The Pakistan Credit Rating Agency Limited

Rating Report

D.G. Khan Cement Company Limited

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Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
03-Apr-2020	AA-	A1+	Stable	Maintain	-
28-Sep-2019	AA-	A1+	Stable	Maintain	-
30-Mar-2019	AA-	A1+	Stable	Maintain	-
16-Nov-2018	AA-	A1+	Stable	Maintain	-
04-May-2018	AA-	A1+	Stable	Initial	-

Rating Rationale and Key Rating Drivers

DG Khan Cement’s ratings reflect company’s strong position in the cement industry emanating from its third highest market share in terms of installed cement capacity. As of 1HFY20, the company’s three manufacturing units are operating at optimal capacity. Cement sector achieved second phase of expansion (18 mln tpa). However, slow local demand and expanded capacity resulted in depressed cement prices (especially in north region). Export is another avenue. Industry wide exports (sizeable increase in South Region) have gone up as new export window is created in Bangladesh market where sector is exporting notable volumes of cement and clinker. Cement sector's local capacity utilization already recorded dip to 65% in 1HFY20 (FY19: 68%). This will be further impacted amid COVID-19 outbreak and country wide lock down being observed. The likelihood of impact is considered high where quantum is directly correlated with tenure of lock down. Curtailed key policy rate will provide much needed breathing space to the sector. DG Khan - through its Hub plant is exporting sizeable amount of clinker to Bangladesh. The profitability of the company took a significant dip where margins deteriorated attributable to depressed prevailing cement prices. The company’s bottom line turned red in 1HFY20. However, bottom line was still supported by the established dividend stream of PKR 1.18bln from investment book; investment book's size of PKR 13.7 bln and PKR 16.3 bln in Nishat Group companies - mainly MCB Bank. The company’s financial profile reflects moderate leveraging; cashflows and coverage impacted because of negative profitability and increase in debt servicing. Going forward, improvement in margins and coverage remains vital. The rating takes into account the association company with Nishat Group. Revival in profitability and EBITDA is crucial, going forward.

The ratings are dependent on improvement of the company’s business vis-à-vis financial risk profile. Industry’s dynamics encompassing expected challenges of substantial decline in local demand or deterioration in cement prices will negatively affect the ratings.

Disclosure

Name of Rated Entity	D.G. Khan Cement Company Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-19),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-19),Criteria | Rating Modifier(Jun-19)
Related Research	Sector Study | Cement(Mar-20)
Rating Analysts	Abdul Wahab | abdul.wahab@pacra.com | +92-42-35869504

Profile

Legal Structure DG Khan Cement Company Limited (D.G. Khan) is a public limited company by shares incorporated in Pakistan in 1978 under the companies Act, 1913. The company is listed on Pakistan Stock Exchange (PSX). The company's registered office is located in 53-A, Lawrence Road, Lahore.

Background Mian Mohammad Yahya (a founder of Nishat Group), beginning with a cotton export house, he soon branched out into ginning, cotton and jute textiles, chemicals, cement and insurance. D.G Khan cement is a part of Nishat Group - renowned business group of Pakistan.

Operations DG Khan Cement is primarily engaged in the manufacturing and sale of Clinker, Ordinary Portland Cement and Sulphate Resistant Cement.

Ownership

Ownership Structure DG Khan Cement is majority owned (48.9%) by Nishat Group mainly through group companies (32%), followed by sponsor family members (~17%). Other is mainly owned by general public.

Stability The ownership of the Company remained the same for many years. Going forward, as the DG Khan Cement is Flagship Company of group, the sponsor will ensure the stability of the Company.

Business Acumen The business acumen of the shareholders is considered very strong.

Financial Strength Nishat's total Market Capitalisation as on June 30, 2018 is about PKR 406 bln (about USD 3.6 billion), Group's total assets are about more than PKR 1,800 billion (about USD 16 billion). 60% of group market capitalization is occupied by banking sector, cement and textiles both hold 12% each, power 6%, hotels & properties 3% and insurance 4%.

Governance

Board Structure The overall control of the company vests in seven member board of directors. Two board members (including CEO) hold executive positions while four are non-executives and one independent director.

Members' Profile Board member's business acumen is considered very strong because of their long association with the company and presence on board of other group companies. Mr. Mahmood Akhtar joined board on March 5th, 2019 because of demise of one director of DG Khan Cement.

Board Effectiveness There are Audit and Human Resource Committee in place to assist the board. Audit Committee reports to the board in line with code of corporate governance.

Financial Transparency M/s. A.F. Ferguson & Co. Chartered Accountants, 'A' SBP panel member, the external auditors have given unqualified opinion on the company's financial statements for the year ended Jun-19.

Management

Organizational Structure DG Khan Cement has a multi-tier organizational structure, divided into four key functions, namely (i) Finance, (ii) Marketing, (iii) Technical and Operations, and (iv) IT. Each function is headed by a separate director who, in turn, reports to the CEO except internal audit function.

