The Pakistan Credit Rating Agency Limited

Rating Report

Engro Polymer & Chemicals Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
18-Jul-2020	AA-	A1+	Stable	Maintain	-
19-Jul-2019	AA-	A1+	Stable	Maintain	-
18-Jan-2019	AA-	A1+	Stable	Maintain	-
19-Jul-2018	AA-	A1+	Stable	Upgrade	-
25-Jan-2018	A+	A1+	Stable	Upgrade	-
30-Jun-2017	A	A1	Stable	Upgrade	-
30-Jun-2016	A-	A2	Stable	Maintain	-
30-Jun-2015	A-	A2	Stable	Downgrade	-

Rating Rationale and Key Rating Drivers

The ratings recognize Engro Polymer's ('EPCL' or 'The Company') established foothold in the local Poly Vinyl Chloride (PVC) and caustic soda market. EPCL is the only manufacturer of PVC with a market share of ~68% in domestic market. Better PVC prices and improved vinyl chain dynamics led to higher revenues in CY19. However, due to Covid-19 outbreak, demand of PVC suffered, affecting the Company's profitability. Demand remained suppressed during initial few months of CY20 but it has started to recover since, due to easing of lockdowns and resumption of construction activities. The Company has undertaken various expansion projects that include both enhancements in capacity of existing product lines and introduction of new products to diversify EPCL's product mix. These include addition of 100K tons capacity to PVC and 50K tons to VCM. CAPEX amount of this project stands at ~PKR 11.5bln after some revision in project cost and currency devaluation. The Company is also entering Hydrogen Per Oxide market through a green field manufacturing facility by investing ~USD 23mln. Due to Covid-19 outbreak and subsequent lockdown, progress of expansion projects has been slow. The revised timeline for PVC/VCM expansion has been extended by 3 months to 6 months and for other projects by 6 months to 1 year due to Covid-19 led shipment disruptions. The Company issued right shares of PKR 5.4bln and raised debt to finance these projects. The Company still enjoys very strong liquidity position on the back of sizable deposits and liquid assets, supplementing it cashflows. The ratings incorporate, EPCL's association with one of the country's leading conglomerate – Engro Corp – and very strong financial profile of the sponsor.

The ratings are dependent upon holding sustained operations and improvement in margins. Successful execution of planned expansion projects, while maintaining stable coverages would remain important to uphold ratings. Sustenance of import and anti-dumping duty is important for the sustainability of the risk profile of the Company.

Disclosure

Name of Rated Entity	Engro Polymer & Chemicals Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-20),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria | Rating Modifier(Jun-20)
Related Research	Sector Study | Chemical(Jul-20)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Engro Polymer and Chemicals Limited ('EPCL' or 'The Company'), established in 1997 and is listed on Pakistan Stock Exchange.

Background Engro Polymer and Chemicals Limited, formerly known as Engro Asahi Polymer and Chemicals Limited, is the only Poly Vinyl Chloride (PVC) manufacturer in Pakistan. The Company is the only fully integrated chemical production facility in the country, located at Port Qasim, Karachi.

Operations The Company is primarily involved in the manufacturing, marketing and distribution of PVC and its allied products with an annual capacity of 195KT. The Company also produces Caustic Soda and its allied products. The Company meets its electricity requirement through captive generation capacity of ~66MW.

Ownership

Ownership Structure Engro Polymer and Chemicals Limited is a subsidiary of Engro Corporation Limited which is ultimately owned by DH Group. Engro Corporation holds majority stake in the company (~56%). The other major shareholder is Mitsubishi Corporation (~11%).

Stability Ownership structure of the Company displays a composite outlook, with defined shareholding pattern of all parties.

Business Acumen Dawood Group is a conglomerate with over three generations of experience in commercial and social enterprises. Currently, the Group has interests in various sectors of the economy including Fertilizers, Foods, Power Generation, Technology, Financial Services, Chemical Storage, and Petrochemicals.

Financial Strength Dawood Group's main holding company is DH Corp. The Groups' main investments in Engro Corp are consolidated in DH Corp. DH Corp had a strong consolidated asset base of ~ PKR 574bln supported by an equity base of ~ PKR 208bln in CY19, signifying a robust strength.

Governance

Board Structure The Board of Directors (BoD) comprises nine members. Five members are from Engro Corp, one member represents Mitsubishi Corporation and the remaining three are independent directors.

Members' Profile Members of the board have a good mix of skills and experience. Mr. Ghias Uddin Khan – the CEO of Engro Corp, is Non-Executive Chairman of Engro Polymer & Chemicals Limited. He helps set a cohesive direction to create growth and value for the group of companies by focusing on long-term strategy and digital transformation.

Board Effectiveness The board has two committees in place; (i) Board Audit Committee and (ii) Board People's Committee. Board Committees are chaired by independent directors to ensure transparent governance.

Financial Transparency A.F.Ferguson & Co. Chartered Accountants are the auditors of the Company. The said firm falls in category 'A' of SBP's panel of auditors. They expressed an unqualified opinion on the Company's financial statements for year ended December 31st, 2019.

