The Pakistan Credit Rating Agency Limited

ENGRO FERTILIZERS LIMITED (EFERT)

INSTRUMENT RATING REPORT

	NEW [Nov-16]	PREVIOUS [Nov-15]
Sukuk Certificates (PKR 3,200 mln)	AA-	AA-
Outlook	Stable	Stable

REPORT CONTENTS

NOVEMBER 2016

About the Sukuk

- The company issued Sukuk of PKR 3,200mln during Jul-14 for a tenor of 5 years. The instrument would have over-the-counter (OTC) listing. The issue will have semi-annual coupon payments payable @6MK+1.75%. Redemption of the Sukuk will be in ten stepped-up semi-annual instalments, starting from Jan15. The instrument is secured by a ranking charge over the fixed assets with a 25% margin. Around 10% of the issue amount (PKR 320mln) has been repaid by end-Sep16 with the remaining (PKR 2,880mln) to be repaid in 6 semi-annual instalments

Profile & Ownership

- Engro Fertilizers Limited (EFert), demerged from Engro chemicals in 2010, and is listed on Pakistan Stock exchange
- Majority owned by Engro Corp (56.45%); during the year, ECorp divested 22% stake, as part of strategic re-alignment to explore opportunities in energy sector
- The total designed capacity of EFert's urea plants – base plant: 975,000 MT per annum and Enven: 1,300,000 MT per annum – accounts for ~33% of industry's demonstrated capacity – second largest capacity

Governance and Management

- EFert's board comprises three Engro Corp's executives, three DG representatives and two independent directors
- Mr. Khalid Siraj Subhani, the CEO of the holding company, is the Board Chairman. Mr. Ruhail Muhammad, the President and CEO of EFert, is a seasoned professional with a long association with Engro group

Performance

- Capacity utilization remained persistently above 80% throughout 9M16, except May-16, when it dropped to 53% due to closure of one plant on account of turnaround
- In 9M16, EFert's topline substantially decreased by 21% to PKR 40bln (9M15: PKR 51bln); predominately decline in urea – volumes (21%) as well as price (5%)
- Urea volumes remained under check until Jun16, in anticipation of price cut due to expected subsidy
- Company offloaded urea, post subsidy, at hefty discount to compete amidst abundant supply in the market; all manufacturers operated at full capacity due to improved availability of gas
- The gross margins of the company plummeted to 28% - two third of previous year (40%)
- However, subsidy (9M16: PKR 4bln, 9M15: Nil) recoverable from GoP, and classified as other income, supplemented operating profit of (PKR 7bln, 9M15: PKR 17bln)
- The finance cost of the company declined due to re-profiling of long term debt. The company profitability stood at PKR 5,656mln (9M15: PKR 9,905mln)

Business Strategy

- Going forward, the company envisages continuous supplies of gas, whereas additional gas supply from Mari is pending in a decision by ECC
- Offtakes kicked off post clarity on subsidy, however, real challenge remains offloading inventory in hand; Govt's decision to allow exports shall be beneficial
- Reduced parity with international price shall continue to keep local price under check, herein, gas pricing plays critical role to keep margins afloat.
- Although GIDC declared null and void by Sindh High Court. GoP would challenge the decision or may some other mechanism to fill the revenue gap; hence, transfer of beneficial impact remains uncertain

Financial Risk

- During 9M16, EFert's working capital requirement increased massively, trickled down by supply surplus situation in the country – mainly urea
- The company met the working capital needs of PKR 20bln, partially through internal sources (proceeds from short term investments: PKR 10bln, cash generated from operations: PKR 10bln) and rest finance through short term borrowings of PKR 5.8bln
- Free cash flows from operations (FCFO) declined by 30% to PKR 12bln, inline with topline of the company, thereby, debt coverage dropped to1.3 times (CY15: 1.9x)
- Long term debt level remained intact at PKR 27bln, as the company replaced expensive PPTFC with low cost debt
- Going forward, the company envisages to keep leveraging at current level – an optimal capital structure considered by the management

