The Pakistan Credit Rating Agency Limited

Rating Report

SGM Sugar Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
06-Nov-2019	BBB-	A3	Stable	Maintain	-
07-May-2019	BBB-	A3	Stable	Maintain	-
31-Dec-2018	BBB-	A3	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflect improving business performance of the Company and support of new sponsors. SGM Sugar has its mill located in Sindh with a crushing capacity of 8,000TCD. The Company has been acquired by 'United Group' of Essarani family. The family has long standing experience in agriculture sector and commodity trading including trading in fertilizer and coal, operating a sugar mill (Sindh Abadgar's Sugar Mills Limited) and ethanol distillery (United Ethanol Limited). Given the size of mill and steps taken by new management, a turnaround in operations is expected. The Company improved its margins and profitability during 9MMY19, though quantum and profits remain small. The financial risk profile is characterized by high leveraging and extended working capital cycle as the Company is holding significant stocks. The coverages improved and remain adequate. Sponsors' commitment to provide financial support provides comfort to the ratings.

The ratings are dependent upon optimizing capacity utilization and achieving operational efficiency envisaged by the management. Any further deterioration in margins and/or cashflows will negatively impact the ratings.

Disclosure	
Name of Rated Entity	SGM Sugar Mills 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 | Sugar(Oct-19)
Rating Analysts	Ayesha Malik | ayesha.malik@pacra.com | +92-42-35869504

Profile

Legal Structure SGM Sugar Mills Limited (the Company) is a public unlisted company.

Background The Company was incorporated on September 11, 2007, as a public limited company under the Companies Ordinance, 1984. It started operations on December 6, 2009. The Company was formerly owned by Dhabi Group, Etihad Group and Mehar Family. However, during May, 2018, Essarani Family acquired the majority stake from Dhabi Group and Etihad Group.

Operations The primary business of the Company involves the sale and manufacturing of crystalline sugar along with ensuing byproducts (Molasses and Bagasse). The Company has a crushing capacity of 8,000 TCD with its mill located in Ghotki, Sindh, whereas the head office is located in Karachi. During MY19, (first full season under new management/ownership) the Company produced 72,926MT of sugar, 35% higher as compared to MY18. Higher production was achieved through successful crop procurement and production efficiencies. The Company achieved a sucrose recovery rate of ~10% and had no opening stock available.

Ownership

Ownership Structure Majority shareholding (66%) lies with the Essarani Family through individuals while remaining (34%) is held by the Mehar Family through individuals.

Stability Ownership is seen as stable as the Company's controlling interest now vests with one family. Each individual in the family holds a defined share in the Company.

Business Acumen Essarani family has been involved in agriculture sector for a significant period of time and owns entities collectively represented under 'United Group'. The Group's entities include Sindh Abadgar's Sugar Mills Limited, United Ethanol Industries Limited (engaged in ethanol manufacturing), Agro Trade Private Limited (engaged in coal trading) and United Agro Chemicals (fertilizer and sugar trading).

Financial Strength SGM Sugar Mills derives its financial strength from United Group. Collectively, the United Group's asset base is ~ PKR 19,356mln supported with an equity base of ~ PKR 9,510mln as at Nov' 18.

Governance

Board Structure The Company's BoD comprises three members all of whom are Essarani family members, including the CEO. Limited size of the board, dominance of sponsoring family and absence of independent oversight indicates room for improvement exists in the overall governance framework.

Members' Profile Mr. Deo Mal Essarani acts as the Chairman of the Board. He has over 46 years of diversified experience and also acts as the Chairman for two other group companies - Sindh Abadgar's Sugar Mills and United Ethanol Industries Limited.

Board Effectiveness Lack of board meetings and low frequency of board meetings reflects negatively on board effectiveness.

Financial Transparency M/s Rahman Sarfaraz Rahim Iqbal Rafiq Chartered Accountants, classified in Category 'A' by the SBP with a satisfactory QCR rating by ICAP, have been appointed as the external auditors of the Company. They have expressed an unqualified opinion on the financial statements for the year ending in September, 2018.

Management

Organizational Structure Highest level of authority lies with the Chief Executive, who is supported by Resident Director Mills and Chief Financial Officer. The Company has established functions for cane procurement, production, mechanical and electrical at mill location that report to the Resident Director. All functions at head office pertaining to finance and purchases report to CFO.

