

PAK ELEKTRON LIMITED (PEL)

RATINGS (JUNE 2008)

	New	Previous
Entity		
Long Term	A	A
Short Term	A1	A1
TFCs / Sukuks		
Privately-placed, Secured TFC (PKR 500mln)	A	A
Privately-placed, Secured Sukuk (PKR 1,200mln)	A+	A+
Privately-placed, Secured Sukuk (PKR 2,000mln)	A+	-

SUMMARY DATA

(Amounts in PKR mln)

	Mar-08 [^]	Jun-07	Jun-06
Total Assets	13,267	11,547	10,108
Equity*	4,277	4,065	3,148
Turnover (Net)	7,189	11,814	9,408
Net Income	269.5	582.2	442.1
Gross Margin (%)	24.6	21.4	21.8
ROE (%)	8.6	16.2	14.9
EBITDA Int. Cover	1.7	2.0	1.9
Debt / Equity (%)	158.4	120.4	147.9

[^] Based on 9 months unaudited results

*Considering preference shares as part of equity

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TFC / SUKUK ISSUES

- PEL issued a privately placed secured TFCs of PKR 500mln in Jun07 for a tenor of 5 years, carrying profit at the rate of 6-months KIBOR plus 325bps, payable semi-annually. Principal redemption of the TFC would be in six equal semi-annual installments commencing from the 30th month after the issuance (Dec09). The instrument is secured by way of first pari passu charge over all current and fixed assets of the company. A reserve fund of PKR 50mln, created out of issue amount, will be maintained till the final redemption.
- The company also has in issue a secured privately-placed Sukuk of PKR 1,200mln based on diminishing *Musharakah*. The Sukuk, issued in Sep07, is for a tenor of 5 years (inclusive of 18 months grace period) carrying profit at the rate of 3-months KIBOR plus 175bps, with a floor of 10% and a cap of 25%, payable quarterly in arrears. The instrument is secured by way of first pari passu charge on specific assets of the company with a 25% margin. PEL intends to issue first two tranches (amounting to PKR 1,100mln) of its second secured privately-placed Sukuk of PKR 2,000mln. The Sukuk is for a tenor of 7 years, with a 3 years grace period, carrying profit at the rate of 3-months KIBOR plus 100bps, with a floor of 8% and a cap of 16%, payable quarterly in arrears. These tranches are secured by way of ranking charge to be upgraded to first pari passu charge within 120 days on present and future plant and machinery of the company with 25% margin.

RATING RATIONALE AND KEY DRIVERS

- The ratings reflect PEL's established position in the domestic power engineering and home appliances segments. The ratings also take into account the company's diversified revenue base emanating from a wide product range that helps in maintaining robust margins in an increasingly competitive environment. Meanwhile, the management has placed greater emphasis on product development, while focusing on quality, to align its strategy to the changing market dynamics. However, PEL's financial leverage is expected to remain high as the company accumulates additional debt to meet its capex and working capital requirements.
- Effective and timely execution of the company's overall growth plans – particularly the success of initiatives in power division and their contribution towards the profitability – while maintaining its leverage at an acceptable level would be crucial for the ratings. Moreover, any adverse changes in the quantum of business and/or credit terms with WAPDA could stress the company's cash flows, in turn, its coverages, which could have negative implications for the ratings. Meanwhile, ratings are likely to benefit once the major expansion and diversification plans start contributing towards profitability with consequent reduction in financial risk.