Management

Organizational Structure The Company operates through eight departments, each headed by an experienced manager. These departments include (i) Audit (ii) Public Affairs (iii) Manufacturing (iv) Marketing (v) Supply Chain (vi) Finance, (vii) Human Resource and (viii) Projects. Each department head directly reports to the CEO.

Management Team A very well qualified and experienced management team is there to run the business operations efficiently. The newly appointed CEO, Mr. Jahangir Piracha, has a degree in chemical engineering with diverse corporate experience spanning over 25 years.

Effectiveness The strong organizational structure ensures effective delegation of functional responsibility across various departments, facilitating a smooth flow of operations. There is a management committee headed by CEO, Mr. Jahangir Piracha to oversee and resolve all operational and managerial issues.

MIS The Company has SAP as ERP solution. Going forward the Company's corporate objective is implementation of state-of-the-art end to end ERP "SAP S4 HANA", including FIORI, Business Planning & Consolidation and Success Factors.

Control Environment The control environment is strengthened by the role of Internal Audit department that provides periodic detailed reports to the Audit Committee for review and assessment and to take necessary remedial actions, where needed.

Business Risk

Industry Dynamics Global PVC demand growth slowed to ~2% during CY19 (CY18: ~3% growth) and clocked at ~44MT (~CY18: 43MT) mainly driven by slowdown in demand for PVC in North American and Europe. However, margins remained healthy and unimpacted as ethylene prices remained in check. Pakistan's per capita PVC consumption remains much lower than regional averages but has the growth potential, as the main reason behind low per capita consumption of PVC is primarily because Pakistan uses PVC in conventional applications e.g. pipes and fittings, film packaging and shoes. Anti-dumping duty is maintained on PVC imports from China, Taiwan, Thailand, and South Korea. Covid-19 led lockdowns adversely affected already slow growth in demand, both locally and internationally.

Relative Position Majority of domestic PVC demand is met through Engro Polymer and Chemicals (~68%). PVC production stood at 197KT with the capacity utilization of 100%. Once the ongoing expansion project concludes, the Company's position in the market will further strength, as its PVC capacity will increase to 295KT. In case of Caustic Soda, Engro Polymer and Chemicals Limited enjoys a state of consistent market share.

Revenues During CY19, the Company's revenue grew by ~7% to PKR 37,837mln (CY18: PKR 35,272mln) mainly due to better average annual prices of PVC. Local sales made up ~98% (CY18: ~97%) of total sales. The Company's topline decreased by ~24% to PKR 7,058mln in 3MCY20 (3MCY19: PKR 9,344mln) because of lower PVC volumes amid Covid-19 related lockdowns.

Margins Despite higher topline, EPCL's gross margins decreased to 21.4% in CY19 (CY18: 24.8%) due to ~31% increase in energy cost. Operating margin remained almost unaltered at 18.9% (CY18: 19%), owing to significant decrease in distribution and marketing expenses during the year. During CY19, the Company net profit decreased to PKR 3,704mln (CY18: PKR 4,917mln) due to the fact that the Company received insurance claims of PKR 547mln and PKR 542mln respectively in CY18, which inflated the profit. As a result, net profit margin decreased to 9.8% (CY18: 13.9%). During 3MCY20, gross margin further decreased to 17.7% (3MCY19: 23.7%) and operating margin to 15.3% (3MCY19: 18.2%) due to volumetric loss. Consequently, the Company's net profit decreased to PKR 168mln during 3MCY20 (3MCY19: PKR 1,092mln).

Sustainability The Company is working on several expansion projects, which include; PVC/VCM expansion, Linear Alkyl Benzene Sulphuric Acid plant, oxygen-based VCM production, High Temperature Direct Chlorination and hydrogen per oxide. Completion of these projects will be delayed due to Covid-19 led interruption. In base operations, demand remained suppressed during initial few months of CY20. However, it has started to recover since, due to easing of lockdowns and resumption of construction activities.

Financial Risk

Working Capital During CY19, the Company's net working capital cycle improved to 12days (CY18: 16days) due to increase in average payable days. The Company availed short term borrowings of PKR 2,159mln in CY19 (CY18: 0), which nullified the impact of increase in net trade assets. Net working cycle remained stable at 12days in 3MCY20 (3MCY19: 15days). Short term borrowings further increased in the period to PKR 3,239mln.

Coverages FCFO decreased by ~9% in CY9 to PKR 8,315mln (CY18: PKR 9,160mln) due to lower profitability. Drop in FCFO resulted in interest coverage ratio declining to 5x (CY18: 16.1x) and debt coverage ratio to 3.1x (CY18: 16.1x). During 3MCY20, interest coverage ratio further decreased to 2.2x (3MCY19: 9x) and debt coverage ratio to 1.5x (3MCY19: 9x). With a decrease in the policy rate of 625bps, coverages are expected to improve.