Management Team Mr. Asha Ram has been appointed as CEO. However, key responsibility for managerial oversight and decision making rests with Dr. Tara Chand Essarani. Dr. Tara Chand is a medical doctor by profession and a member of Pakistan Sugar Mills Association. He is also the CEO of Sindh Abadgar's Sugar Mills Limited and United Ethanol Industries Limited. He has over fifteen years of experience in the Sugar Industry.

Effectiveness The Company has no management committees in place. However, meetings are conducted fortnightly to discuss business performance and organizational structure changes. All HODs and CEO are present at the meetings. In addition, further meetings are called as required.

MIS The Company is using an in-house web based Information System having four integrated modules; GL, sales and receivable, store and cane procurement.

Control Environment Internal audit department exists at the Group level. The Group is in the phase of extending the same services on shared basis to the Company.

Business Risk

Industry Dynamics Pakistan's sugar industry is the 2nd largest agro based industry, comprising ~90 mills with annual crushing capacity estimated around 65 – 70 mln MT. The industry has been under pressure of late owing to a supply glut over the previous seasons combined with a distortion in the support price mechanism. Additionally, a slowdown in international sugar prices have made exports viable only through subsidy support. During MY19, overall sugar production fell by ~20%, YoY, to 5.3 mln MT on the back of lower crop availability. The government approved an export quota of 1.1mln tons, however, no subsidy was announced, leading to low quantities availed. During the FY20 Budget, sales tax levied on sugar was increased to 17%, charged on the price of PKR 60/KG, effective from July 1, 2019. Under the current scenario, sales to unregistered buyers have been disallowed and CNIC of all buyers must be maintained. This has been made effective from August 1, 2019.

Relative Position Owing to high number of players in the industry, companies relatively have low market share. The Company had a market share of ~ 1% during MY19.

Revenues The Company's revenue stream comprises the sale of sugar and molasses. During 9MMY19, the Company posted net revenue worth PKR 2,001mln. The Company did not engage in any sales during the first quarter of MY19 in anticipation of better prices. This led to lower sales despite increased production during the period. Additionally, the Company was able to gain a higher price of molasses, which augmented revenues.

Margins Inefficient operations in recent years has led the Company to post losses over successive years. During 9MMY19, under the new management, the Company posted a gross margin of ~17%, as compared to ~4% in MY18. Higher gross margin is attributable to favorable prices of sugar in local market, along with production efficiency. Similarly, a sharp decline in administration costs, arising from shared group functions, helped the Company to post operating profit of ~PKR 280mln as compared to operating loss of ~PKR 97mln in MY18. This translates into an operating margin of ~14% (MY18: ~(3)%). Nonetheless, profitability was impacted owing to high finance costs arising from an elevated interest rate and high stock holding costs. The Company posted net profit of PKR 7mln in 9MMY19.

Sustainability Going forward, the management aims to improve business performance through efficient operations with no major expansion activity planned. The overall profitability is expected to improve as the Company holds significant inventory.

Financial Risk

Working Capital The Company witnessed elevated working capital requirements during 9MMY19 on the back of high stocks. During 9MMY19, inventory days increased to 273 days as compared to 62 days in MY18. This was the primary reason behind inflated net working capital days of 284 days (MY18: 57 days). Moreover, no cushion for additional short-term funds constraints the Company's working capital performance. However, this is expected to improve in the coming quarter as the Company unloads stocks and reduces short-term exposure.

Coverages Despite improved cashflows, coverage ratios to remained adequate owing to surged finance costs arising from high interest rates and higher utilization of short-term lines to support operations. FCFO during 9MMY19 stood at ~PKR 593mln as compared to ~PKR 15mln during MY18. Meanwhile, finance costs rose to ~PKR 328mln in 9MMY19 as compared to ~PKR 148mln in MY18. Resultantly, impact of improved cashflows was subdued. During 9MMY19, interest coverage increased to 1.8x (MY18: 0.1x) and core coverage increased to 1.2x (MY18).

Capitalization The Company has a highly leveraged capital structure represented by a leveraging ratio of ~73% during 9MMY19 (MY 18.6%). Total debt is inclined towards long-term borrowings, representing ~56% of total borrowings in 9MMY19. An increase in total debt was witnessed during the nine month period owing to higher utilization of short-term lines. Additionally, the Company expects to convert sponsors loan worth PKR 660mln (extended by Mr. Asha Ram) into equity. The figure is currently classified as advance against equity.

