The Pakistan Credit Rating Agency Limited

Rating Report

Descon Oxychem Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
17-May-2024	A+	A1	Stable	Maintain	-
17-May-2023	A+	A1	Stable	Maintain	-
17-May-2022	A+	A1	Stable	Upgrade	-
01-Jul-2021	A	A1	Positive	Maintain	-
01-Jul-2020	A	A1	Positive	Maintain	-
02-Jul-2019	A	A1	Positive	Maintain	-
31-Dec-2018	A	A1	Positive	Maintain	-
30-Jun-2018	A	A1	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

Descon Oxychem Limited (‘DOL’ or ‘the Company’) is primarily engaged in the manufacturing, procurement, and sale of Hydrogen Peroxide (H_2O_2) & allied products having a variety of applications in multiple sectors including textile, mining, pulp & paper, water treatment, sugar, food & beverages, cosmetics, and poultry. The ratings reflect the Company’s leading position in the local H_2O_2 market, underpinned by a solid sponsorship background and propitious clientele. Pakistan’s H_2O_2 industry has shown progress during recent years as the application of definitive anti-dumping duty offers an enabling environment to local producers. During FY23, the Company indirectly benefitted from the substantial PKR devaluation owing to its export-oriented customer base, particularly the textile sector, which resulted in an impressive growth of ~58% YoY in revenues. However, during 1HFY24, the sales returned to normal owing to currency stabilization and an oversupply of imported H_2O_2, after clearance of consignments stranded amid import restrictions, prompting importers/commercial traders to slash the prices to remain competitive. The cost breakup is dominated by natural gas and power expenses, reflecting the risk generated by the Company’s reliance on price-sensitive energy sources. During 1HFY24, the company's profitability matrix was impacted by the steep rise in the prices of these cost drivers. DOL manages to augment its revenue position by using state-of-the-art technology plant, efficient production processes, and strengthening its footprint; predominantly in the higher profitability region and segments. Over the years, the Company has made considerable volumetric growth as import substitution is being encouraged. The key opportunity is generically available to the Company if investments are made in terms of capturing the vacuum created after the cessation of production of a key competitor. The financial risk profile of the Company remains good, characterized by efficient working capital management and healthy coverages. DOL’s capital structure is low-leveraged; encompasses STBs and a solid equity base. Ratings draw comfort from DOL’s association with the financially sound and experienced business group - DESCON. Going forward, the company intends to enhance its production capacity to achieve economies of scale and better consumption factors. Related FEED studies have been initiated. Moreover, the Company’s ability to pass on the impact of cost escalations by materializing the envisaged strategy remains pivotal for the sustainability of the profitability matrix.

The ratings are dependent on the DOL’s ability to retain its position amidst a changing business environment and the management’s ability for successful strategy execution by tapping new segments. With the growth in DOL’s revenue; prudent financial performance, strong coverages, and effective liquidity profile shall remain imperative.

Disclosure

Name of Rated Entity	Descon Oxychem Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Rating(Jul-23),Methodology | Correlation Between Long-term & Short-term Rating Scales(Jul-23),Methodology | Rating Modifiers(Apr-23)
Related Research	Sector Study | Chemical(Jul-23)
Rating Analysts	Sohail Ahmed Qureshi | sohail.ahmed@pacra.com | +92-42-35869504

Profile

Legal Structure Descon Oxychem Limited (hereinafter referred to as "Descon Oxychem" or "the Company") is a public listed entity incorporated under the Companies Ordinance, 1984 (now "Companies Act, 2017"). It has a free float of ~30% at the end Mar-24.

Background Descon Oxychem was incorporated as a private limited company in 2004 and was listed in September 2008. It is a project of the Descon Group. Following commissioning in October 2008, the Company's plant started commercial production in March 2009.

Operations The core operations of Descon Oxychem comprise the manufacturing & distribution of Hydrogen Peroxide (HPO) of up to 60% concentration. Its production facility is located at 18-KM Lahore Sheikhupura Road, consisting of an HPO plant with a technology-licensed capacity of ~42,000 MT per annum and a Hydrogen plant. The capacity of the plant had been increased by 25% with effect from Feb-21.

