The Pakistan Credit Rating Agency Limited

# Rating Report

## Descon Oxychem Limited

**Report Contents**



**Rating History**

| Dissemination Date | Long Term Rating | Short Term Rating | Outlook | Action | Rating Watch |
|---|---|---|---|---|---|
| 30-Jun-2018 | A | A1 | Stable | Maintain | - |
| 30-Jun-2017 | A | A1 | Stable | Maintain | - |
| 22-Sep-2016 | A | A1 | Stable | Maintain | - |
| 11-Dec-2015 | A | A1 | Stable | Maintain | - |
| 12-Dec-2014 | A | A1 | Stable | Maintain | - |

### Rating Rationale and Key Rating Drivers

The ratings recognize the company's leading position in the local Hydrogen Peroxide market, supplemented by efficient production process, sound technological infrastructure, and effective control environment. Ratings also draw comfort from Descon Oxychem's association with a financially sound and experienced business group - DESCON - which has continuously demonstrated support. One of the only two manufacturers in Pakistan market, Descon Oxychem has gradually strengthened its footprints; particularly in north region. Market Share enhanced considerably over the years (FY17: ~53%, FY15: ~44%). Superior capacity utilization than peers takes benefit from advanced technology and specifications backed by required capital investment. Related debt from financial institution has been repaid completely, while debt from associates converted into cumulative, non-voting preference shares. Capitalizing on available fiscal space, the company is poised to take expansion; thereby increasing capacity by 25%, to be financed entirely through debt, to the tune of PKR 1bln. Currently Free cashflows (FCFO) provides requisite cushion for expansion, after servicing for cumulative preference dividends (having character of interest). Lately profitability declined slightly in the wake of thin pricing, translating into lower FCFO. Sustainability of FCFO remains critical, going forward, keeping in view fluctuating nature of hydrogen peroxide international price trend, as well as moderate demand growth in local industry.

The ratings are dependent on improved competitiveness of the company. Timely execution of expansion plan, translation of the same into added profitability, would impact positively on the ratings. Meanwhile smooth operations from current plant would remain important. Prudent management of debt matrix, keeping it conservative, shall be critical.

| Disclosure | |
|---|---|
| **Name of Rated Entity** | Descon Oxychem Limited |
| **Type of Relationship** | Solicited |
| **Purpose of the Rating** | Entity Rating |
| **Applicable Criteria** | Methodology \| Corporate Rating Methodology(Jul-17),Methodology \| Correlation between long-term and short-term rating scale(Jun-17),Methodology \| Criteria Modifiers(Jun-17) |
| **Related Research** | Sector Study \| Hydrogen Peroxide(Jun-18) |
| **Rating Analysts** | Hamza Ghalib \| hamza.ghalib@pacra.com \| +92-42-35869504 |

| Descon Oxychem Limited (DOL) - Profile | |
|---|---|
| **Incorporated** | 2004. |
| **Commercial Production** | 2009. |
| **Legal status** | Listed. |
| **Major business lines** | Manufacturing and sale of $H_2O_2$ |
| **Capacity** | 28,000 MT |
| **Plant Location** | 18-Km Lahore Sheikhupura Road |
| **Head office** | 18-km, Ferozepur Rd, Lahore |

## Industry Snapshot

- $H_2O_2$ (Hydrogen Peroxide - HPO), industry presently has two players (a) DOL and (b) Sitara Peroxide (SPL) with an installed capacity of 28,000 MT and 30,000 MT respectively.
- The domestic demand currently stands close to 66 K tons. Out of the country's total demand ~13%-15% is met through imports while the rest is being catered by two players i.e. DOL and SPL.
- Market Share (DOL: ~53%, SPL: 34%)
- Anti-dumping duty has been imposed on multiple international players.

## Ownership

- DESCON, the principal sponsor of DOL, holds majority shareholding (~61%) through associated companies (~17%) and sponsoring family members (~44%). Meanwhile, 30% and 9% stake rests with general public and financial institutions, respectively.
- DESCON has footholds in engineering business through its flagship company – Descon Engineering Limited. DESCON, over the years, has expanded its horizons beyond Pakistan, particularly the Middle East.

## Governance

- Eight member board of directors including the CEO. Board comprises one executive director, five non-executive, and two independent member. The directors of the company hold senior positions in associated companies and serve on the boards of other group companies.
- Mr. Abdul Razak Dawood - founder and key man behind DESCON - is the Chairman of the board. He is a veteran and business icon. Meanwhile, Mr.Taimur Dawood and Mr.Faisal Dawood, sons of Mr. Abdul Razak Dawood, also serve as directors on the board.
- Four board committees in place; (i) Enterprise Risk Management Committee, (ii) Audit Committee, (iii) Human Resource &Remuneration Committee and (iv) Compliance Committee.