PKR mln

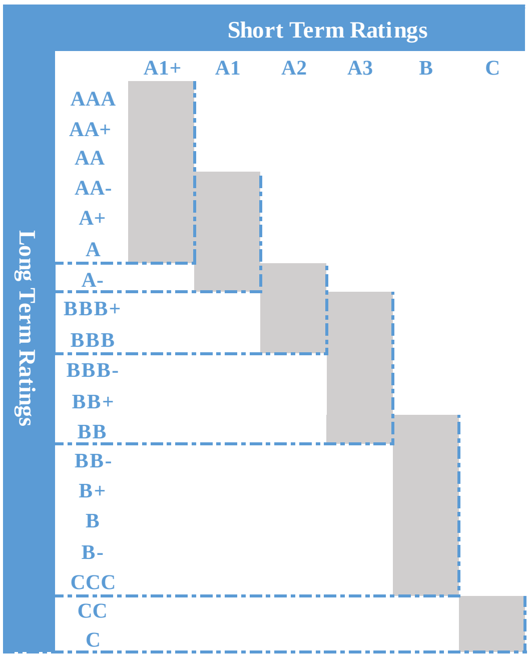
SGM Sugar Mills Limited	Jun-19	Sep-18	Sep-17	Sep-16
Sugar	9M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	5,414	5,681	4,605	4,818
2 Investments	-	-	-	-
3 Related Party Exposure	-	-	-	-
4 Current Assets	2,655	291	847	239
a Inventories	*1,993*	-	*589*	*5*
b Trade Receivables	*141*	-	*0*	*0*
5 Total Assets	8,068	5,972	5,452	5,057
6 Current Liabilities	207	553	1,551	1,525
a Trade Payables	*93*	*27*	*69*	*109*
7 Borrowings	5,178	2,800	1,830	1,074
8 Related Party Exposure	-	-	1,208	935
9 Non-Current Liabilities	717	775	520	712
10 Net Assets	1,966	1,844	343	812
11 Shareholders' Equity	1,967	1,844	343	812
B INCOME STATEMENT				
1 Sales	2,001	3,483	2,194	2,447
a Cost of Good Sold	*(1,666)*	*(3,360)*	*(2,526)*	*(2,643)*
2 Gross Profit	336	123	(332)	(197)
a Operating Expenses	(56)	(219)	(152)	(151)
3 Operating Profit	280	(97)	(484)	(348)
a Non Operating Income or (Expense)	*34*	*456*	*16*	*186*
4 Profit or (Loss) before Interest and Tax	313	360	(468)	(162)
a Total Finance Cost	*(340)*	*(155)*	*(188)*	*(214)*
b Taxation	*34*	*(0)*	*52*	*61*
6 Net Income Or (Loss)	7	205	(604)	(315)
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*593*	*15*	*(121)*	*194*
b Net Cash from Operating Activities before Working Capital Changes	*288*	*(723)*	*(166)*	*134*
c Changes in Working Capital	*(2,704)*	*445*	*(702)*	*309*
1 Net Cash provided by Operating Activities	(2,416)	(278)	(867)	443
2 Net Cash (Used in) or Available From Investing Activities	(46)	(7)	(156)	(54)
3 Net Cash (Used in) or Available From Financing Activities	2,493	307	1,029	(389)
4 Net Cash generated or (Used) during the period	31	22	6	0
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-23.4%	58.8%	-10.3%	-36.5%
b Gross Profit Margin	16.8%	3.5%	-15.1%	-8.0%
c Net Profit Margin	0.4%	5.9%	-27.5%	-12.9%
d Cash Conversion Efficiency (EBITDA/Sales)	31.3%	1.8%	-4.5%	9.4%
e Return on Equity (ROE)	0.5%	18.8%	-104.6%	-30.4%
2 Working Capital Management				
a Gross Working Capital (Average Days)	292	62	98	8
b Net Working Capital (Average Days)	284	57	83	-7
c Current Ratio (Total Current Assets/Total Current Liabilities)	12.8	0.5	0.5	0.2
3 Coverages				
a EBITDA / Finance Cost	1.9	0.4	-0.5	1.1
b FCFO / Finance Cost+CMLTB+Excess STB	1.2	0.0	0.0	0.1
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	7.9	-23.1	-12.1	-180.6
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	72.5%	60.3%	89.9%	71.2%
b Interest or Markup Payable (Days)	81.4	157.1	0.0	0.0
c Average Borrowing Rate	11.0%	5.1%	7.4%	13.4%

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