The Pakistan Credit Rating Agency Limited

Rating Report

Mehran Sugar Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
22-Oct-2019	A-	A2	Stable	Maintain	-
03-May-2019	A-	A2	Stable	Maintain	-
03-Dec-2018	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The sugar industry of Pakistan has remained under pressure in recent times. A persistent supply glut negatively impacted players across the industry. Additionally, slowdown in international sugar prices rendered domestically manufactured sugar uncompetitive, making exports viable only through subsidy support. However, prices during the current season (MY19) have improved owing to lower sugar production and depletion of carryover stock. This has impacted profitability for industry players positively. Moreover, retirement of subsidy amount due by the government has eased the liquidity pressure to an extent.

The Ratings reflect Meharan Sugar Mills Limited's (the Company) strong business profile emanating from a diversified revenue stream, robust governance and ability to post high recovery rates consistently, averaging in excess of 11% over the past five years. To mitigate risks associated with seasonality and volatility in the sugar industry, the Company's profitability is supported through a strategic joint venture investment in 'Unicol Limited', an ethanol production company, and sale of electricity generation. The Company has made strategic investments in the FMCG sector through a joint-venture 'UniFoods Industries Limited' and in the energy sector through its wholly-owned subsidiary, 'Mehran Energy Limted'. However, income from these avenues is not expected anytime soon. The Ratings draw comfort from Mehran Sugar's ability to maintain healthy margins despite volatility in the sugar industry and a sizable liquid investment portfolio. The investment portfolio remains exposed to market vicissitude, especially in current dynamics. The Company's financial risk profile is characterized by a leveraged capital structure, strong coverage ratios and adequate working capital management.

The Ratings are dependent on the Company's ability to maintain strong cashflows and coverages while adhering to strict financial discipline, with an increased emphasis on working capital management. Any significant deterioration in margins and/or coverages will have a negative impact on ratings.

Disclosure	
Name of Rated Entity	Mehran Sugar Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	PACRA_Methodology_Corporate_FY19(Jun-19),PACRA_Crtieria_LT ST Relationship_FY19(Jun-19),PACRA_Criteria_Rating Modifiers_FY19(Jun-19)
Related Research	Sector Study | Sugar(Oct-19)
Rating Analysts	Ayesha Malik | ayesha.malik@pacra.com | +92-42-35869504

Profile

Legal Structure Mehran Sugar Mills Limited (the Company) is a public limited company listed on the Pakistan Stock Exchange.

Background The Company was established in 1965 and was listed on the Karachi Stock Exchange in 1968. It began with production capacity of 1,500 TCD. The Company increased capacity to 3,500 TCD and installed a second unit, Tandem B, in 1994. The Company, through a joint venture established a distillery in 2007, 'Unicol Limited', with a production capacity of 200,000 liters/day. It has made investments in the FMCG and energy sectors as well.

Operations The Company is primarily engaged in the production and sale of sugar and ancillary products. It's head office is in Karachi, whereas, the mill is located in Deh Daro Sutha, District Tando Allahyar, over an area of 127 Acres with an installed capacity of 12,500 TCD. The Company also carries a significant investment portfolio and participates in the equity market. Moreover, it has a power generation capacity of 14MW, with excess power sold to HESCO. During MY19, the Company produced 80,332 MT of sugar, 33% less compared to MY18, while yielding a sucrose recovery rate of 11.44% (MY18: 11.52%), one of the highest in the country. Primary factor of low sugar production can be traced to lower crop availability on the back of water shortage faced by farmers across the country.

Ownership

Ownership Structure Majority shareholding rests with individuals of Hasham Family (76%) ('Hasham Group'). Shareholding is divided among families of three brothers, Mr. M. Kasim Hasham (30%), Mr. M. Ebrahim Hasham (28%) and Mr. M. Hussain Hasham (18%). The remaining shareholding is split between the general public and financial institutions.

Stability Ownership is seen as stable as the Company's controlling interest vests with one Group. Each family within the Group holds a defined share in the Company.

Business Acumen The sponsors have presence of over five decades in the sugar industry. In 2004, Hasham Group entered the Ethanol segment through Unicol Limited. The Group has lately ventured into FMCG sector through another joint venture, 'UniFoods Limited'. Other prominent Group entities include, UniEnergy Limited, Pakistan Molasses Company (Pvt.) Ltd and Mogul Tobacco Company (Pvt.) Ltd.

Financial Strength During 9MMY19, the Company alone had an asset base of ~PKR 7.7bln which is supported by an equity base of ~PKR 2.5bln. Total debt stands at ~PKR 2.8bln. Moreover, It achieved a turnover (net) of ~PKR 4bln with a bottom-line of ~PKR 369mln. Mehran Sugar together with other entities of the Group give sufficient strength to the Company to support it times of stress.

Governance

Board Structure The Board comprises eight individuals, which include two executive members, four non- executive members and two independent Directors.

