RATING REPORT

Two Star Industries (Pvt.) Limited

REPORT DATE:
May 3rd, 2019

RATING ANALYSTS:

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RATING DETAILS		
	Initial Rating	
Rating Category	Long-term	Short-term
Entity	A-	A-2
Rating Outlook	Stable	
Rating Date	*April 22nd, 2019*	

COMPANY INFORMATION	
Incorporated in 2016	**External auditors:** Mushtaq & Co Chartered Accountants
Public Limited Company	**Chairman of the Board:** Mian Muhammad Saleem
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Muhammad Shakeel Umer
Umer Group & Associates – 50%	
RYK Group & Associates – 50%	

APPLICABLE METHODOLOGY(IES)
Applicable Rating Criteria: Corporates (May, 2016)
https://www.vis.com.pk/kc-meth.aspx

Two Star Industries (Pvt.) Limited

OVERVIEW OF THE INSTITUTION

Two Star Industries (Pvt.) Limited was incorporated in November 2016 under the Companies Act 2017. The manufacturing facility is located at Kot Khatra, Rajana to Kamalia Road, District Toba Tek Singh

Profile of CEO

Mr. Shakeel is the CEO and director of the company with over 37 years of experience. He has been on the board of directors of other group companies including Bhanero Textile Mills Limited, Blessed Textile Mills Limited and Faisal Spinning Mills Limited.

RATING RATIONALE

Group Profile

Umer group and associates (UG) holds 50% ownership in Two Star Industries (Pvt.) Limited (TSIL) while the other half is owned by RYK group (RYK) and associates. UG has diversified presence in the footwear, retail, leather, dairy, power generation, sugar, and construction sectors; however, its core strength lies in the textile business. UG operates through 3 companies in the textile sector.

RYK Group is primarily involved in agribusiness & bio-energy. RYK comprises two integrated sugarcane processing companies: RYK Sugar Mill Limited & Alliance Sugar Mills (Pvt.) Limited.

Company Profile

TSIL was incorporated in October 2016 by way of acquiring the manufacturing facility of Kamalia Sugar Mills Limited which has been operational since 1976. The company had 2 units with crushing capacity of 6000 and 8000 tons per day during MY18. Post-BMR, the manufacturing facility can crush cane upto 19,500 tons per day. Head office of the company is situated in Lahore and manufacturing facility is located in Toba Tek Singh.

Industry Dynamics

Sugar

Local demand supply dynamics projected to depict some improvement in MY19; upward pressure expected in local prices

Over the last two years, excess supply of sugar has prevailed on account of sugar production outpacing the overall consumption. Significant increase in production and lower allowable export quota set by the Government resulted in a sizeable increase in ending inventory at end-MY17. While production continued to outpace supply, higher export quota of 1.5m tons (with subsidy benefit by federal government and an additional subsidy by Sindh government for sugar mills in Sindh) has facilitated in reducing inventory levels which continued to remain at elevated levels at end-MY18. Decline in production for MY19 (expected to be considerably lower at around 5.5 m tons which would be close to the domestic consumption for MY19) along with export quota of 1.1m tons allowed is expected to improve local demand supply dynamics (resulting in lower ending inventory) and may result in some uptick in prices. However, profitability of sugar mills will remain dependent on quantum of increase in domestic prices of sugar along with quantity of sugar exported. Subsidy allowed by Punjab Government is significantly lower vis-à-vis overall subsidy of prior year while no subsidy has been announced by the Federal and Sindh Government. However, export orders from China of 300,000 tons of sugar from Pakistan at a price of $375 bodes well for industry dynamics; TSIL has committed 10,000 tons in this regard.

Mn Tons	MY16	MY17	MY18
Opening Inventory	0.849	0.777	2.326
Sugar Production	5.1	7.048	6.5
Sugar Available	5.949	7.825	8.826
Domestic Consumption	4.9	5.1	5.4
Exports	0.272	0.399	1.92
Ending Inventory	0.777	2.326	1.5

Global oversupply situation to persist; export prices expected to remain under pressure in MY19

Baring two years (MY16 & MY17), global production of sugar has outpaced consumption over the last decade resulting in sizeable global sugar ending inventory. Resultantly, ending inventory has stood at over 50% of the total consumption over the last 5 years. The demand-supply dynamics have kept international sugar prices on the lower side during MY18 (Average sugar prices were $357.5/tonne in MY18 vis-à-vis $477.4/tonne in MY17). Going forward, global stock levels are projected to rise as higher production from India is expected to offset decline in production in Brazil and European Union. Resultantly, international prices are expected to remain bearish during MY19 with exports for local producers being only profitable with subsidy support from government. India is forecasted to become the largest sugar producer (due to enhanced yields and increase in area under cultivation) in the world in MY19 overtaking Brazil for the first time in the last fifteen years. Other major sugar producers include Brazil, Thailand, China, USA, Mexico, and Pakistan.

