The Pakistan Credit Rating Agency Limited

Rating Report

Engro Fertilizers Limited

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Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
28-Jan-2019	AA	A1+	Stable	Maintain	-
27-Jul-2018	AA	A1+	Stable	Upgrade	-
30-Dec-2017	AA-	A1+	Stable	Maintain	-
20-Apr-2017	AA-	A1+	Stable	Maintain	-
20-Apr-2017	AA-	A1+	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

The ratings take into account sustained operations of the company; capacity utilization at both plants remained high on the back of continued gas supply from Mari and other. The risk of gas curtailment has diminished with strengthening of local reservoirs and continued import of RLNG. The company has been able to secure sustainable gas supply. Efert is benefiting from the incentivized gas pricing of 70 cents under the fertilizer policy 2001. Plus, the latest domestic supply/demand scenario is favorable, increased urea prices, provided additional cushion to the business in enhancing its margins. Meanwhile, timely recovery of remaining subsidy remains important. GIDC related developments are expected to crystallize over the shorter horizon, which are likely to provide benefit to industry players generally and Efert particularly. The financial risk profile of the company is characterized by moderate leveraging. Efert continues to derive strength from its association with Engro Corporation – a corporate conglomerate.

The ratings are dependent on sustainability of operations and profitability, resulting in sustained risk profile of the company. Any constraint to perceived ability to keep business and financial risk in respective matrix may impact the ratings.

Disclosure	
Name of Rated Entity	Engro Fertilizers Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-18),Methodology | Criteria | Rating Modifier(Jun-18),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study | Agriculture Input and Services(Jan-18)
Rating Analysts	Raniya Tanawar | raniya.tanawar@pacra.com | +92-42-35869504

Profile

Legal Structure Engro Fertilizers Limited (hereinafter referred to as ‘‘the Company’’ or ‘‘Efert’’), incorporated in 2010, is listed on Pakistan Stock Exchange (PSX) with its head office in Karachi.

Background As part of continual expansions and diversifications in the Company’s enterprises necessitated a broad restructuring in Engro Chemical Pakistan Ltd. which subsequently demerged to form a new Engro subsidiary – Engro Fertilizers Limited. The shareholding was gradually reduced from 100% as part of strategic re-alignment to explore new opportunities in other promising sectors involved.

Operations EFert, a leading name in the country’s Fertilizer market, is primarily in the business of manufacturing and marketing of urea and in other fertilizers, including NPK and DAP trading. EFert has a strong country wide distribution network. In line with the objective to develop the complex and specialized fertilizer market, major popular product line of EFert comprises Urea sold under the brand name of Engro Urea and NPK – complex fertilizer – as Zarkhez.

Ownership

Ownership Structure EFert is ~56.45% owned by Engro Corporation (ECorp), a prominent corporate conglomerate of the country. Free float as at Dec’18: ~43%

Stability The ownership structure of EFert is strong, backed by two corporate entities – ECorp and DHCorp – wherein the propensity and ability to provide support, through equity and debt, is relatively high.

Business Acumen Engro Corporation Limited (Holding Company) is a renowned multinational company,having a vast, well-diversified business portfolio spanning across various sectors

Financial Strength Company’s prominent and long presence in the fertilizer industry has enabled it to sustain a strong financial, including strong backing from sponsors support is inevitable.

Governance

Board Structure EFert’s Seven-membered board comprises three Engro Corp’s executives and four independent directors.

Members’ Profile Eferts board is chaired by a seasoned professional Mr. Ghias Khan. He is the CEO of the holding company-Engro Corp, with a long association with Engro Group. Overall members profile is considered strong.

Board Effectiveness EFert has two board committees viz. Board Audit Committee and Board Compensation Committee while ECorp’s Board Investment Committee oversees the investment related matters of EFert and other subsidiaries as well.

Financial Transparency The external auditors of the company, A.F. Ferguson & Co. rated ‘A’ on the SBP panel, have expressed an unqualified opinion on the financial statements for the year Ended Dec, 2017 and an unmodified review for the half year ended June’18.

Management

Organizational Structure The operations of the company are divided into six major departments, headed by able professionals, who report directly to the CEO.

Management Team EFert’s core strength is derived from the quality of management, and is duly recognized for its highly professional and long-term outlook. Mr. Nadir Salar Qureshi is the EFert’s newly appointed acting President and Chief Executive Officer, He is also the Chief Strategy Officer of Engro Corp. Mr. Imran Ahmed, is the new CFO of the company. Earlier he was associated with Shell (Pak Arab Pipeline company Limited) in the similar capacity

Effectiveness To ensure professional efficacy throughout the business, the company has three principal operation committees, – i) Management Committee, ii) Corporate Health, Safety and Environment Committee and iii) Committee for Organizational and Employee Development

MIS EFert utilizes completely integrated and real time ERP solution with technical services provided by IBM Global Services. The ERP enables high level of integration between functions to ensure smoother data flow amongst related business process.