## Management & Control

- Mr. Imran Qureshi is the newly appointed CEO of the company, joined DOL since 28th May 2018. Mr. Imran Qureshi is foreign qualified, having overall experience of ~20 years in his portfolio. Capitalizing his experience amidst expansion plans would remain important.
- Mr. Muhammad Saqib Abbas is the CFO of the company since 2016. All management team is well qualified mostly associated with the company since long. Average experience years of top management clocks in at ~24yrs, reflecting good management profile.
- The company has implemented R12 version of the Oracle E-business suite application, which is also used at other associated companies of DESCON. Top management receives daily performance report of plant's operation throughput which results in optimal monitoring.

## Business Risk

- The major consumer of HPO in the domestic market is the Textile Industry; it represents more than three-fourth of the total domestic demand; this is followed by Paper & Board industry.
- During FY17, the topline of company has improved YoY basis (FY17: PKR 1,961mln; FY16: PKR 1,582mln), up by ~24%. This improvement has been seen on back of increased selling price and meagre increase in the volumes. Cost of production increased by lower proportion (17%) than revenues, culminating improved gross profit margin (FY17: ~26%, FY16: ~22%).
- During FY17, operating expenses have increased by ~7% and reached to PKR ~152mln (FY16: 142mln). Finance cost has decreased significantly (FY17: PKR 12mln; FY16: PKR 77mln) owing to complete repayment of long-term loan, boded well with the profitability (Pre-tax profit margin: FY17: 17%, FY16: 8.5%).
- Improved topline, better performance management and lower finance cost elevated the net profit as the bottom-line of the company ended green (FY17: PKR 205mln; FY16: PKR 45mln).
- During 9MFY18 topline of company decreased (9MFY18: PKR 1,470mln; 9MFY17: PKR 1,497mln) by ~2% YoY owing to declining prices as the company has served DTRE/EOU customers at substantially lower tariffs. DTRE/EOU customers are exempt from all custom duties and related taxation. Cost of sales increased by 1% to PKR 1,092mln (9MFY17: PKR 1,079mln). Gross margin took a hit as high RLNG rate charged to the industry during the winter months (9MFY18: ~26%; 9MFY17: ~28%). Accounting for taxation, net income of the company stood at PKR ~160mln (9MFY17: PKR ~174mln), plunged by ~8%.
- Going forward, management of the company is planning to expand its current production capacity by ~25%. New capacity is expected to come online by FY20. After incorporating expansion, new capacity will be set out to be at 35,000 MT (Current: 28,000 MT). DOL has a capacity utilization of ~122% with the actual production of ~34,300 MT. Post expansion, DOL's actual production would reach to approx. 43,000 MT, replicating strong demand of Hydrogen Peroxide.
- With the new capacity to come online revenues are expected to increase overtime with the CAGR of ~9%. This growth will also enable company to expand its market share while keeping its strong hold in the domestic market.

## Financial Risk

- DOL's cash cycle remained robust as almost all sales are on cash basis while the company is offered a credit period of 90 days by its sourcing partners. Over the years, DOL's working capital management has improved which is evident from continuous reduction in net working capital days (9MFY18: 5 days, end-Jun17: 6 days, end-Jun16: 3 days).
- During 9MFY18, FCFO of the company has reduced to PKR 350mln (9MFY17: PKR 440mln) owing to reduction in profitability, however, coverages remained sturdy attributing to continuous reduction in finance cost. Nevertheless, incorporating cumulative preference dividend (bearing character of interest), interest coverage stand at 2.6x in 9MFY18, though remained adequate on back of offloading debt (FY17: 3.8x)
- During FY17, company has re-paid its long-term borrowings hence slightly levered capital structure (FY17: 2.4%, FY16: 21.2%). The trend is continued in 9MFY18.
- Descon Oxychem's management is planning to expand its current production facility by 7,000 MT with an estimated project cost of PKR ~1.2bln; will be financed through debt. With the new debt to be acquired leveraging is expected to increase to ~40% during FY20.
- As the company plans to acquire debt for the expansion. Herein, timely completion of the projects in order to generate incremental cash flows in line with the debt repayments avoiding any pressure on the coverages would remain critical.

