

AZGARD NINE LIMITED (ANL)

RATINGS* (JULY 2006)

AZGARD NINE LIMITED

	NEW	PREVIOUS
ENTITY		
Long Term	A	A
Short Term	A1	A1
TFCs		
<i>Secured, listed</i>		
PKR 2,144mln	A+	A+
<i>Secured, privately placed</i>		
PKR 2,500mln	A+	-

*ANL's ratings are placed on RatingWatch.

FINANCIAL DATA

PKR (mln)

	31-Dec-05	30-Sep-04
Total Assets	10,541.2	6,297.2
Net Turnover	4,422.5	3,155.9
Net Income	741.3	375.3
EBITDA	1405.2	712.4
EBITDA/ Interest (x)	4.8	5.8
Net Interest Cover	3.73	4.13
Total Debt/ Equity (%)	322.02	231.09

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BACKGROUND

Azgard Nine Limited (ANL) – previously Legler Nafees Denim Mills – started commercial production in 1997. It is listed on the Karachi stock Exchange. ANL is a vertically integrated unit, comprising spinning, weaving, stitching, dyeing and finishing. It is currently one of the top quality manufacturers and exporters of yarn, denim fabrics and garments. The manufacturing facility of ANL is located 2.5 kms off Manga-Raiwind road, district Kasur, and the other unit is located in Muzaffargarh. The company's expansion in stitching, weaving, and spinning facilities in 2005, all of which is coming online in the current year, is expected to double the overall capacity. Additionally, the company has recently purchased a garment stitching facility in Lahore. The highly professional management of the company is embarked upon a vision of fully leveraging the company's strategic assets – physical and human – to become a truly global player. A comprehensive strategy is, therefore, in place to emulate best international practices in corporate governance, production efficiencies and environmental standards.

RATING RATIONALE

ASSESSMENT

- The ratings reflect the company's ongoing efforts aimed at diversification and expansion, as well as the sustained progression towards a higher level of value-addition in all areas of textile operations. This, in turn, is an outcome of the company's committed and progressive management, a critical rating factor. The company's business risk profile and performance have remained robust despite the changing textile landscape as well as the company's own expansionary stance. Meanwhile, the ratings have been placed on RatingWatch pending the company's acquisition of Pak American Fertilizer Limited (PAFL).
- With strong selling prices – guaranteed by virtue of quality of products and good relations with buyers – any volatility in ANL's margins in recent years has mainly been outcome of movement in cotton prices. Thus, an improvement in ANL's 2005 gross margins was mainly an outcome of a reduction in cotton prices. A commensurate increase in operating margins was precluded due to a significant increase in selling and administrative costs as the management continued with its policy of greater investment in HR and other efficiencies. The company's investment portfolio yielded investment income of around PKR 302mln – including capital gains and dividend income – that augmented the bottom line. Hence, despite the increased financial costs associated with the capex incurred during the year, net margins and ROE registered improvement.
- Current year prospects are sanguine. The company has built up a substantial inventory of cotton to alleviate the impact of rising prices. Thus, margins are unlikely to suffer a material adverse impact. The enhanced spinning, weaving, and garment capacity is expected to come online during the year in a phased manner, with a commensurate increase in sales volume. Earnings from the company's investment portfolio – though reduced in size – are likely to continue to augment the bottom line. Additionally, the company's garment sales are expected to benefit from a recent reduction in the duty on garments. The company's 1QFY06 results are indicative of positive performance prospects from textile operations.
- Cash flows improved in 2005, but remained under stress due to the company's policy of maintaining a large level of inventory, compelling it to rely almost entirely on external funding to meet its capital expenditure relating to expansion in production capacity. The corresponding increase in debt and financial costs resulted in a decline in the company's capital structure and coverages respectively, though these remained sound.
- The company is currently in the process of acquiring Pak American Fertilizer Limited (PAFL). ANL would directly acquire around 38% shareholding in PAFL and the balance through a wholly owned subsidiary incorporated for this purpose. PAFL's acquisition price is around PKR 16.1bln. The acquisition is being funded through a combination of fresh equity injection (PKR 4.6bln has been received against recently completed right issue) and borrowings. ANL was unable to meet the initial deadline allotted by the Privatization Commission for payment of the remaining funds, and has now received an extension on this deadline to July 15, 2006. The management is confident of meeting this deadline as negotiations for borrowings (PKR 4.6bln directly by ANL and PKR 6.4bln by the subsidiary) are at the final stages. The company would have the option of prepayment of the whole or a part of the debt. This would enable the company to consider other funding options – including foreign loans – to reduce the cost of debt.
- The acquisition of PAFL, apart from providing diversification of revenue stream, would result in an improvement in the company's business risk profile. However, the financial risk profile of ANL is likely to come under some pressure due to the additional debt. The company's plan of making another right issue of PKR 2.5bln within thirteen months of acquisition, proceeds of which would be utilized for debt repayment, is expected to provide support to the capital structure. Nevertheless, the company's coverages are likely to register a decline in the first year after acquisition. Thereafter, the situation is likely to improve with increasing revenues and reduction in the debt burden.

TFC ISSUES

- The company issued a secured TFC of PKR 2,144mln in 2005 to meet its expansion plans as well as BMRE expenditure. The TFC issue is of a seven-year tenure, and carries a profit rate of 6 months KIBOR plus 240 basis points, with no cap or floor. Principal redemption will be in ten unequal semi-annual installments starting from Mar-08. The TFC contains a 25% conversion option. This allows TFC holders the right of conversion of up to 25% of the value of their TFCs into ordinary shares (non-voting and non-participatory) at a 30% discount to the preceding three months average share price of ordinary shares, at any time between Jan-2008 to Mar-2008. It is secured by way of first parri passu charge on the present and future fixed assets of the company with a 25% margin. Considering the security and margin, the TFC is assigned a rating of "A+", a one-notch higher rating than the entity rating.
- The company's proposed TFC of PKR 2,500mln is of a thirteen-month tenor, and proceeds will be utilized towards PAFL's acquisition. The company has given an undertaking that it will make a right issue of a similar amount – underwritten by Jahangir Siddiqui & Company Limited – by April 2007 to repay this TFC. The TFC carries profit, payable quarterly, at the rate of 6-months KIBOR plus 300 basis points, with no floor and cap. Principal redemption will be upon maturity. The issue is secured by a second ranking charge over all present and future assets of ANL, excluding PAFL shares, with 25% margin. Considering the security structure and the repayment plan, the TFC has been assigned a rating of "A+".

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