0m (FY21: Rs. 205.0; FY20: Rs. 204.5m) at end-HY22; the loan has no fixed terms of repayment and is likely to remain vested in the company in the medium to long-term. As a result of increase in utilization of short-term borrowings, gearing and leverage trended upwards to 1.64x (FY21: 1.18x; FY20: 1.36x) and 2.08x (FY21: 1.81x; FY20: 1.66x) respectively at end-HY22. With no sizable capex planned in the medium term leading to no new long-term loan procurement projected coupled with significant reduction in working capital requirements with discontinuation of billet manufacturing unit, leverage indicators are expected to trend downwards going forward.

Corporate governance framework has significant room for improvement

Overall board structure and oversight has room for improvement through induction of independent directors, greater discussion on future strategy along with improvisation in internal control framework. Development and documentation of a formal succession plan is also considered important.

Razaque Steels (Private) Limited Appendix I

FINANCIAL SUMMARY *(amounts in PKR millions)*					
BALANCE SHEET	**FY18**	**FY19**	**FY20**	**FY21**	**HY22**
Fixed Assets	517.4	629.5	655.6	649.8	1,051.7
Stock-in-Trade	838.8	850.2	615.1	906.3	1,144.6
Trade Debts	421.0	690.4	814.4	954.7	1,212.4
Tax Refund from Government	184.9	168.0	229.0	230.2	307.9
Cash & Bank Balances	5.2	3.5	2.3	6.5	3.3
Total Assets	2,215.3	2,552.9	2,551.6	3,189.4	4,069.0
Trade and Other Payables	315.4	189.6	211.7	601.3	442.2
Long Term Debt	-	-	16.3	20.7	12.4
Short Term Debt	1,037.0	1,150.3	1,096.2	1,168.2	1,742.0
Total Debt	1,037.0	1,150.3	1,112.5	1,188.9	1,754.4
Total Liabilities	1,237.0	1,374.0	1,361.3	1,815.9	2,222.4
Paid up Capital	20.0	20.0	20.0	20.0	20.0
Tier-I Equity	662.3	811.2	819.3	1,005.7	1,069.1
Total Equity	1,030.1	1,174.9	1,187.0	1,373.5	1,846.6
INCOME STATEMENT					
Net Sales	3,224.0	3,944.7	4,313.2	4,894.4	3,611.8
Gross Profit	209.2	176.1	286.1	476.8	219.7
Profit Before Tax	146.9	(3.5)	(4.8)	268.6	107.4
Profit After Tax	103.3	(6.1)	(2.9)	185.9	61.1
RATIO ANALYSIS					
Gross Margin (%)	6.5%	4.5%	6.6%	9.7%	6.1%
Net Margin	3.2%	-0.2%	-0.07%	3.80%	1.69%
Trade debts/Sales	13.1%	17.5%	18.9%	19.5%	16.8%
FFO	131.8	14.4	(92.1)	224.6	96.1
FFO to Total Debt (x)	0.13	0.01	(0.08)	0.19	0.11
FFO to Long Term Debt (x)	NA	NA	(5.66)	10.85	15.47
Current Ratio (x)	1.34	1.34	1.31	1.33	1.33
Debt Servicing Coverage Ratio (x)	3.67	1.13	0.47	3.00	2.59
Gearing (x)	1.51	1.42	1.36	1.18	1.64
Debt Leverage (x)	1.87	1.69	1.66	1.81	2.08
ROAA (%)	6.3%	-	-	6.5%	3.4%
ROAE (%)	20.3%	-	-	20.4%	11.8%
(Stock + Trade Debts)/ Short Term Borrowings (x)	1.25	1.34	1.30	1.59	1.35
Cash Conversion Cycle (days)	75	114	112	95	82

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	Razaque Steels (Private) Limited
Sector	Steel Industry
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
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.
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.
Due Diligence Meeting Conducted	(see table below)

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
22/06/2022	BBB-	A-3	Stable	Re-affirmed
24/05/2021	BBB-	A-3	Stable	Re-affirmed
03/09/2020	BBB-	A-3	Stable	Re-affirmed
11/19/2018	BBB-	A-3	Stable	Initial

Due Diligence Meeting Conducted

Name	Designation	Date
Mr. Farhana Mowjee	Director	May 11, 2022
Mr. Irshad Mowjee	Director	