Control Environment Company has smooth trail of business processes with highly qualified top management. Business processes are automated to an extensive level. Further, a separated internal audit function exists which directly reports to the audit committee.

Business Risk

Industry Dynamics The fertilizer industry is prevalent for Agriculture & allied sector of the country. The production capacity is of 6.9mln MT of urea, 0.7mln MT of DAP and 2.2mln MT of others. The industry benefits from the demand of its major product urea and oligopolistic market conditions. The fertilizer industry has been facing volatility in past two years with respect to i) gas availability and price fluctuation ii) shutdown of LNG based urea plants iii) rain shortage, removal of subsidy and Iv) Urea prices hike. The industry revived from the supply surplus situation in CY16 but came down to supply shortage of Urea by the end of CY17, however with GoP’s assistance the situation got controlled.

Relative Position Efert has been significantly contributing in Urea market and takes the liberty of being the second largest in the industry with total installed capacity of 2.3mln M.tons which accounts for ~33% of industry’s demonstrated capacity. The company successfully managed to capture the market share, ~36% in 9M18 as against ~30% in 9M17, followed by shutdown of some major urea production plants (Fatimafert, Agritech & Pakarab Fertilizer). Moreover, the company now has a 100% owned subsidiary; namely Efert Agritrade (with a bottom line of PKR ~1.15bln), for the purpose of DAP trading in particular .

Revenues In 9MCY18, EFert’s topline decreased by 6.3% YoY, clocked in at PKR ~49bln (9MCY17: PKR ~52bln) including subsidy: since DAP business has been transferred to the newly formed subsidiary (revenue base PKR ~19bln). However, the company's topline observed subtle growth over the period, predominantly led by moderate offtakes as well as overall reduced Urea exports. Also, the total industry Urea sales observed a meagre uptick, and clocked in at 4,132 KT(9MCY17: 4,088 KT),up ~ 1%, while EFERT 9MCY18 domestic sales were 1,496 KT, up 22% (9MCY17: 1,231 KT). despite the decreasing trend in DAP offtake: 9MCY18: 1,236 KT, 9MCY17: 1,279 KT (decline of 3% YoY) EFERT recorded sales of 327 KT (9MCY17; 234 KT).

Margins Company booked subsidy from GoP of PKR ~1.3bln in 9M18 (9MCY17: PKR ~4.1bln). The finance cost of the company has also seen a decline, stood at PKR ~1.3bln (9MCY17 - PKR ~1.98bln, 9MCY16: PKR ~2.36bln) on the back of low leveraging. The company profitability stood at PKR ~12.5bln (9MCY17: PKR ~6.7bln, 9MCY16: PKR ~5.7bln) translating into improved margins 9MCY18; ~26% (CY17: ~15%). The rise in margins is mainly attributable to the increased prices during CY18 and emanates from the gross margin level, 9MCY18: ~44% (CY17: ~37%).

Sustainability The Company continues to explore new avenues particularly in pesticides and agri farming sectors. These are expected to yield positive results in the long run. With an aim of diversifying product portfolio Efert’s Specialty Fertilizer Business has started marketing 4 new products; Zoron, Power Potash, SSP+Zn and Zabardast Urea in CY18.

Financial Risk

Working Capital During 9MCY18, Efert’s working capital requirement remained comfortable (~10 days), after the supply surplus situation in the country got over, with around 260KTons (Jan-Sep) of urea opening inventory. Improved industry sales, lower production and significant exports, industry inventory depleted to 130 KT compared to 787 KT at the end of Sept’18. The company met the working capital needs through internal sources (cash generated from operations: PKR ~22bln) and the rest financed through short term borrowings of PKR ~1.4bln.