RATING RATIONALE

The ratings take into account sustained operations of the company; capacity utilization at both plants remained high on the back of continued gas supply from Mari and other. The risk of gas has diminished with strengthening of local reservoirs and continued import of RLNG. Better availability of gas has improved overall availability of urea in the market. This, along with declining international prices, has kept local prices under check. Lately, higher inventory levels forced competitive price reduction, in turn reduction in margins. Industry's ability to manage increasing business risk is dependent on price induced demand increase – that should help off load high inventories and create absorption of improved production levels – and arresting of global downturn in international urea prices. Wherein, any further reduction may force price cut. EFert business fundaments remain largely in line with industry dynamics. It has experienced squeeze in margins and, in turn, cashflows. The financial risk profile of the company is characterized by moderate leveraging, which has currently spurred due to high working capital requirements. EFert continues to derive strength from its association with Engro Corporation – a corporate conglomerate.

KEY RATING DRIVERS

The ratings are dependent on sustained risk profile of the company. Any constraint to perceived ability to keep business and financial risk in respective matrix, may impact the ratings.

INDUSTRY

Pakistan fertilizers sector has production capacity of 6.9mln MT of urea, 0.7mln MT of DAP and 2.2mln MT of others. The industry benefits from the latent demand of its major product urea and oligopolistic market conditions. Industry is currently facing supply surplus issues because of increased capacity utilization and lower international urea price. Margins, though high, are under pressure.

PKR mln

Engro Fertilizers Limited (EFert)

BALANCE SHEET	30-Sep-16	31-Dec-15	31-Dec-14	31-Dec-13
	9M	Annual	Annual	Annual
Non-Current Assets	**75,971**	**72,459**	**75,175**	**79,563**
Investments (Incl. Associates)	**560**	**4,383**	**-**	**-**
Equity	560	4,383	-	-
Current Assets	**34,742**	**16,627**	**11,221**	**12,308**
Inventory	16,477	6,942	1,101	1,382
Trade Receivables	6,790	2,262	757	758
Others	11,474	7,423	9,363	10,168
Total Assets	**111,916**	**105,382**	**111,472**	**109,929**
Debt	**36,421**	**36,074**	**44,003**	**55,821**
Long-term (Incl. Current Maturity of Long-Term Debt)	36,421	36,074	44,003	55,821
Other Short-term Liabilities	26,448	20,164	27,643	19,749
Other Long-term Liabilities	7,820	6,617	5,347	9,290
Shareholder's Equity	**41,227**	**42,526**	**34,478**	**25,069**
Total Liabilities & Equity	**111,916**	**105,382**	**111,472**	**109,929**
INCOME STATEMENT				
Turnover	**40,892**	**87,615**	**61,425**	**50,129**
Gross Profit	11,442	32,180	22,603	22,121
Other Income	3,623	(771)	409	293
Financial Charges	(2,363)	(3,923)	(5,903)	(9,918)
Net Income	**5,656**	**15,027**	**8,208**	**5,497**
Cashflow Statement				
Free Cashflow from Operations (FCFO)	12,391	26,173	19,493	21,350
Net Cash changes in Working Capital	(20,211)	(17,142)	6,661	10,055
Net Cash from Operating Activities	(10,507)	4,641	19,063	24,808
Net Cash from InvestingActivities	7,579	8,165	(5,641)	(17,794)
Net Cash from Financing Activities	2,097	(16,384)	(13,692)	(5,821)
Net Cash generated during the period	(831)	(3,578)	(270)	1,193
Ratio Analysis				
Performance				
Turnover Growth	-21.3%	42.6%	22.5%	63.7%
Gross Margin	28.0%	36.7%	36.8%	44.1%
Net Margin	12.5%	17.2%	13.4%	11.0%
ROE	26.6%	34.4%	25.0%	23.4%
Coverages				
Debt Service Coverage (x) (FCFO/Gross Interest+CMLTD+Uncovered STB)	1.3	1.9	1.6	1.1
Interest Coverage (x) (FCFO/Gross Interest)	5.3	7.0	3.6	2.2
Debt Payback (Years) (Total Lt.Debt (excluding Covered Short Term Borrowings) / FCFO)	2.7	1.5	2.8	6.1
Liquidity				
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	66.8	-86.3	-13.9	6.2
Capital Structure (Total Debt/Total Debt+Equity)	29.7%	45.9%	56.1%	71.1%