Management Team The CEO, Mr. Raza Mansha, is a graduate from University of Pennsylvania and is associated with the company in capacity of CEO since 2003. Mr. Raza is involved in all strategic and key business and financial decisions of the company. The management is equipped with strong technical skills and enjoys long association with the company.

Effectiveness The company has executive committee in place. All the heads meet on regular basis to discuss the company matters and to ensure smooth running of operations.

MIS Daily reporting encompass daily, monthly and yearly comparisons along with month to date and year to date figures from each manufacturing site. System generates monthly accounts which are accessible through cloud.

Control Environment DG Khan Cement deploys an Oracle based ERP solution implemented at head office, all manufacturing sites and sales offices. DG Khan Cement has two manufacturing units located in 'Khairpur and DG Khan' – both categorized in North Region and third in Hub Baluhistan in South region. Plants are of European technology.

Business Risk

Industry Dynamics Cement industry is divided into North and South region – majority (76%) operational capacity exists in North region. Industry has completed phase II of capacity expansion of around 18mln tons per annum. Till end-Aug19, local cement despatches deteriorated significantly amid muted local demand. Afterwards, PSDP disbursements stimulated activity whereby local despatches picked up pace. During 8MFY20, north region witnessed 16% growth in local despatches where exports recorded curtailment of 3%. Exports to Afghanistan inched up, if sustained will provide breathing space to the north region. South region witnessed uptrend in export despatches which is correlated with longevity of export window available through sea. Industry dynamics significantly shifted attributable to augmentation in supply side which resulted in depressed prices; situation has become real challenging for players operating in north region. Low cement prices and high energy and fuel costs have resulted in erosion of profitability. Furthermore, high finance costs amplified the effect on financial matrix of cement players (especially in north region). Currently, long term leveraging of industry is moderate (28% as at end-Dec19) whilst total leveraging stands at 55%. Recent decrease in policy rate will provide little cushion to stressed fundamentals. Going forward, restoration of cement prices and margins is crucial for the sector as no huge infrastructural project is on the horizon and Coronavirus outbreak has negatively impacted economies around the globe. Post management of Covid-19 crises, local despatches may take time to pick up pace whilst ambiguity prevails on conditions related to export market.

Relative Position DG Khan Cement Company Limited operates with a cement production capacity of 7.1mln tons p.a.; the third largest player, having 10.2% share of the country's cement capacity (operational) as at Feb-20. During 1HFY20, the company's capacity utilization levels achieved optimal utilisation mainly attributable to the clinker being exported through Hub plant.

Revenues During FY19, DG Khan Cement reported revenue of PKR 40.5bln (FY18: PKR 30.7bln), demonstrating YOY growth of ~32% due to addition of Line-III. However, in 1HFY20 company couldn't maintain the trend where topline only grew by ~5% (1HFY20: PKR 20.8bln; 1HFY19: PKR 19.7bln). Company started exporting to Bangladesh through its Hub plant (started production in Jul-18). Dividend income (1HFY20: PKR 1.2bln, FY19: PKR 1.9bln) from strategic investments in group companies strengthened the revenue stream. Finance costs increased drastically by 536% YoY to PKR 3.3bln (1HFY20: 2.5bln) attributable to high leveraging and peaked interest rates. In 1HFY20, this profitability trend turned into loss of PKR 847mln (1HFY19: profit of PKR 1.7bln).

Margins During 1HFY20, international coal prices remained range bound (7MFY20: USD 77, FY19: USD 88) due to cut down of imports by China. However, due to the massive Pak rupee depreciation and depressed cement prices (since Mar-19) especially in north region has significantly impacted margins. Gross and operating margin worsen to ~5% (FY19: 13.2%) and -2% (FY19: ~8.5%) respectively.

Sustainability Going forward, management is focused on sustaining its cost leadership and performance uptrend, while servicing long-term debt.

Financial Risk

Working Capital During FY19, DGKCC's net cash cycle (net working capital days)– stood at -2 days (end-Dec19: 10days; end-Jun18: -13days) which was considered better. The company manages its working capital requirements through mix of internal generation and short term borrowings. At end-Dec19, the company reported STBs of PKR 18.9bln (FY19: PKR 20.2bln; FY18: PKR 12.2bln).

Coverages During FY19, EBITDA clocked in at PKR 7.5bln (FY18: PKR 9.1bln) down by ~18% YOY. While in 1HFY20, this decreased to PKR 1.7 bln. Hence, declined free cash flows YOY (end-Dec19: PKR 1 bln; end-Jun19: PKR 3.6bln; end-Jun18: PKR 7.1bln). Interest coverage ratio also deteriorated (end-Dec19: -0.3x; end-Jun19: 1.3x; end-Jun18: 18.4x).

Capitalization Long-term debt inched down due to scheduled repayment of loans (end-Dec19: PKR 15bln; end-Jun19: PKR 16bln; end-Jun18: PKR 17.7bln). Debt to debt plus equity ratio was (end-Dec19: 35%; end-Jun19: 37%). The company's short term borrowings remained high (end-Dec19: PKR 18.5bln; end-Jun19: PKR 20.2bln; end-Jun18: PKR 12.2bln).