Capitalization During CY19, the Company's leveraging increased significantly to ~55% (CY18: 30.9%) due to increase a total borrowing to PKR 21,658mln (CY18: PKR 7,500mln) due to increase in long term borrowing and lease liabilities (arising due to application of IFRS 16 covenants). EPCL's leveraging further slightly increased to ~56.1% in 3MCY20 because of increase in total borrowings. The Company issued a privately placed, secured Sukuk of PKR 8.75bln (inclusive of PKR 5bln green shoe option) on 11-Jan-2019 at 3MK+.90bps. Tenor of the Sukuk is 7.5 years with initial 5.5 years as grace period.

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Financial Summary
PKR mln

Engro Polymer & Chemicals Limited Chemicals	Mar-20 3M	Dec-19 12M	Dec-18 12M	Dec-17 12M
A BALANCE SHEET				
1 Non-Current Assets	36,039	34,006	19,589	16,203
2 Investments	-	-	7,703	150
3 Related Party Exposure	1,831	1,800	173	142
4 Current Assets	17,379	16,240	8,506	7,821
a Inventories	*3,648*	*4,303*	*3,581*	*3,681*
b Trade Receivables	*335*	*470*	*430*	*505*
5 Total Assets	55,249	52,045	35,971	24,315
6 Current Liabilities	14,433	12,656	11,337	7,845
a Trade Payables	*4,084*	*2,845*	*3,447*	*1,715*
7 Borrowings	22,918	21,658	7,500	8,750
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	-	-	390	-
10 Net Assets	17,898	17,731	16,744	7,720
11 Shareholders' Equity	17,899	17,731	16,744	7,720
B INCOME STATEMENT				
1 Sales	7,058	37,837	35,272	27,731
a Cost of Good Sold	*(5,807)*	*(29,731)*	*(26,536)*	*(21,665)*
2 Gross Profit	1,251	8,106	8,736	6,065
a Operating Expenses	(170)	(957)	(2,044)	(1,912)
3 Operating Profit	1,082	7,149	6,692	4,153
a Non Operating Income or (Expense)	*(136)*	*(320)*	*363*	*(223)*
4 Profit or (Loss) before Interest and Tax	946	6,828	7,055	3,930
a Total Finance Cost	*(768)*	*(1,786)*	*(606)*	*(821)*
b Taxation	*(10)*	*(1,339)*	*(1,531)*	*(1,060)*
6 Net Income Or (Loss)	168	3,704	4,917	2,049
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*1,548*	*8,315*	*9,160*	*5,863*
b Net Cash from Operating Activities before Working Capital Changes	*706*	*6,828*	*8,183*	*5,212*
c Changes in Working Capital	*1,694*	*(176)*	*1,097*	*(3,363)*
1 Net Cash provided by Operating Activities	2,400	6,652	9,280	1,850
2 Net Cash (Used in) or Available From Investing Activities	(1,922)	(18,917)	(11,474)	(449)
3 Net Cash (Used in) or Available From Financing Activities	(893)	11,683	2,873	(1,092)
4 Net Cash generated or (Used) during the period	(415)	(581)	679	308
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-25.4%	7.3%	27.2%	21.3%
b Gross Profit Margin	17.7%	21.4%	24.8%	21.9%
c Net Profit Margin	2.4%	9.8%	13.9%	7.4%
d Cash Conversion Efficiency (EBITDA/Sales)	27.8%	25.4%	27.2%	22.1%
e Return on Equity (ROE)	3.8%	21.5%	40.2%	29.9%
2 Working Capital Management				
a Gross Working Capital (Average Days)	57	42	42	65
b Net Working Capital (Average Days)	12	12	16	30
c Current Ratio (Total Current Assets/Total Current Liabilities)	1.2	1.3	0.8	1.0
3 Coverages				
a EBITDA / Finance Cost	2.7	5.8	16.9	8.4
b FCFO / Finance Cost+CMLTB+Excess STB	1.5	3.1	16.1	8.0
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	6.0	2.9	0.9	1.7
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	56.1%	55.0%	30.9%	53.1%
b Interest or Markup Payable (Days)	70.1	80.0	41.7	67.5
c Average Borrowing Rate	12.9%	11.5%	7.0%	8.0%

Credit Rating

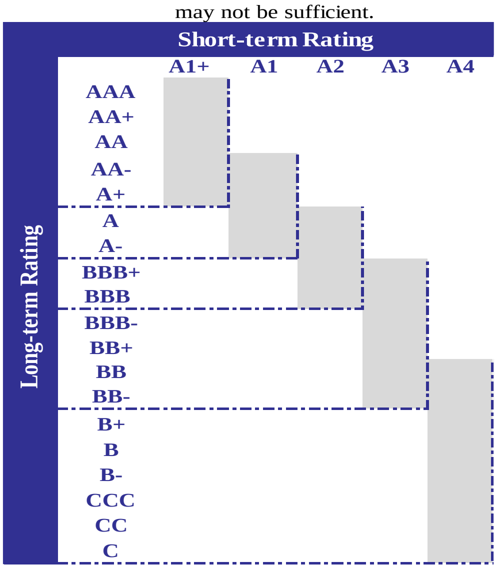
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
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 Rating

Scale	Definition
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
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

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 some material identifiable event with indeterminable rating implications. 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 rating 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) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) 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.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities
a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments
a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating

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