The Pakistan Credit Rating Agency Limited

STANDARD RATING SCALES & DEFINITIONS

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

LONG TERM RATINGS	
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments.
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances or economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk**. A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business, and economic environment.
CCC CC C	**Very high credit risk**. "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

SHORT TERM RATINGS

A1+: The highest capacity for timely repayment.

A1:. A strong capacity for timely repayment.

A2: A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.

A3: An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.

B: The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.

C: An inadequate capacity to ensure timely repayment.

Rating Watch
Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. Rating Watch may carry designation – Positive (rating may be raised, negative (lowered), or developing (direction is unclear). A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled.

Outlook (Stable, Positive, Negative, Developing)
Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Suspension
It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, a suspended rating should be considered withdrawn.

Withdrawn
A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, or e) the entity/issuer defaults.

Regulatory and Supplementary Disclosure

Name of Issuer Engro Fertilizers Limited
Name of Issue Engro Fertilizers Limited | Sukuk III | Jul-14
Sector Fertilizers
Type of Relationship Solicited

Purpose of the Rating Independent Risk Assessment

Rating History

Dissemination Date	Rating	Outlook	Action
18-Nov-16	AA-	Stable	Maintain
18-Nov-15	AA-	Stable	Upgrade
08-Jan-15	A+	Stable	Maintain
08-Jul-14	A+	Stable	Initial
23-Jun-14	A+	Stable	Preliminary

Instrument Details

Nature of Instrument	Size of Issue (PKR mln)	Tenor (yrs)	Security	Nature of Assets	Trustee
Sukuk	PKR 3,200mln	5	Mortage on Fixed Assets and Hypothecated charge on current assets	EnVen plant including all its assets at Daharki / Stores and spares at Daharki	Pak Brunei Investment Company Limited

Amortization Schedule: Refer to Annexure I

Related Criteria and Research

Rating Methodology: Corporate Rating Methodology
Sector Research: Fertilizer Sector | Overview | October 2016

Rating Analysts

Shoaib Afzal
shoaib.afzal@pacra.com
(92-42-35869504)

Amara S. Gondal
amara.gondal@pacra.com
(92-42-35869504)

Rating Team Statement

Rating Procedure
Rating is an opinion on relative credit worthiness of an entity or debt instrument. It does not constitute recommendation to buy, hold or sell any security. The rating team for this assignment does not have any beneficial interest, direct or indirect in the rated entity/instrument.

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Probability of Default (PD)

PACRA's Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA's transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA's Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past

Due Date Principal	Opening Principal	Principal Repayment	Due Date Markup/ Profit	Markup/Profit Rate		Markup/Profit Payment	Installment Payable	Principal Outstanding
	PKR in mln			Base	Spread	PKR in mln		
09-Jan-15	3,200	80	09-Jan-15	6M Kibor	175bps	195	275	3,120
09-Jul-15	3,120	80	09-Jul-15	6M Kibor	175bps	238	318	3,040
09-Jan-16	3,040	80	09-Jan-16	6M Kibor	175bps	237	317	2,960
09-Jul-16	2,960	80	09-Jul-16	6M Kibor	175bps	228	308	2,880
09-Jan-17	2,880	320	09-Jan-17	6M Kibor	175bps	227	547	2,560
09-Jul-17	2,560	320	09-Jul-17	6M Kibor	175bps	204	524	2,240
09-Jan-18	2,240	560	09-Jan-18	6M Kibor	175bps	188	748	1,680
09-Jul-18	1,680	560	09-Jul-18	6M Kibor	175bps	151	711	1,120
09-Jan-19	1,120	560	09-Jan-19	6M Kibor	175bps	106	666	560
09-Jul-19	560	560	09-Jul-19	6M Kibor	175bps	58	618	0