PKR mln

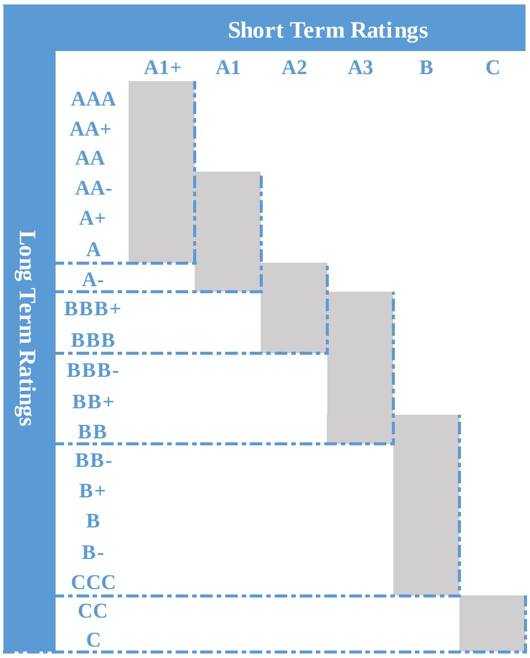
DG Khan Cement	Dec-19	Jun-19	Jun-18	Jun-17
Infrastructure | Cement	6M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	79,742	80,041	76,554	62,507
2 Investments	137	130	164	186
3 Related Party Exposure	30,957	27,276	33,120	36,428
4 Current Assets	15,918	18,494	12,051	9,251
a Inventories	*2,592*	*3,714*	*1,378*	*1,163*
b Trade Receivables	*1,483*	*1,192*	*188*	*220*
5 Total Assets	126,754	125,941	121,889	108,371
6 Current Liabilities	10,110	8,908	8,007	5,755
a Trade Payables	*3,412*	*3,261*	*3,559*	*1,527*
7 Borrowings	39,264	41,324	32,277	21,615
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	3,961	4,781	4,471	6,133
10 Net Assets	73,419	70,928	77,134	74,869
11 Shareholders' Equity	73,419	70,928	77,134	74,869
B INCOME STATEMENT				
1 Sales	20,888	40,517	30,668	30,136
a Cost of Good Sold	*(19,867)*	*(35,154)*	*(21,928)*	*(18,292)*
2 Gross Profit	1,021	5,362	8,740	11,845
a Operating Expenses	(1,422)	(1,934)	(1,523)	(1,530)
3 Operating Profit	(401)	3,428	7,217	10,314
a Non Operating Income or (Expense)	*1,135*	*1,867*	*672*	*1,227*
4 Profit or (Loss) before Interest and Tax	734	5,295	7,889	11,541
a Total Finance Cost	*(2,456)*	*(3,304)*	*(519)*	*(383)*
b Taxation	*875*	*(381)*	*1,468*	*(3,183)*
6 Net Income Or (Loss)	(847)	1,610	8,838	7,975
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*1,007*	*6,920*	*7,182*	*8,629*
b Net Cash from Operating Activities before Working Capital Changes	*(1,447)*	*3,974*	*6,794*	*10,388*
c Changes in Working Capital	*4,279*	*(5,505)*	*2,117*	*(2,533)*
1 Net Cash provided by Operating Activities	2,832	(1,531)	8,911	7,855
2 Net Cash (Used in) or Available From Investing Activities	(435)	(5,444)	(16,071)	(17,837)
3 Net Cash (Used in) or Available From Financing Activities	(1,097)	(872)	3,706	6,861
4 Net Cash generated or (Used) during the period	1,300	(7,847)	(3,455)	(3,120)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	3.1%	32.1%	1.8%	1.5%
b Gross Profit Margin	4.9%	13.2%	28.5%	39.3%
c Net Profit Margin	-4.1%	4.0%	28.8%	26.5%
d Cash Conversion Efficiency (EBITDA/Sales)	8.3%	18.6%	29.6%	39.0%
e Return on Equity (ROE)	-2.3%	2.2%	11.6%	11.3%
2 Working Capital Management				
a Gross Working Capital (Average Days)	39	29	18	14
b Net Working Capital (Average Days)	10	-2	-13	-6
c Current Ratio (Total Current Assets/Total Current Liabilities)	1.6	2.1	1.5	1.6
3 Coverages				
a EBITDA / Finance Cost	0.7	2.3	18.4	34.0
b FCFO / Finance Cost+CMLTB+Excess STB	0.1	0.4	0.7	1.5
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	-11.5	8.7	4.2	2.2
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	34.8%	36.8%	29.5%	22.4%
b Interest or Markup Payable (Days)	58.9	90.3	257.6	229.3
c Average Borrowing Rate	12.2%	8.9%	1.8%	2.4%

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.

Regulatory and Supplementary Disclosure
(Credit Rating Companies Regulations,2016)

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)
Proprietary Information