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
02-Jul-2019	A	A1	Positive	Maintain	-
31-Dec-2018	A	A1	Positive	Maintain	-
30-Jun-2018	A	A1	Stable	Maintain	-
30-Jun-2017	A	A1	Stable	Maintain	-
22-Sep-2016	A	A1	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

The ratings recognize Descon Oxychem's leading position in the local Hydrogen Peroxide market, supplemented by efficient production processes, sound technological infrastructure and effective control environment. One of the only two manufacturers in Pakistan's market, Descon Oxychem has gradually strengthened its footprint; particularly in the North region. Recent upturn in global HPO prices accompanied by Pakistan Rupee devaluation has boded well with the Company's profitability. Meanwhile, financial risk profile remains strong characterized by efficient working capital management and strong cashflows. With expectation of continued growth in demand for HPO, the Company is presently undergoing 25% capacity expansion to be financed mainly by debt amounting to ~PKR 1.5bln. Timely execution of expansion and generation of incremental cash flows is critical to sustain higher level of leveraging. Ratings further draw comfort from Descon Oxychem's association with a financially sound and experienced business group - DESCON - which has continuously demonstrated support.

The ratings are dependent on improved competitiveness of the company. Timely execution of expansion plan and translation of the same into improved 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 Ratings(Jun-18),Methodology | Criteria | Rating Modifier(Jun-18),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study | Chemical(Jun-19)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Descon Oxychem Limited (Descon Oxychem) is a public limited concern incorporated in 2004.

Background Descon Oxychem was incorporated as a private limited company and was listed in September, 2008. It is a project of the Descon Group. Following commissioning in October 2008, the Company's plant started commercial production in March 2009.

Operations The main business of Descon Oxychem is the manufacture and distribution of Hydrogen Peroxide (HPO) up to 60% concentration. Its production facility is located at 18 Km Lahore Sheikhupura Road consisting of an HPO plant with a capacity of 28,000 MT per anum and a Hydrogen plant.

Ownership

Ownership Structure The major shareholding of Descon Oxychem (~61%) lies with the Descon Group through Group companies. In Dec17, as part of the Group's scheme of corporate restructuring, the stake of Descon Engineering Limited as well as the sponsor family individuals was transferred to DEL Chemicals (Private) Limited. DEL Chemicals (Private) Limited is now the holding company of Descon Oxychem Limited with ~51% shareholding. Meanwhile, 39% of the company's stake rests with the general public and public sector Institutions.

Stability The transfer of the Company's ownership to a holding company provides clarity to Descon Oxychem's ownership structure, boding well for its stability.

Business Acumen Descon Oxychem has been operating in engineering, chemicals and power as its core businesses since 1977. Mr. Abdul Razak Dawood, current Advisor to the Prime Minister for Commerce, Textile, Industry and Production, is founder and former Chairman of the Descon Group. The Razak Dawood Family is one of the well-known business families of the Country.

Financial Strength The Descon Group has expanded its footing in diversified business avenues with a sizable portfolio of strategic investments, enhancing the Group's financial strength. The Group has shown willingness and ability to support the Group companies in times of need.

Governance

Board Structure Descon Oxychem's Board comprises eight-members. Mr. Abdul Razak Dawood resigned as Chairman of the Board in Aug18 upon appointment as Advisor to Prime Minister for Commerce, Textile, Industry and Production, and was replaced by Mr. Taimur Dawood. The Board now comprises one executive director, four non-executive, and three independent members. The Board structure is considered strong.

Members' Profile Descon Oxychem's Board comprises highly qualified members and has a blend of business studies, engineering and finance professionals. Mr. Taimur Dawood, Chairman, leads the Board with over 15 years of work experience in diversified sectors.

Board Effectiveness Strong attendance of Board members in Board meetings and proper documentation of minutes bodes well for the Board's effectiveness. Further, four Board committees have been formed to assist the Board.

Financial Transparency A.F. Ferguson & Co., listed in Category "A" of the State Bank's panel of auditors, is the external auditor of the company. They expressed an unqualified opinion on the company's financial statements for FY18 and 1HFY19. The Company has outsourced its internal audit function to KPMG Taseer Hadi & Co.

Management

Organizational Structure The Company operates through seven functional departments, each headed by an experienced manager. Some business functions including IT, Human Resources and Accounting & Finance are shared at Group level.