Ownership

Ownership Structure Descon Group, the principal sponsor of Descon Oxychem holds a majority shareholding of ~72.63% through associated companies while the remaining ~27.37% stake rests with the general public and financial institutions.

Stability The transfer of the Company's ownership to a holding company provides clarity to Descon Oxychem's ownership structure, boding well for its stability.

Business Acumen Descon has been operating in engineering, chemicals, and power as its core businesses since 1977. Mr. Abdul Razak Dawood, advisor to the former Prime Minister for Commerce, Textile, Industry & Production, is the founder and former Chairman of Descon Group. The Razak Dawood family is one of the well-known business families of Pakistan.

Financial Strength The Descon Group has expanded its footing in diversified business avenues with a considerable portfolio of strategic investments, enhancing the group's financial strength. The Group has shown willingness and ability to support the associated companies in times of need.

Governance

Board Structure The Company's board comprises eight members including one executive, four non-executive, and three independent directors. Descon Oxychem's board structure is considered strong.

Members' Profile Descon Oxychem's board comprises highly qualified members and has a blend of business, engineering, and finance professionals. Mr. Faisal Dawood has taken over as the chairman. He possesses extensive experience and has served at various management position within the engineering and chemical divisions of the Descon Group.

Board Effectiveness Strong attendance of members in board meetings and proper documentation of minutes bodes well for the board's effectiveness. Further, four board committees have been formed to assist the Board.

Financial Transparency M/s A.F. Ferguson & Co., listed in Category "A" of the State Bank's panel of auditors, the external auditor of the Company, expressed an unqualified opinion on the Company's financial statements for the period ended June 30, 2023. Meanwhile, the Company has outsourced its internal audit function to M/s KPMG Taseer Hadi & Co. Moreover, during 1HFY24, M/S Crowe Hussain Chaudhury & Co. took over as the external auditors of the company.

Management

Organizational Structure The Company operates through seven functional departments, each headed by an experienced manager. Some business functions including IT, Human Resources, and Accounting & Finance are shared at the Group level.

Management Team Mr. Mohsin Zia is currently serving as the CEO of Descon Oxychem Limited. He holds 30+ years of diverse experience in marketing services, business development, sales management, supply-chain management, and strategy development. He is assisted by an experienced management team.

Effectiveness Descon Oxychem's senior management receives daily performance reports of the plant's operations which results in optimal monitoring. Key management personnel meet on a regular basis to discuss key business issues, reflecting well on the management's effectiveness.

MIS The Company has implemented the R12 version of the Oracle E-business suite application, which is also used at other associated companies of Descon. The ERP solution generates various MIS reports related to production, inventory management, sales, and trade receivables/payables, resulting in improved efficiency.

Control Environment The Company's HPO plant was supplied by Chematur Engineering, Sweden; regular visits by Chematur's staff also ensure efficient operations and high quality of the final product. Descon Oxychem is among the few operators of Chematur technology in Pakistan. Further, the Company has also implemented a Quality Hygiene Safety Model and Reliability Centre Management which helps in improving plant reliability.

Business Risk

Industry Dynamics Pakistan's HPO industry has remained with only one local producer i.e. Descon Oxychem Ltd, with a capacity of ~42,000 MT per annum, after Sitara Chemicals ceased its production during 1HFY24. Currently, the domestic demand outstrips the supply and is estimated at ~80,000-110,000MT. Hence, over 50% of the local demand is being met through imports. Major consumer of HPO is the textile industry, accounting for more than 3/4 of the total domestic demand (70%); this is followed by the mining, paper & board, & food industries. Going forward, Engro Polymer and Chemicals intends to enter the HPO industry with ~28,000MT capacity (at 50pc concentration). Anti-dumping is installed on imports based on foreign manufacturers selling products at significantly lower margins/loss to make the business less sustainable for local players. This is necessary to protect foreign exchange reserves and encourage local industry.