ASSESSMENT

- The company's overall operations encompass two business segments (a) power equipment and (b) appliances. In the recent years, there has been a gradual shift in the company's business profile, as the proportion of power segment in the overall turnover has increased. During FY07, PEL maintained its growth momentum, largely driven by the power segment, with around 25% increase in turnover. The company maintained its strong margins and, due to higher overall turnover, improved its profitability. The revision in sales price of its products with WAPDA, the major power equipment customer, has enabled PEL to sustain its gross margins despite increasing raw material prices. Moreover, the inherent price stability in power products, emanating from the implicit understanding among relatively limited number of players for each product, leads to stable margins.
- During 3QFY08, overall sales of the company declined due to reduced demand from WAPDA and KESC for power products. On the other hand, appliances segment posted strong results – 24% growth in turnover – and its proportion in the overall revenues increased to 54%. However, the company suffered substantial revaluation loss on its investments, which further dampened the profitability for the period (3QFY08: PKR 269mln; 3QFY07: PKR 453mln). Nevertheless, PEL maintained its strong market position in each of its product categories. Although the company remains well positioned to capitalize on growth opportunities arising from the demand for power products by power and distribution companies, the current energy deficiency in the country and stressed financial situation of WAPDA might impact the demand, particularly in the short-term.
- Going forward, the management intends to increase the proportion of power segment in overall business due to relatively better and stable margins. In this context, the company has improved its product range namely: (a) installation of grid stations on turnkey basis, and, (b) power transformers. Meanwhile, to diversify its customer base and explore further growth opportunities, the management is planning to export power products – mainly power transformers – and is setting up a new factory for this purpose. The management intends to export these transformers to Saudi Arabia and European markets and envisages high demand due to global supply deficiency scenario. PEL has also taken certain initiatives in appliances segment to ease pressure on margins including widening the product range (introducing geysers, water dispensers, standing split ACs) and exploring regional markets for exports. Timely and effective execution of these initiatives would help the company in maintaining its market position and improve profitability. The management also plans to implement ERP system to have an integrated technology platform and to better streamline its business processes across various segments and products.
- The capital structure of the company remains relatively highly leveraged. However, the preference shares of PKR 580mln, redeemable at the option of PEL or otherwise convertible into ordinary shares, provide some degree of comfort. A part of these shares were converted into ordinary shares at prescribed conversion ratio during the year. The management is in the process of issuing a Sukuk of PKR 2,000mln to raise long-term fund. The Sukuk proceeds would be utilized to re-profile part of the debt structure by swapping PKR 1.1bn bank loans (SPV PKR 600mln and PPTFC PKR 500mln), while remaining funds would be deployed to meet the company's capex and working capital requirements. Although the Sukuk would further increase the company's leveraging, it would reduce its dependence on short-term running finance and is expected to help rationalize finance cost. However, this impact might be diluted due to rising interest rate environment in the country. Going forward, the equity base of the company is expected to improve through proposed issue of preference shares of around PKR 300mln in the near future. Consequently, the gearing of the company is projected to decline, in turn, improving coverages. The cash flows from operations have remained stressed due to significant increase in the working capital requirements, an outcome of increased proportion of appliances segment in overall turnover. The company needs to strengthen its working capital management to rationalize its inventory buildup. The planned technological upgradation is expected to facilitate this process with better accessibility to information.

PROFILE

- PEL, incorporated in 1956, is listed on all the stock exchanges in Pakistan. The company is a leading manufacturer of power equipment and home appliances. The power division primarily manufactures transformers, energy meters, and switchgears. To achieve further diversification, the company has embarked upon undertaking erection of grid stations on turnkey basis and manufacturing of power transformers. The appliances division mainly specializes in refrigerators and split air conditioners, while new consumer products have also been added to the product range. PEL has an extensive nationwide dealership network of over 1,400 outlets and adequate after sales service arrangements. The company plans to acquire an engineering or power distribution company amongst various government owned entities on the privatization agenda.
- Saigol Group, the majority shareholder in PEL, has diversified business interests in textile and energy sectors, albeit, over the years, PEL has emerged as the flagship company for the group. The company's Chairman/Chief Executive, Mr. Naseem Saigol, who is also the Chairman of the Saigol Group of Companies, is a well-known businessman, and actively participates in the strategic management of the company and overlooks policymaking. The Managing Director of PEL, a Chartered Accountant by profession, has been associated with the company for the last nine years and is supported by a professional management team.
- The ten members BoD include three representatives of the Saigol family, in addition to two executive directors, and one NIT and three NBP nominees. However, the four nominated members have relatively limited participation, especially in strategy formulation.