



SHAKARGANJ MILLS LIMITED (SML)

RATINGS (MARCH 2008)

SHAKARGANJ MILLS LIMITED

	New
Entity	
Long Term	BBB+
Short Term	A2
TFC	
Secured	A-
privately placed	
PKR 1,200mln	

FINANCIAL DATA

PKR (mln)

	30-Sep-07	30-Sep-06
Total Assets	10,910.5	11,7181.8
Equity	4771.1	3,705.4
Profit after Tax	1051.1	66.6
ROA (%)	5.69	0.57
ROE (%)	13.0	1.80
Total	115.0	199.8
Debt/Equity (%)		

ANALYSTS

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TFC ISSUE

The company is in the process of issuing a secured TFC of PKR 1,200mln (including a green shoe option of PKR 400mln) for a period of 6 years. The instrument carries profit at a rate of 6-month KIBOR plus 225bps. The principal redemption would be in 10 equal semiannual installments beginning from the 18th month after issuance. The instrument would be secured by first pari passu mortgage charge on all immovable and hypothecation charge on all moveable properties of SML with a 25% margin. The company can exercise call option at anytime by giving 60-day notice.

RATING RATIONALE AND KEY DRIVERS

- The ratings reflect relatively high business risk of SML's operations, an outcome of cyclical nature of sugar industry. Nevertheless, the ratings recognize the management's ongoing efforts to reduce interdependency of various business segments – sugar, ethanol, and particleboard – to add stability to its core revenues, in turn, cashflows. Meanwhile, SML has a relatively strained capital structure – indeed improving – engendering high, albeit manageable, financial risk.
- These ratings are dependent on the effective execution of the company's overall growth strategy and, in turn, resulting in improved performance from core operations helping in managing high business risk. Any prolonged downturn in sugar industry resulting from either development/s in domestic or international markets, leading to increased financial risk, would have negative implication for the ratings.

ASSESSMENT

- In recent years, the availability of sugar has remained on higher side compared to demand due to better sugarcane crops and carryover stocks. As a consequence sugar prices in the country remained under pressure, squeezing the margins of sugar mills. Moreover, international sugar prices, with higher output in major sugar producing countries, have also declined, limiting the export prospects. Going forward, sugar prices are expected to remain depressed on the back of high sugar production in the current year. At the same time, despite recent withdrawal of export duty, the export prospects have not improved due to depressed international prices. Nevertheless, given 25% duty on sugar imports, domestic industry is protected from international competition to that extent. In tandem with industry, SML registered a low turnover growth and experienced greater variability in its performance from sugar operations during FY06 and FY07. Moreover, given that it is located in Punjab, with relatively higher sugar surplus than Sindh, its performance was more subdued compared to a few peers.

- Although the company has diversified into ethanol and particleboard businesses. The performance of these segments was highly correlated with the core sugar business. The management, being cognizant of this, is taking various steps to reduce interdependency and intends to establish these divisions as independent businesses. In this regard, while increasing the product range, SML is working on improving the supply chain management ensuring consistent supply of raw materials from diversified sources. The distillery division, exporting around 80% ethanol to Europe and Japan, has ensured relatively high margins in recent years. During FY07, the company was able to fetch better margins on account of increased selling prices. In order to capitalize on increased demand of extra neutral grade alcohol, the management has recently installed such facility at its Bhone site. It would help SML in fetching high margins, going forward. During 1QFY08, the company's operating profitability improved significantly compared to previous periods mainly on the back of higher margins in all major segment. However, the bottom line remained under pressure due to high finance cost. Going forward, the company is likely to maintain the improving trend in performance, wherein with targeted volume growth it is likely to manage the impact of high finance cost.

- SML, in an effort to lower its business risk, diversified in the textile business. However, this has not been helpful and is also passing through a downturn. The management would either reorganize or divest this segment, going forward. SML, since establishment of engineering division, has achieved significant reduction in maintenance cost. Based on its experience, SML intends to gradually develop this unit for manufacturing of heavy and specialized machinery for sugar, cement and chemical industries. The management has signed a power sale agreement with WAPDA for sale of 7MW electricity, to be produced by utilizing biogas generated during production of molasses. The cash inflow is expected to begin within FY08. With relatively low fixed and variable cost, the management is expecting a sizeable contribution from this segment towards its bottomline profitability.

- SML recently has diversified in food sector through its wholly owned subsidiary, Shakarganj Food Product Limited (SFPL). SFPL is in dairy product business, being branded as "Good milk" and is also exporting concentrated fruit juices. Although the food business offers good growth potential, but at the same time, it requires a long gestation period.

- In the past, SML had a sizeable investment portfolio comprising mainly investment in equities. However, in line with its strategy of reducing the size of the portfolio, SML divested its holding in PICIC and other investments. This resulted in significant capital gain PKR 2.1bln to the company, which was utilized for repaying debt. Currently, the company holds investments in two mutual funds. However, the management intends to divest these holdings shortly.

- Although the debt to equity ratio has shown improving trend, SML still has relatively leveraged capital structure. This has magnified the financial risk owing to relatively stressed cashflows from core operations. However, the overall cash flows improved substantially during FY07 on realization of capital gains. Given improving prospects of performance mainly on the back of distillery division, coverages are likely to improve, going forward. The management of SML is in the final stage of issuing Term Finance Certificates amounting to PKR 1,200mln for mainly re-profiling of comparatively high cost short-term borrowings. Additionally, a portion of proceeds would also be utilized for financing expansion in the sugar facility. The debt profiling would benefit the company by not only changing maturity profile of debt, but also by bringing the financial cost down to some extent.

PROFILE

- Shakarganj Mills Limited (SML), listed on all the stock exchanges, commenced its operations in 1974. It is one of the largest sugar producers in Punjab. The company has diversified business operations comprising a) Sugar – in addition to bulk, also has branded retail sugar products, b) Ethanol – produces three grades of ethanol, c) Particleboard, d) Textile and e) Food business through a wholly owned subsidiary. It also has a Sugar Research Institute set up in 1983, supporting its sugar related businesses.

- The company currently operates two sugar units located in Jhang and Bhone with a combined capacity of 2.2mln tons p.a. The distillery unit has a capacity of 43.2mln litres p.a. while building material division has a capacity of 6,000 tones p.a. In sugar segment, SML is developing its third sugar facility at Trimu, Jhang with crushing capacity of 0.56mln tons p.a. alongwith a distillery unit. These new facilities are targeted to commence commercial production within the current year.

- The textile operations, comprising a spinning unit with 8.8mln spun yarn capacity, were acquired in 2004. The company has currently invested PKR 542mln in SFPL and intends to bring in some strategic investors to arrange resources for SFPL's future expansion plans.

- Crescent group owns majority shareholding of around 59% in SML, mainly through its different companies and family members. A team of professionals supports Mr. Ahsan M. Saleem, the CEO of the company. The company has experienced a fair degree of stability at senior management level.