Relative Position At present, Descon Oxychem remains the HPO leader with a market share of more than 50%. With Engro Polymer and Chemicals' new plant, the Company's market share may diminish to some degree. However, with continually rising local demand and enhanced capacity expansion, Descon Oxychem is expected to remain the leading player in the industry.

Revenues The Company derives majority of its revenue from local sales (~92%) augmented by ~8% from exports, local sales are predominant to the textile sector for bleaching & dyeing purposes while the remaining minor portion of sales is made to mining & food sector consumers. During 1HFY24, the top line of the Company has shown a decline of ~13.7% and clocked in at ~PKR 2,899mln (FY23: PKR 6,721mln, FY22: ~PKR 4,250mln). Revenue growth in FY23 was observed on the back of enhanced capacity, better placement of volume, & revised prices.

Margins The Company's gross margin showed a significant decline in 1HFY24 and reported at ~20.2% (FY23: ~41.0%) on the back of increased cost of raw materials, and elevated energy prices. The same translated into a decreased operating profit margin (1HFY24: 13.6%, FY23: ~35.3%). Finance cost decreased to PKR 13mln. However, the net margin diluted and stood at ~9.2% during 1HFY24 (FY23: 20.8%, FY22: 11.1%).

Sustainability Descon Oxychem regularly invests in BMR. Optimal capacity utilization is of utmost importance to manage costs & sustain high margins. Efforts to penetrate new market segments have been successfully implemented alongside organic growth in the Textile, Mining & Food sectors. The company is also exploring other options to diversify into downstream products which will further strengthen the usage of HPO in the local market.

Financial Risk

Working Capital Descon Oxychem's cash cycle remains robust as nearly all sales are on a cash basis while the Company is offered a credit period of ~90 days by its sourcing partners. Over the period, working capital cycle has stretched which is evident from the gross cash cycle (1HFY24: ~59 days, FY23: ~37 days). Most of the Company's sales are cash-based, resulting in a very short net cash cycle (1HFY24, ~39 days: FY23: ~15 days). The strategic piling up of raw materials to hedge against inflation has remained the primary factor behind increased working capital days during the period.

Coverages The Company's FCFO locked at PKR -18mln in 1HFY24 owing to decreased profitability. In coverages, interest coverage was significantly diluted (1HFY24: ~-3.1x, FY23: ~201.7x). Its debt coverage ratio also significantly declined in 1HFY24 and recorded at ~-0.8x (FY23: ~38x). However, this can be attributable to higher tax payments during the period and the coverages are expected to improve in the coming quarters.

Capitalization Descon Oxychem's leveraging has decreased significantly over the years. During FY21, the Company obtained a long-term loan for the expansion project. resultantly, leveraging increased to ~36.7% in FY21. However, the loan was prepaid prompting a decrease in leverage to ~13.4% during FY22. As at end Dec-23, leveraging further improved to ~10.7%. Long-term loan makes ~37% of the total debt of the Company.