Management Team Mr. Imran Qureshi is the current CEO of Descon Oxychem, appointed in May18. Mr. Imran has overall 20 years of experience experience in the textile, chemical and paints sectors. Mr. Imran is assisted by an experienced and professional management team.

Effectiveness Descon Oxychem's senior management receives daily performance reports of the plant's operations which results in optimal monitoring. Key management personnel meet on daily and weekly basis to discuss key issues, reflecting well on the management's effectiveness.

MIS The company has implemented R12 version of the Oracle E-business suite application, which is also used at other associated companies of Descon. The ERP solution generates various MIS reports related to production, inventory management, sales and trade receivables/payables, resulting in to better reporting and increased efficiency.

Control Environment The Company's HPO plant was supplied by Chematur Engineering, Sweden; regular visits by Chematur's staff also ensure efficient operations and high quality of final product. Descon Oxychem has been given the license to be the sole operator of Chematur technology in Pakistan. Descon Oxychem has implemented Quality hygiene Safety Model and Reliability Centre Management which helped to improve plant reliability.

Business Risk

Industry Dynamics Pakistan's HPO industry presently comprises two players: Descon Oxychem and Sitara Peroxide with an installed capacity of 28,000 MT and 30,000 MT respectively. Currently, the domestic demand outstrips the supply and is estimated at ~69,500 MT. Hence, ~15-20% of demand is met through imports. Going forward, Engro Polymer and Chemicals is entering the HPO industry with 20,000 MT capacity. Anti-dumping duties have been imposed on multiple international players.

Relative Position Presently, Descon Oxychem remains the HPO market leader with market share of ~51%. With Engro Polymer and Chemicals' new plant, the Company's market share may diminish, going forward. However, with continually rising local demand and capacity expansion underway, Descon Oxychem is expected to remain the leading player.

Revenues Descon Oxychem derives its revenues predominantly from local sales (~99%). In 9MFY19, its revenues witnessed robust growth of ~39%, amounting to ~PKR 2,039mln, on the back of higher HPO prices driven by an increase in international pricing complimented by the devaluation of Pakistan Rupee.

Margins Due to increase in the cost of gas (owing to higher RLNG component in gas mix) and electricity, the main raw materials for the production of HPO, the Company's production cost rose ~23% during 9MFY19. However, it was able to transfer this cost to end consumers on the back of higher prices. Resultantly, gross margins increased to ~34% (9MFY18: ~26%), and are expected to stabilize around ~30% in the near future. Finance cost increased by ~40% during the period owing to payment of preference dividend as well as interest on long-term loan availed during the period for redemption of preference shares. Nevertheless, the bottomline showed robust growth, amounting to ~PKR 232mln (9MFY18: ~PKR 27mln) driven by strong revenue growth and cost controls.

Sustainability The Company is currently in the process of expanding its production capacity by ~25%. The new capacity is expected to be online by 2HFY20. After incorporating the expansion, the new capacity will set out to be 35,000 MT. In FY18, the Company carried out de-bottlenecking of its plant, enabling it to achieve ~120% capacity utilization. Post expansion, Descon Oxychem's actual production would reach ~43,000 MT, replicating strong demand of HPO. Since power is a key resource, the Company has installed a diesel generator to ensure uninterrupted power supply.

Financial Risk

Working Capital Descon Oxychem's cash cycle remains robust as nearly all sales are on cash basis while the company is offered a credit period of 90 days by its sourcing partners. Over the years, working capital management has improved which is evident from continuous reduction in net working capital day which stood at 8 days in 9MFY19 (9MFY18: 5 days). The Company also maintains a significant borrowing cushion.

Coverages In 9MFY19, the Company's operational cashflows witnessed strong growth (~50%), amounting to ~PKR 530mln owing to improvement in profitability. Due to interest on sponsor loan acquired during the period and cumulative preference dividend, the Company's interest coverage clocked in at 2.3x in 9MFY19 (9MFY18: 2.6x) while core debt coverage amounted to 1.9x (9MFY18: 2.6x).

Capitalization Descon Oxychem's leveraging has decreased over the years. Leveraging stood at ~58% in 9MFY19 (9MFY18: ~65%), comprising primarily of a long-term loan of ~PKR 1.1bln obtained from an associated concern for redemption of preference shares. Going forward, leveraging is expected to rise up to ~65% when the Company further acquires a long-term loan of ~PKR 1.5bln for financing its expansion project.