Members' Profile Members have significant experience in the sugar industry, which is balanced by an adequate mix of business, financial, legal and marketing experts. Mr. M. Kasim Hasham, Board Chairman, has significant experience in the sugar and packaging industry. Mr. Amjad Waheed, CEO NBP Funds, and Mr. Mohammad Bashir, an industrialist, serve as independent Directors on Board.

Board Effectiveness During the year four Board meetings were convened with high attendance of members. Additionally, the Board has formed two committees to monitor effectiveness, namely, the Human Resources and Remuneration Committee and the Audit Committee.

Financial Transparency EY Ford Rodhes Chartered Accountants, classified in category 'A' by the SBP, with a satisfactory QCR rating are the external auditors of the Company. They have expressed an unqualified opinion on the financial statements of the Company for the year ending in September, 2018.

Management

Organizational Structure Organizational structure is split between the head office and production site. All functions at site are headed by the Resident Director. The CFO, Resident Director & Director Cane/ Development report directly to the Managing Director. The Company is headed by the Managing Director under the oversight of the CEO.

Management Team Senior management has long association with the Company adding the required experience in sugar industry and their respective fields. During the year, Mr. Muhammad Hanif Aziz resigned from his position as company secretary. He was replaced by Mr. Sumair Ali Khan and still continues his role as CFO.

Effectiveness The Company has instituted an Executive Committee comprising of all head of departments headed by the CEO and MD. The Committee meets on a monthly basis for review performance and enable short-term decision making.

MIS The Company has deployed an integrated in-house system, which has a Sugar Cane Management module, Store Management module and HR module. Further, it has installed a Investment Portfolio Management System to ensure effective oversight of it's short-term investments.

Control Environment The Company has a sufficiently staffed in-house internal audit department that reports directly to the Board's Audit Committee.

Business Risk

Industry Dynamics Pakistan's sugar industry is the 2nd largest agro based industry, comprising ~90 mills with annual crushing capacity estimated around 65 – 70 mln MT. The sugar industry of Pakistan has remained under pressure in recent times. Prices during the current season (MY19) have improved owing to lower sugar production and depletion of carryover stock. Sugar production fell by ~20%, YoY, to 5.3mln MT. This has impacted the profitability for industry players positively. Moreover, provision of subsidy amount by the government has eased the liquidity pressure. An export quota of 1.1mln tons was approved, nonetheless, absence of subsidy led to low quantities availed. During the FY20 budget, sales tax levied on sugar was increased to 17% charged on the price of PKR 60/KG, effective from July 1, 2019. Additionally, provision of CNIC for all buyers has been made mandatory. This has been made effective from August 1, 2019.

Relative Position Owing to high number of players in the industry, companies relatively have low market share. The Company had a market share of ~ 1% during MY19.

Revenues The Company's top line comprises of sugar sales along with the sale of by products (bagasse and molasses). Revenue is dominated by sugar sales, contributing ~90% towards total revenue, with by-product sales summing up to a relatively nominal figure. During 9MMY19, the Company posted net revenue of ~PKR 3,995mln, an increase of 8%, YoY. Increased revenue can be seen as a factor of higher sugar prices and unloading of accumulated carry over stock. Moreover, the Company was able to gain higher prices on the sale of by-products. However, revenue growth was curtailed owing to lower production during the current season and absence of exports.

Margins During 9MMY19, the Company posted a gross margin of ~20%, as compared to ~11% in 9MMY18 on the back of higher domestic sugar prices. Similarly, a slight reduction in administration costs and absence of exports, leading to lower distribution costs, resulted in an operating margin of ~15% during 9MMY19 (9MM18: 3%). The Company's overall profitability is supported by supplementary income from strategic investments. During 9MMY19, net inflow of ~PKR 191mln was received. Overall profitability remained subdued as finance costs during 9MMY19 more than doubled, YoY, standing at ~PKR 290mln (9MMY18: ~PKR 138mln). The Company posted a net profit of ~PKR 369mln during 9MMY19 (9MMY18: ~PKR 287mln), translating into a margin of ~9% (9MMY18: ~6%) .

Sustainability Going forward, the Company plans on enhancing business performance through efficiency in operations. Profitability can be impacted due to subdued stock market as the Company has a sizable investment portfolio.

Financial Risk

Working Capital During 9MMY19, the Company was able to improve net working capital days on the back of lower inventory days as it offloaded carry over stock during the period. Inventory days during 9MMY19 dropped to 114 days as compared to 123 days in 9MMY18. As a result of this, net working capital days stood at 117 days during 9MMY19 (9MMY18: 131 days). Persistence of short-term debt mismatch continued through 9MMY19. However, a sizeable portfolio of liquid short-term investments provide comfort.

Coverages FCFO during 9MMY19 increased to ~PKR 703mln (9MMY18: ~PKR 264mln) on the back of better profitability. However, a 102% increase in finance costs led to only a slight improvement in coverage ratios. During the nine month period, interest coverage increased to 2.6x as compared to 2.1x in the corresponding period. Meanwhile, core coverage increased to 1.4x as compared to 0.9x in 9MMY18.