Coverages Efert’s ably generates free cash flows from operations (FCFO), stood at PKR ~18.8bln at end-Sep18 (9MCY17: ~13.7bln), an increase of ~36%, in line with a rise in profit before tax PKR ~16.4bln (9MCY17: ~14.9bln, 9MCY16: PKR ~13.3bln) of the company. As a result, interest coverage increased to 13.6 times (9MCY17: 7.3times). With current maturity of long term debt (CMLTD) dropping to PKR 3.3mln (9MCY17: 8bln),

Capitalization Efert has been aptly managing its capital structure by reducing its debt levels: 9MCY18 ~38% (9MCY17: ~43%). Borrowings have been continuously reducing while standing at 26bln in comparison to PKR 32bln 9M17 (9M16: PKR 36bln). The company has replaced expensive PPTFC with low cost debt. Going forward, the company envisages to keep an optimal capital structure. The company issued Sukuk of PKR 3,200mln during Jul-14 for a tenor of 5 years. Mark-up arrangement includes 6M KIBOR + 175bps. The instrument is secured by a ranking charge over fixed assets with a 25% margin and hypothecated charge on current assets. The instrument shall mature in July'19. PKR~560mln of the issued amount is outstanding, as of today.

Engro Fertilizers Limited (EFert)

BALANCE SHEET	30-Sep-18	31-Dec-17	31-Dec-16
	9MCY18	CY17	CY16
Non-Current Assets	**72,768**	**73,533**	**74,740**
Investments (Incl. Associates)	**20,315**	**9,644**	**703**
Equity	560	560	560
Debt	19,754	9,083	143
Current Assets	**20,626**	**23,156**	**26,985**
Inventory	3,085	3,528	6,820
Trade Receivables	3,491	3,485	7,585
Others	14,049	16,143	12,580
Total Assets	**113,708**	**106,333**	**102,428**
Debt	**25,881**	**30,954**	**34,601**
Long-term (Incl. Current Maturity of Long-Term Debt)	25,881	30,954	34,601
Other Short-term Liabilities	35,867	24,739	18,827
Other Long-term Liabilities	7,759	9,627	7,718
Shareholder's Equity	**44,201**	**41,013**	**41,283**
Total Liabilities & Equity	**113,709**	**106,333**	**102,428**

INCOME STATEMENT			
Turnover	**48,585**	**67,990**	**77,397**
Gross Profit	21,382	25,452	24,989
Other Income	1,580	(136)	(887)
Financial Charges	(1,350)	(2,560)	(3,136)
Net Income	**12,536**	**10,137**	**9,025**

Cashflow Statement			
Free Cashflow from Operations (FCFO)	18,383	18,730	17,986
Net Cash changes in Working Capital	4,815	12,090	(13,839)
Net Cash from Operating Activities	21,668	28,205	775
Net Cash from InvestingActivities	(19,735)	(5,136)	(2,422)
Net Cash from Financing Activities	(9,064)	(15,062)	(10,748)
Net Cash generated during the period	(7,132)	8,006	(12,395)

Ratio Analysis			
Performance			
Turnover Growth	1.8%	-12.2%	-8.9%
Gross Margin	44.0%	37.4%	32.3%
Net Margin	25.8%	14.9%	11.7%
Coverages			
Debt Service Coverage (x) (FCFO/Gross Interest+CMLTD+Uncovered STB)	4.8	1.8	2.2
Interest Coverage (x) (FCFO/Gross Interest)	13.6	7.3	5.7
Debt Payback (Years) (Total Lt.Debt (excluding Covered Short Term Borrowings) / F(	1.1	1.9	2.3
Liquidity			
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	10.4	-8.6	-16.2
Capital Structure (Total Debt/Total Debt+Equity)	38.1%	44.3%	46.9%

Rating Scale

Credit Rating Scale & Definitions

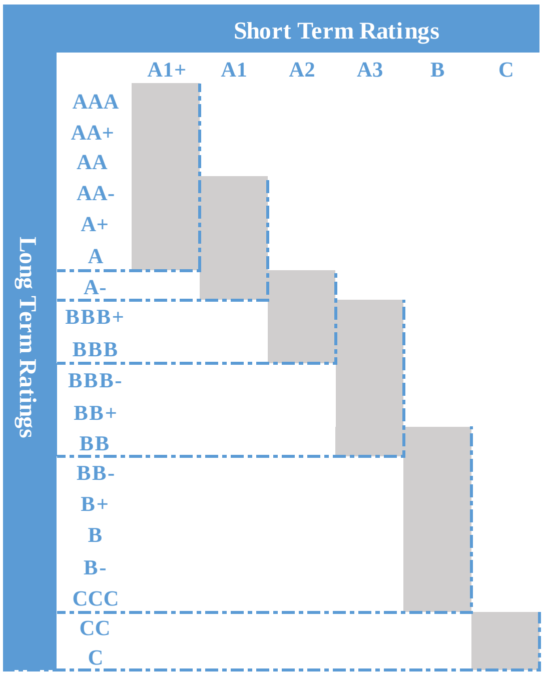
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings

A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term “family members” shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers’ associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst’s area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
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