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Financial Summary
PKR mln

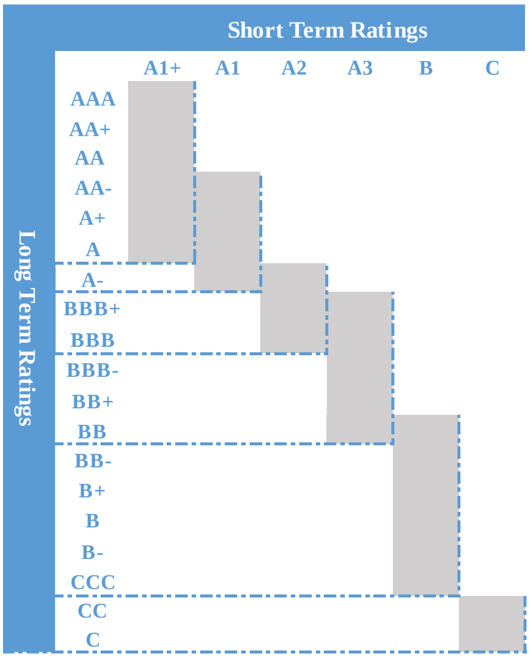
Descon Oxychem Limited	Mar-19	Jun-18	Jun-17	Jun-16
Chemicals	9M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	1,474	1,455	1,625	1,836
2 Investments	-	-	-	-
3 Related Party Exposure	-	-	-	-
4 Current Assets	728	585	535	712
a Inventories	*87*	*26*	*48*	*33*
b Trade Receivables	*119*	*39*	*67*	*54*
5 Total Assets	2,202	2,039	2,160	2,547
6 Current Liabilities	298	263	401	628
a Trade Payables	*65*	*90*	*85*	*72*
7 Borrowings	120	-	42	407
8 Related Party Exposure	978	1,100	1,100	1,100
9 Non-Current Liabilities	-	-	-	-
10 Net Assets	806	676	617	413
11 Shareholders' Equity	806	676	617	413
B INCOME STATEMENT				
1 Sales	2,039	2,088	1,961	1,582
a Cost of Good Sold	*(1,347)*	*(1,472)*	*(1,454)*	*(1,238)*
2 Gross Porfit	692	616	507	343
a Operating Expenses	(117)	(152)	(152)	(142)
3 Operating Profit	574	465	354	201
a Non Operating Income	*(31)*	*(6)*	*(9)*	*9*
4 Profit or (Loss) before Interest and Tax	543	459	345	210
a Total Finance Cost	*(230)*	*(269)*	*(12)*	*(77)*
b Taxation	*(81)*	*(132)*	*(129)*	*(89)*
6 Net Income Or (Loss)	232	58	205	45
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*530*	*591*	*541*	*384*
b Net Cash from Operating Activities before Working Capital Changes	*527*	*394*	*261*	*332*
c Changes in Working Capital	*(181)*	*54*	*(44)*	*34*
1 Net Cash provided by Operating Activities	345	449	217	366
2 Net Cash (Used in) or Available From Investing Activities	(146)	(51)	(52)	(44)
3 Net Cash (Used in) or Available From Financing Activities	(216)	(306)	(364)	(175)
4 Net Cash generated or (Used) during the period	(17)	91	(200)	146
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	30.2%	6.5%	24.0%	12.2%
b Gross Profit Margin	33.9%	29.5%	25.8%	21.7%
c Net Profit Margin	11.4%	2.8%	10.4%	2.8%
d Cash Conversion Efficiency (EBITDA/Sales)	33.0%	29.9%	28.0%	24.8%
e Return on Equity (ROE)	41.8%	9.0%	39.8%	11.4%
2 Working Capital Management				
a Gross Working Capital (Average Days)	18	16	19	32
b Net Working Capital (Average Days)	8	0	4	20
c Current Ratio (Total Current Assets/Total Current Liabilities)	2.4	2.2	1.3	1.1
3 Coverages				
a EBITDA / Finance Cost	2.9	2.3	68.4	5.5
b FCFO / Finance Cost+CMLTB+Excess STB	1.9	2.2	67.4	1.2
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	2.6	3.4	2.1	4.7
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	57.7%	62.0%	64.9%	78.5%

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