The Pakistan Credit Rating Agency Limited

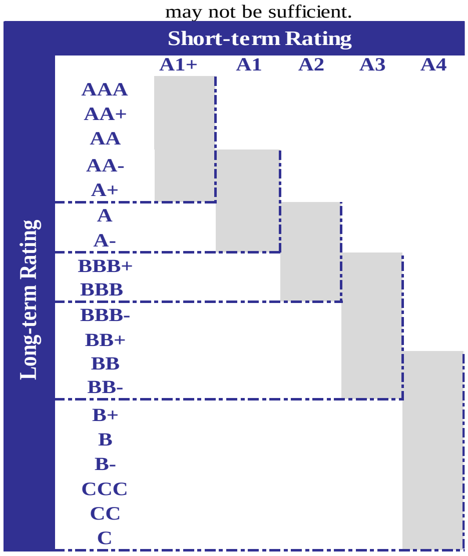
Descon Oxychem Limited	Dec-23	Jun-23	Jun-22	Jun-21
Chemicals	6M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	2,247	2,349	2,546	2,477
2 Investments	225	897	150	561
3 Related Party Exposure	2	2	-	-
4 Current Assets	1,831	1,788	1,209	855
a Inventories	*903*	*717*	*249*	*155*
b Trade Receivables	*75*	*166*	*237*	*72*
5 Total Assets	4,306	5,036	3,905	3,893
6 Current Liabilities	773	1,506	915	382
a Trade Payables	*256*	*364*	*451*	*119*
7 Borrowings	355	261	366	1,189
8 Related Party Exposure	-	-	-	5
9 Non-Current Liabilities	203	209	265	253
10 Net Assets	2,975	3,059	2,359	2,063
11 Shareholders' Equity	2,975	3,059	2,359	2,063
B INCOME STATEMENT				
1 Sales	2,899	6,721	4,250	2,805
a Cost of Good Sold	*(2,315)*	*(3,965)*	*(3,149)*	*(2,192)*
2 Gross Profit	585	2,756	1,102	613
a Operating Expenses	(190)	(383)	(201)	(156)
3 Operating Profit	395	2,373	901	457
a Non Operating Income or (Expense)	*91*	*(123)*	*(46)*	*(4)*
4 Profit or (Loss) before Interest and Tax	486	2,250	855	453
a Total Finance Cost	*(13)*	*(26)*	*(53)*	*(69)*
b Taxation	*(207)*	*(823)*	*(332)*	*(109)*
6 Net Income Or (Loss)	266	1,401	471	274
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*(18)*	*2,374*	*1,118*	*669*
b Net Cash from Operating Activities before	*(26)*	*2,345*	*1,065*	*625*
c Changes in Working Capital	*(339)*	*(474)*	*(9)*	*(79)*
1 Net Cash provided by Operating Activities	(365)	1,871	1,056	546
2 Net Cash (Used in) or Available From Inve	568	(905)	20	(1,266)
3 Net Cash (Used in) or Available From Fina	(259)	(824)	(1,027)	770
4 Net Cash generated or (Used) during the p	(56)	142	49	50
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-13.7%	58.1%	51.5%	6.2%
b Gross Profit Margin	20.2%	41.0%	25.9%	21.9%
c Net Profit Margin	9.2%	20.8%	11.1%	9.8%
d Cash Conversion Efficiency (FCFO adjuste	-12.3%	28.3%	26.1%	21.1%
*e Return on Equity [Net Profit Margin * Ass*	17.6%	51.7%	21.3%	13.7%
2 Working Capital Management				
a Gross Working Capital (Average Days)	59	37	31	30
b Net Working Capital (Average Days)	39	15	6	9
c Current Ratio (Current Assets / Current Li	2.4	1.2	1.3	2.2
3 Coverages				
a EBITDA / Finance Cost	109.8	235.1	25.4	12.4
b FCFO / Finance Cost+CMLTB+Excess ST	-0.8	38.0	8.5	2.6
c Debt Payback (Total Borrowings+Excess S	-2.7	0.1	0.3	1.9
4 Capital Structure				
a Total Borrowings / (Total Borrowings+Sha	10.7%	7.9%	13.4%	36.7%
b Interest or Markup Payable (Days)	100.7	10.7	67.6	124.2
c Entity Average Borrowing Rate	3.9%	3.8%	7.5%	7.8%

Credit Rating

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 Rating	
Scale	**Definition**
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 Rating	
Scale	**Definition**
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
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

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 some material identifiable event with indeterminable rating implications. 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 rating 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) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) 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.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):
a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Companies Rating

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 | Clause 11-(A)(p).
(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 | 17-(a)
(19) PACRA reviews all the outstanding ratings periodically, on annual basis; Provided that public dissemination of annual review and, in an instance of change in rating will be made; | Chapter III | 17-(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 | 17-(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 | 17-(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 | 14-3(f)(vii)

Proprietary Information