Mn Tons	MY16	MY17	MY18
Opening Inventory	96.40	91.21	88.06
Sugar Production	164.20	168.30	179.44
Sugar Available	260.60	259.51	267.50
Consumption	169.09	171.40	174.40
Import Demand	66.00	60.04	57.40
Exports	66.30	60.10	61.09
Ending Inventory	91.21	88.06	89.41

Existing pricing dynamics are a drag on the profitability of the sector. Based on current international prices and existing exchange rate, international prices are still at a discount to local prices

Local retail prices which are driven by market forces had remained depressed during FY18 on account of surplus supply of sugar. Higher fixed sugarcane prices set by the government to facilitate growers and farmers coupled with depressed retail prices had compressed margins for the industry. Given the recent increase in sugar prices, this trend has reversed with retail prices now being higher vis-à-vis cost of production. Resultantly, margins and profitability are expected to show case some improvement. On the export front, current international prices (assuming exchange rate of 140)

translate into a discount vis-à-vis local prices.

Per Kg Prices	MY14	MY15	MY16	MY17	MY18
Average Local Prices (Rs)	54.8	58.91	63.77	61.43	53.57
Average International Prices (USD)	0.459	0.377	0.461	0.474	0.358

Operating Performance

The company operated at a crushing capacity of 14,000 tons per day with an average recovery rate of 9.57% (MY17: 9.47%) during MY18. However the company undertook BMR which has resulted in an enhancement of capacity to 19,500 tons per day. Crushing volume was recorded at 1.69m MT during MY18 vis-à-vis 1.79m MT in MY17 mainly due to lower number of days in operation for the sugar mill. As a result, plant operated at a capacity utilization of 87% during MY18. In line with lower volumes crushed despite slightly higher recovery rate, sugar production witnessed a slight decline during MY18 vis-à-vis last year. Meanwhile, higher availability of sugar has kept production volumes for molasses on the higher side. In line with the increase in production capacity, volumes of molasses production are also expected to increase, going forward.

Operating Performance	MY17	MY18
Capacity per day	14,000	14,000
Crushing Period	149	139
Total Crushing Capacity (MT)	2,086,000	1,946,000
Cane Crushed (MT)	1,794,534	1,698,598
Utilization	86%	87%
Sugar Production (MT)	169,926	162,514
Recovery Ratio	9.47%	9.57%
Molasses Produced (MT)	83,286	84,845
Molasses Recovery	4.64%	5%

Financial Profile

Enhanced subsidy on exports translated into a significant jump in exports sales and has kept local sales on the lower side. An expected improvement in local pricing dynamics may shift the sales mix towards domestic market, going forward.

In view of higher allowable export quota and subsidy provided by the government, sales composition of the company has witnessed a significant shift. Export sales represented 67% in MY18 vis-à-vis 15% during MY17. Sugar sales clocked in at Rs. 8.2b during MY18 vis-à-vis Rs. 4.7b in MY17 registering a sizeable growth of 74%. Growth in sales was primarily a function of higher volumetric export sales on the back of an extension in export quota and subsidy provided by the government. As per the management, key export markets of the company are Afghanistan and Tajikistan. Given the presence of subsidy from Punjab Government only, export volumes might stay on a lower side.

Stagnant domestic sugar consumption along with prevailing supply glut has pushed down domestic sales for the company. Local sales represented 33% in MY18 vis-à-vis 85% during MY17. Despite

depressed local sales during the outgoing year, pricing dynamics are expected to improve on the back of a lower projected sugarcane produce this year. Given lower subsidy, decreased export quota and an expected improvement in retail pricing, sales mix of the company is projected to shift more towards local sales, going forward.

The company is also engaged in selling molasses which contributed 6% to the overall sales during MY18 vis-à-vis 14% in MY17. The decline in molasses sales is attributable to a dip in price due to high availability of molasses during the outgoing year. However, rates of molasses are currently witnessing an uptick due to restricted overall sugarcane output which is expected to remain high, going forward.

Better profitability was a function of higher volumetric sales growth, lower procurement cost booked and extended export subsidy support provided by the government. Going forward, improved industry dynamics are expected to support overall performance.

