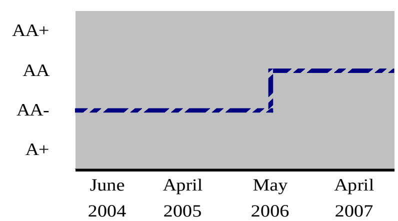
ENGRO CHEMICAL PAKISTAN LIMITED (ECPL)

Ratings (September 2007)

ENTITY	New	Previous
Long Term	AA	AA
Short Term	A1+	A1+
Proposed TFCs		
Secured, listed		
1st Issue *(PKR 4,000mln)*	AA	-
Subordinated		
2nd Issue *(PKR 6,000mln)*	AA	-

L.T Entity Rating History



Financial Data
PKR (mln)

	31-Dec-06	31-Dec-05
Total Assets	15,980.8	14,111.6
Equity	9,370.1	7,375.6
Net Income	2,547.3	2,319.1
EBITDA	4,430.2	4,108.8
ROA (%)	16.93	16.99
ROE (%)	30.42	33.22
EBITDA / Interest (x)	12.38	19.11
Net Debt / Equity (%)	23.01	31.17

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TFC Issues

ECPL plans to issue two TFCs (a) a secured TFC of PKR 4,000mln, and (b) a secured but subordinate TFC of PKR 6,000mln, in near term. The first TFC would have green shoe option of PKR 1,000mln. The tenor of the 1st instrument would be 8 years carrying profit based on 6-month KIBOR *plus* 155bps. Major portion of the principal would be repaid in two semi-annual instalments, beginning 90th month. The instrument would be secured by way of second ranking charge on all present and future fixed assets of ECPL to be upgraded within 90 days from the date of issue to first pari passu charge. The 2nd TFC would be perpetual, carrying profit based on 6-months KIBOR *plus* 170bps. The instrument would have call option exercisable at all instalment payment dates after 5 years and put option after 10 years. This instrument would be secured by way of a ranking charge on assets after the claim of senior debt providers is settled.

Assessment

- The ratings reflect ECPL's relatively low business risk emanating from a favourable demand / supply equilibrium and stable margins. The ratings also take into account the company's well-conceived strategy of persevering its position through growth. In line with this strategy, ECPL is undergoing major expansion in its core urea manufacturing facility that would be funded through combination of equity injection and significant procurement of debt. While this would stretch ECPL's currently low leveraged capital structure and robust cash flows, the financial risk is expected to remain within acceptable limits. Meanwhile, the company's diversification strategy continues to augment profitability in terms of return on investment in subsidiaries.
- In 2006 the urea demand, after witnessing consistently higher growth during the last few years, increased by a marginal 1% to 5.2 mln tons. This was on account of higher base effect of last year and subsidy available on DAP during the later part of the year and onwards. This is in line with the GoP's clearly articulated plan of more balanced use of different fertilizers. The local demand continued to remain in excess of local production even though local production was 2.3% higher despite shutdowns by some producers. The shortage in supply was met through higher cost imports. Due to inelastic demand emanating from the supply shortage and high prices of imported products, companies were able to transfer the impact of rising feedstock prices onto the end consumer. Although urea offtake witnessed a decline YoY in Rabi'07, it is expected to grow at around 4% in the medium-term. With limited potential for growth in production in the medium-term, domestic demand / supply gap is expected to increase until commencement of ECPL's urea expansion project and Fatima Fertilizer. Beyond 2010, market is expected to reach demand / supply equilibrium while the margins are expected to remain stable.
- In the absence of maintenance shutdown, ECPL produced 969,000 tons of urea during 2006 representing a 6% increase on YoY basis leading to higher capacity utilization. However, the company's turnover, despite hike in average urea price, declined owing to considerable decrease in sales of imported urea and *Zarkhez*, alongwith subsidy on phosphatic fertilizers. Meanwhile, ECPL was the only fertilizer plant in the country that recorded improved gross margins during 2006 to 24.1% (2005: 21.6%) mainly due to increase in plant turnaround time. ECPL's ROE, in spite of 10% increase in net income, experienced 3pps deterioration owing to 10% right issue. Although the funds were generated in the beginning of the year, these were mainly utilized for injecting equity in its currently non-profitable wholly owned subsidiaries – Engro Foods Limited (EFL) and Engro Energy (Pvt.) Limited (EEL). During 2006, the company further invested PKR 850mln in EFL. EFL is projected to have losses of about PKR 2bln during the first four years of operations. This is more than the earlier loss estimate due to higher than initially expected fixed cost, a consequence of higher expansion. The trend in performance was maintained during 1H07, despite decline in gross margins, primarily due to higher sales of phosphatic fertilizer and enhanced dividend income from its subsidiaries.
- ECPL has embarked upon expanding its core urea manufacturing business for which the GoP has assured an uninterrupted supply of gas. The new urea plant, which would cost around \$ 1bln, with capacity of 1.3 MT is expected to lead to higher efficiency in operations. ECPL's post expansion market share for urea would increase from 19% to 35%. The company is also planning for (a) expansion and back integration of Engro Polymer & Chemical Limited (EPCL), (b) initiation of EEL's first project – independent power plant (IPP), and (c) enhancement of EFL production capacity.
- The company plans to finance these projects with a combination of equity and debt in a manner that it remains around targeted gearing. The debt would be a combination of local and foreign financing arrangements. ECPL is likely to experience peak gearing in 2009, otherwise the gearing is targeted to remain in the vicinity of 2 times of the equity. With increased financial obligations, the cash flows and coverages are likely to come under stress. However, ECPL's already strong cash generation ability would be further augmented once the new plant starts operations, which largely mitigates the associated risk.

Key Rating Drivers

- These ratings are dependent on the effective execution of the company's overall growth plans. While implementation risk such as time / cost over runs, if not managed properly, could adversely impact the company's performance and, in turn, its ratings. Moreover, unforeseen macro economic factors like (a) decline in urea offtake resulting in significant imbalance between demand / supply (b) unfavourable changes in the fertilizer policy (c) any sharp increase in input cost, could also have adverse impact on the company's performance. Meanwhile, ratings are likely to have positive implications in the long-term once the new plant starts contributing towards profitability with declining gearing and there is sustainable improvement in joint venture / subsidiaries performances.

Profile

- ECPL was incorporated in 1965 as Esso Pakistan Fertilizer Company Ltd. The core business of ECPL is manufacturing and marketing of fertilizers and it is the second largest producer of urea in the country, which is produced at the plant site in Daharki. ECPL also produces NPK (*Zarkhez*) at Port Qasim and markets MAP under the brand name *Zorawar* and DAP.
- ECPL has also diversified its interests in the form of two joint ventures with foreign collaboration, the first, Engro Vopak Terminal Limited (EVTL), being a jetty and chemical terminal facility at Port Qasim, and the other, EPCL now a subsidiary, the first PVC resin manufacturing plant in the country.
- The Dawood Group (DG) holds a majority 42% stake in ECPL, while the holding of Engro employees and Employees Trust stands at 12%. The BoD of ECPL comprises five members from its own management, three from the DG, and two other non-executive directors. The association of DG has augmented the capacity of the Board to guide the management in formulating its long-term strategy.