**The Pakistan Credit Rating Agency Limited** | **Financial Summary**

**Descon OxychemLimited** | **PKR mln**

| BALANCE SHEET | 31-Mar-18 | 30-Jun-17 | 31-Mar-17 | 30-Jun-16 | 30-Jun-15 |
|---|---|---|---|---|---|
| | 9M | FY17 | 9M | FY16 | FY15 |
| **Non-Current Assets** | **1,495** | **1,625** | **1,634** | **1,836** | **2,016** |
| **Investments (incl. Associates)** | **-** | **-** | **-** | **-** | **-** |
| Equity | - | - | - | - | - |
| Debt Securities (incl. income funds) | - | - | - | - | - |
| **Current Assets** | **547** | **535** | **560** | **712** | **638** |
| Inventory | 55 | 48 | 24 | 33 | 104 |
| Trade Receivables | 57 | 67 | 108 | 54 | 89 |
| Others | 435 | 420 | 428 | 625 | 446 |
| **Total Assets** | **2,042** | **2,160** | **2,195** | **2,547** | **2,654** |
| | | | | | |
| **Debt/Borrowings** | **77** | **42** | **-** | **407** | **552** |
| Short-Term | 77 | 42 | - | 50 | 52 |
| Long-Term (incl. Current Maturity of Long-Term Debt) | - | - | - | 357 | 500 |
| Other Short-Term Liabilities | 220 | 401 | 508 | 628 | 182 |
| Other Long-Term Liabilities | - | - | - | - | 1,543 |
| **Shareholder's Equity** | **1,745** | **1,717** | **1,687** | **1,513** | **377** |
| **Total Liabilities & Equity** | **2,042** | **2,160** | **2,195** | **2,547** | **2,654** |
| **INCOME STATEMENT** | | | | | |
| **Turnover** | **1,470** | **1,961** | **1,497** | **1,582** | **1,409** |
| Gross Profit | 378 | 507 | 418 | 343 | 268 |
| Other Income | (17) | (9) | (8) | 9 | 6 |
| Financial Charges | (4) | (12) | (11) | (77) | (212) |
| **Net Income** | **160** | **205** | **174** | **45** | **(119)** |
| **Cash Flow Statement** | | | | | |
| Free Cash Flows from Operations (FCFO) | 350 | 541 | 440 | 384 | 269 |
| Net Cash changes in Working Capital | (16) | (44) | (32) | 34 | (38) |
| Net Cash from Operating Activities | 139 | 217 | 225 | 366 | 145 |
| Net Cash from InvestingActivities | (55) | (52) | (4) | (44) | (8) |
| Net Cash from Financing Activities | (97) | (364) | (407) | (175) | (67) |
| Net Cash generated during the period | (13) | (200) | (186) | 146 | 70 |
| **Ratio Analysis** | | | | | |
| **Performance** | | | | | |
| Turnover Growth (v.s same period last year) | -1.8% | 24.0% | 32.3% | 12.2% | -6.0% |
| Gross Margin | 25.7% | 25.8% | 27.9% | 21.7% | 19.0% |
| Net Margin | 10.9% | 10.4% | 11.6% | 2.8% | -8.4% |
| ROE | 12.2% | 11.9% | 13.8% | 3.0% | -31.5% |
| **Coverages** | | | | | |
| Debt Service Coverage (times) (FCFO/Gross Interest+CMLTD+Uncovered STB) | 2.6 | 3.8 | 40.8 | 0.8 | 0.7 |
| Interest Coverage (times) (FCFO/Gross Interest) | 2.6 | 3.8 | 40.8 | 1.8 | 1.3 |
| Debt Payback (Total LT Debt Including Uncovered Total STBs) / (FCFO - Gross I | 0.1 | 0.1 | 0.0 | 2.0 | 47.8 |
| **Liquidity** | | | | | |
| Net Cash Cycle (Inventory Days + Receivable Days - Payable Days) | 5 | 6 | 20 | 3 | 41 |
| **Leveraging** (Total Debt/Total Debt+Equity)** | 4.3% | 2.4% | 0.0% | 21.2% | 88.1% |

***Total Debt = Long-Term Debt + Short-Term Debt*

# Rating Scale

## Credit Rating Scale & Definitions

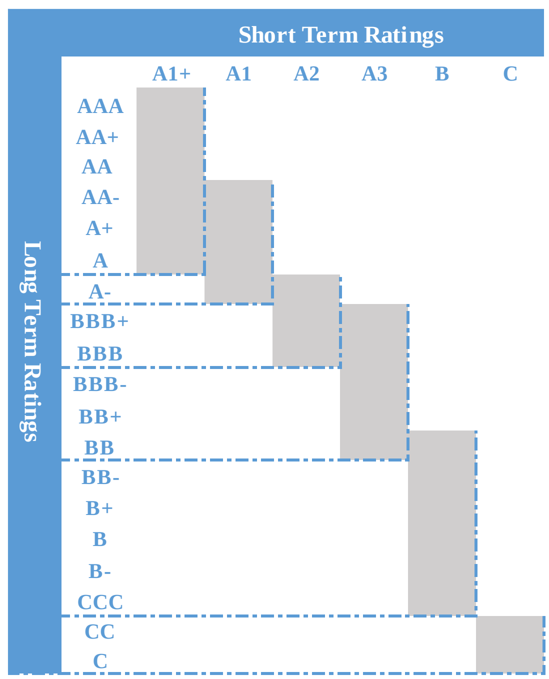
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

### Long Term Ratings

| | |
|---|---|
| AAA | **Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments |
| AA+<br>AA<br>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+<br>A<br>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+<br>BBB<br>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 and in economic conditions are more likely to impair this capacity. |
| BB+<br>BB<br>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+<br>B<br>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<br>CC<br>C | **Very high credit risk.** Substantial 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. |




**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'.

**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. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

**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, the 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, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

**Harmonization** A change in rating due to revision in applicable methodology or underlying scale.

**Rating Team Statements**
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term “family members” shall include only those family members who are dependent on the analyst and members of the rating committee

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(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

**Conduct of Business**
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
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(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
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(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
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(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
**Probability of Default**
(22) 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 | Chapter III | 14-(f-VII)
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