Considerable increase in overall gross margins (FY18: 10%; FY17: -4%) were witnessed during FY18. While the company registered superior export margins, local margins have remained under pressure due to absence of subsidy and depressed retail pricing of sugar. Gross profit was recorded at Rs. 860m in MY18 vis-à-vis a gross loss of Rs. 197m during MY17. Increase in export activity resulted into higher distribution and administrative expenses while other income remained stagnant during the outgoing year. As a result, the company recorded an operating profit of Rs. 793m in MY18 vis-à-vis an operating loss of Rs. 227m during MY17. Moreover, finance costs increased to Rs. 690m in MY18 vis-à-vis Rs. 225m due to higher average borrowings mobilized to finance the acquisition of sugar mill. Going forward, monetary tightening is expected to have a considerable impact on bottomline as total borrowings mobilized comprise KIBOR based borrowings; however the impact of higher growth expectation in topline profitability is expected to offset the sizeable finance costs resulting into better overall profitability.

Existing liquidity profile is considered moderate, which is expected to improve.

Funds Flow from Operations increased to Rs. 451m (MY17: -Rs. 455m) in MY18 translating into FFO to long term debt of 0.07x (MY17: Nil). Currently, FFO in relation to the outstanding debt obligations is weak; however the ratio is expected to improve based on higher projected profitability and FFO, going forward. Debt Service Coverage Ratio (DSCR) is projected to remain above 1.0x over the rating horizon. Inventory levels have remained at elevated levels (MY18: Rs. 3b; MY17: Rs. 3.1b). Utilization of short term borrowings stood slightly lower though still remains sizeable (MY18: Rs. 3.94b; MY17: Rs. 4.35b). In line with higher expected sales, inventory level and short term borrowing is projected to decline going forward. Stock in trade and receivables (trade debts and subsidy receivable) represented 102% (MY17: 73%) of short term borrowings at end MY18. Net cash cycle was reported on the higher side at 120 days while current ratio was reported at 0.91x (MY17: 1.14x) at end-MY18

Elevated leverage indicators vis-à-vis rating benchmarks whereas equity base enhanced mainly on account of capital injection. Additional capital injection coupled with expected enhanced profitability would improve capitalization and liquidity indicators, going forward.

The company undertook a long term loan of Rs. 6.7b to finance acquisition of the manufacturing facility in MY18. The facility has a grace period of 2 years with 40 equal quarterly installments to be paid in 10 years. As per the financing terms, repayment of loan would officially commence in MY20 with first installment to be paid in 2QMY20. However, the management intends to repay the first 2

tranches of long term loan in advance by end-MY19. The sponsors have planned to partially finance the early repayments by injecting further equity of Rs. 500m in the ongoing year while remaining amount is planned to be serviced by internal cash generation. The overall interest bearing debt of the company stood at Rs. 10.6b at end-MY18. High debt profile of the company has translated into elevated leverage indicators as gearing stood at 5.33x (MY17: 2.94x) and debt leverage was at 5.71x (MY17: 3.26x) at end-MY18. On the other hand, equity base was supported by sponsor capital injection of Rs. 500m in MY18. Additional planned equity injection along with expectations of higher profitability is projected to lower leverage indicators below 3x by end-MY19.

Two Star Industries (Pvt.) Limited Appendix I

FINANCIAL SUMMARY *(amounts in Rs. in millions)*		
BALANCE SHEET	**MY17**	**MY18**
Fixed Assets	826	9,164
Stock-in-Trade	3,106	3,008
Trade Debts	8	3
Other Receivables	66	931
Cash & Bank Balances	11	7
Other Assets	2,297	282
Total Assets	6,314	13,395
Trade and Other Payables	413	536
Long Term Debt *(*incl. current maturity)*	-	6,713
Short Term Debt	4,358	3,935
Other Liabilities	59	214
Total Liabilities	4,830	11,398
Total Equity	1,484	1,997
INCOME STATEMENT	**MY17**	**MY18**
Net Sales	5,380	8,705
Gross Profit	(197)	860
Operating Profit	(227)	792
Finance Cost	225	690
Profit After Tax	(516)	19
RATIO ANALYSIS	**MY17**	**MY18**
Gross Margin (%)	-4%	10%
Net Margin (%)	-10%	0.22%
PBT Margin (%)	-8%	1%
Net Working Capital	669	(426)
Net Cash Cycle	N/A	120
FFO	(455)	448
FFO to Total Debt (x)	(0.10)	0.04
FFO to Long Term Debt (x)	-	0.07
Current Ratio (x)	1.14	0.91
(Recievables+Inventory/ST Borrowings) (x)	0.73	1.0
Debt Servicing Coverage Ratio (x)	-	-
Gearing (x)	2.94	5.33
Leverage (x)	3.26	5.71
ROAA (%)	-	0.20
ROAE (%)	-	1.12

ISSUE/ISSUER RATING SCALE & DEFINITIONS 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: 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	Two Star Industries (Pvt.) Limited				
Sector	Sugar				
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				
	22-April-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.				
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