

## DEWAN FAROOQUE MOTORS LIMITED (DFML)

### RATINGS (FEBRUARY 2007)

#### DEWAN FAROOQUE MOTORS LIMITED

ENTITY	NEW
Long Term	A
Short Term	A2

### FINANCIAL DATA

PKR (mln)	30-Jun-06	30-June-05
Total Assets	7,713.2	6,287.3
Equity	1,636.0	1,300.7
Operating profits	607.6	647.1
Net Income	191.9	306.0
Gross Margin (%)	12.2	11.9
ROE (%)	13.1	26.6
Net Debt / Equity (%)	216.5	171.9

### ANALYSTS

Maimoon Rasheed  
+92 42 586 9504  
maimoon@pacra.com

Shahzad Saleem  
+92 42 586 9504  
shahzad@pacra.com

### PROFILE

DFML, incorporated in 1998 and listed on all the three stock exchanges, is majority owned by Dewan Mushtaq Group through Dewan family members and other group companies. The Group, an established conglomerate in the country, has interests in synthetic fibers, automotive and allied, sugar and allied, textiles, oil and gas, cement, and general trading sectors.

DFML has technical collaboration and licensing agreements with Hyundai and Kia. The manufacturing facility has an annual installed production capacity of 10,000 units on a single shift basis. DFML's countrywide distribution network comprises 23 3-S dealerships.

The BoD of the company comprises seven members all related to the Dewan family. By developing acumen in the related fields, the board, particularly the CEO, Mr. Dewan Mohammad Yousaf Farooqui, has played a critical role in formulating the medium to long-term business strategy of the company.

### ASSESSMENT

The ratings reflect the company's sound business strategy supported by an adequate capital structure. Although, at present, the company is exposed to a relatively high business risk compared to other established automobile manufacturers in the country, it is implementing a series of measures to improve its competitive position. At the same time, DFML's association with a diversified business group is also a key rating factor.

The company, given strong competitiveness of recognized Japanese auto manufacturers, opted for lower cost Korean alternative for technical collaboration. Since inception, DFML has followed a distinctive strategy of identifying specific market niches in various auto segments. This strategy had a mixed response with some successes and failures in the past. The company's 1-ton light commercial vehicle (LCV) – Hyundai-Shehzore – is currently the market leader in its respective category. Similarly, Hyundai-Santro targeted to capture high-end 1000cc cars segment has been a success. Although the company also launched a variety of locally assembled vehicles under the brand umbrella of Kia, these could not establish significant presence. At the same time, recent attempts to tap relatively high-end segment of auto market by importing different vehicles of Hyundai and Kia have not yielded expected results.

The country's auto sector has witnessed phenomenal growth in recent years primarily due to (a) availability of various consumer financing options and (b) a favorable economic environment leading to higher income levels. DFML also benefited from this phenomenon. However, the GoP's decision of allowing used vehicles beginning FY05 negatively impacted DFML and it was the worst hit among four major players in the auto sector. The impact was more pronounced towards the end of FY06 and in the current year as sales of Santro – the company's major revenue driver – have taken a major dip. This has led to significant weakening in the company's profitability indicators. To overcome this situation, DFML has reduced the price of Santro to induce higher demand. Additionally, the company has restricted further import of its CKD units to reduce the existing high inventory, which would help in minimizing the financial cost. DFML is also executing an order for armed forces, which, though non-recurring, would provide support to the company's bottom line during FY07.

Going forward, the company is pursuing a multi-pronged strategy including reliance on Japanese franchise to improve its profitability. The strategy, inter-alia, envisages capitalizing upon opportunities in the LCV category. The company plans to manufacture different variants of LCV of Mitsubishi brand for one of its group companies – Dewan Mushtaq Motor Company (Pvt.) Limited (DMMC) – which is the sole partner of Mitsubishi Motors in Pakistan. According to the proposed deal, DFML would charge for providing assembling services and the cost of all related modifications at existing facilities and equipments would be borne by DMMC. This is expected to emanate as a stable, growing source of revenue while spreading the incidence of DFML's fixed cost.

The recently approved Auto Industry Development Plan has provided much needed long-term stability in the regulatory structure for auto industry. At the same time, it has reaffirmed the relatively tightened stance towards import of used vehicles. This is expected to gradually improve the demand for Santro with depletion of existing stock of previously imported vehicles in the country. This alongwith the company's plan to introduce a new variant of Santro (Auto transmission) is expected to have positive impact on sales. The company is also planning to assemble a competitively priced sports utility vehicle (SUV) in FY08. However, the benefits of these initiatives are likely to be more pronounced in FY08 and beyond.

The gearing of DFML remains at a high level of around two times its equity base. Moreover, a sizeable portion of borrowings has been utilized to finance DFML's strategic investment of PKR 700mln in Dewan Cement Limited. However, the cash flows have been restrained recently due to higher inventory levels and squeezed profitability resulting in weakened coverages. Nevertheless, with expected inflow of non-recurring trading profit and ability to callback loans provided to associates, this is not likely to be critical. Going forward, with the reduction in inventory levels and expected improvement in profitability, coverages are expected to improve. Meanwhile, the company is planning to issue a TFC in order to substitute its long-term loans.

### Key Rating Drivers

These ratings are dependent on effective execution of the company's strategy to improve profitability and manage its relatively high level of business risk. Nevertheless, any significant delay or adverse changes in terms and conditions of the proposed arrangement for assembling 'Mitsubishi' vehicles would have immediate negative implications for the ratings. Moreover, macro economic factors like (a) significant increase in interest rates leading to unexpected decline in the magnitude of auto financing (b) unfavorable changes in national auto policy (c) any sharp increase in input cost, could also have adverse impact on the company's ratings. Meanwhile, material, sustainable improvement in the financial profile of the company would have positive implications for the ratings.