Capitalization The Company has a leveraged capital structure, represented by a debt-to-equity ratio of ~59% during 9MMY19. Total debt is inclined towards short-term borrowings, which represented 68% of total borrowings in 9MMY19. Short-term lines are utilized to support operations during the crushing cycle. During 9MMY19, total borrowings stood at ~PKR 3,619mln, reflecting a reduction of 16% over 9MMY18. This was primarily attributable to relatively lower short-term borrowings.

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Financial Summary
PKR mln

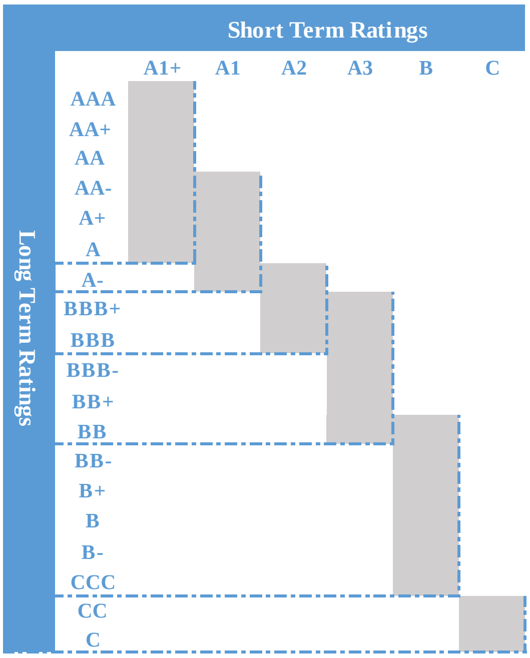
Mehran Sugar Mills Limited	Jun-19	Sep-18	Sep-17	Sep-16
Sugar	9M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	2,159	2,169	2,189	1,954
2 Investments	1,065	1,259	830	1,106
3 Related Party Exposure	1,248	1,192	982	769
4 Current Assets	3,247	2,215	1,721	688
a Inventories	*2,164*	*1,167*	*1,223*	*456*
b Trade Receivables	*354*	*131*	*175*	*11*
5 Total Assets	7,719	6,834	5,723	4,517
6 Current Liabilities	1,112	858	1,248	1,168
a Trade Payables	*295*	*98*	*132*	*91*
7 Borrowings	3,619	2,955	1,778	509
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	451	412	478	517
10 Net Assets	2,538	2,609	2,219	2,323
11 Shareholders' Equity	2,538	2,609	2,218	2,323
B INCOME STATEMENT				
1 Sales	3,995	4,791	5,501	7,113
a Cost of Good Sold	*(3,192)*	*(4,201)*	*(5,233)*	*(6,370)*
2 Gross Profit	803	590	268	743
a Operating Expenses	(221)	(388)	(326)	(234)
3 Operating Profit	582	202	(59)	509
a Non Operating Income or (Expense)	*190*	*440*	*453*	*258*
4 Profit or (Loss) before Interest and Tax	772	642	395	766
a Total Finance Cost	*(290)*	*(212)*	*(197)*	*(98)*
b Taxation	*(112)*	*(17)*	*(67)*	*(126)*
6 Net Income Or (Loss)	369	413	131	542
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*703*	*425*	*23*	*675*
b Net Cash from Operating Activities before Working Capital Changes	*646*	*454*	*(150)*	*597*
c Changes in Working Capital	*(783)*	*(877)*	*(928)*	*419*
1 Net Cash provided by Operating Activities	(138)	(422)	(1,078)	1,016
2 Net Cash (Used in) or Available From Investing Activities	(318)	(741)	17	(658)
3 Net Cash (Used in) or Available From Financing Activities	527	1,150	1,055	(370)
4 Net Cash generated or (Used) during the period	71	(13)	(6)	(11)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	11.2%	-12.9%	-22.7%	--
b Gross Profit Margin	20.1%	12.3%	4.9%	10.4%
c Net Profit Margin	9.2%	8.6%	2.4%	7.6%
d Cash Conversion Efficiency (EBITDA/Sales)	19.3%	11.0%	3.7%	10.5%
e Return on Equity (ROE)	19.1%	17.1%	5.8%	25.9%
2 Working Capital Management				
a Gross Working Capital (Average Days)	131	103	62	100
b Net Working Capital (Average Days)	117	95	54	96
c Current Ratio (Total Current Assets/Total Current Liabilities)	2.9	2.6	1.4	0.6
3 Coverages				
a EBITDA / Finance Cost	2.9	2.7	1.1	7.8
b FCFO / Finance Cost+CMLTB+Excess STB	1.4	1.0	0.1	2.4
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	2.0	4.3	-4.0	0.9
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	58.8%	53.1%	44.5%	18.0%
b Interest or Markup Payable (Days)	109.4	92.0	0.0	0.0
c Average Borrowing Rate	10.8%	8.3%	16.4%	16.7%

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+ 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 and in 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.** 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.

Regulatory and Supplementary Disclosure

(Credit Rating Companies Regulations,2016)

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

Restrictions

(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(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.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest

(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
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review

(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)

Proprietary Information