The Pakistan Credit Rating Agency Limited

Rating Report

Descon Oxychem Limited

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Rating History					
Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
31-Dec-2018	A	A1	Positive	Maintain	-
30-Jun-2018	A	A1	Stable	Maintain	-
30-Jun-2017	A	A1	Stable	Maintain	-
22-Sep-2016	A	A1	Stable	Maintain	-
11-Dec-2015	A	A1	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

The ratings recognize the company's leading position in the local Hydrogen Peroxide market, supplemented by efficient production process, sound technological infrastructure, and effective control environment. Ratings also draw comfort from Descon Oxychem’s association with a financially sound and experienced business group - DESCON - which has continuously demonstrated support. One of the only two manufacturers in Pakistan market, Descon Oxychem has gradually strengthened its footprints; particularly in north region. Market Share enhanced considerably over the years solidifying Descon Oxychem's position as market leader. Related debt from financial institution has been repaid completely, while debt from associates has been converted into cumulative, non-voting preference shares. Capitalizing on available fiscal space, the company is poised to undertake expansion to increase capacity by 25%. The expansion will be financed mainly through debt, to the tune of PKR 1.1bln. Currently Free cashflows (FCFO) provides requisite cushion for the debt. Recently higher Hydrogen Peroxide prices in international markets have boded well as the company generated better cashflows and profitability. Sustainability of FCFO remains critical, going forward, keeping in view fluctuating nature of hydrogen peroxide international price trend, as well as moderate demand growth in local industry.

The ratings are dependent on improved competitiveness of the company. Timely execution of expansion plan and translation of the same into added profitability would impact positively on the ratings. Meanwhile smooth operations from current plant would remain important. Prudent management of debt matrix, keeping it conservative, shall be critical.

Disclosure	
Name of Rated Entity	Descon Oxychem 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 | Hydrogen Peroxide(Jun-18)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Descon Oxychem Limited, a project of DESCON group, produces Hydrogen Peroxide (HPO), was incorporated in 2004 as a private limited company.

Background In August 2008, the company was listed on Pakistan Stock Exchange with effect from Sep15, 2008. Following commissioning in October 2008, the plant started commercial production in March 2009.

Operations The main business of the company is the manufacture and distribution of HPO up to 60% concentration. The production facility is located at 18 Km Lahore Sheikhupura Road and mainly consists of a) HPO plant with a capacity of 28,000 MT per anum and b) Hydrogen plant. Descon Oxychem's total power requirement is ~2.7MW which is being provided by LESCO – with dedicated lines. The company has also installed backup diesel generator with a 3.5MW capacity

Ownership

Ownership Structure Descon, the principal sponsor of Descon Oxychem, holds majority shareholding (61%) through associated companies (17%) and sponsoring family members (44%). Meanwhile, 39% of the company's stake rests with general public and public sector Institutions.

Stability Descon Oxychem's association with Descon group brings stablity to the company's ownership. Next generation of the sponsors have taken control of the management of the business after resignation of Abdul Razzaq Dawood.

Business Acumen Descon has been operating in engineering, chemicals and power as its core businesses since 1977. Originating from Pakistan, Descon has, over the years, expanded its horizons to Abu Dhabi, Saudi Arabia, Qatar, Oman and Egypt. With 19 companies (including Descon Oxychem) operating from Group's platform, Descon Engineering Limited is the flagship company of the DESCON and for past 31 years it has contributed to the engineering sector in Pakistan.

Financial Strength Descon Oxychem possesses a robust financial strength due to its association with the Descon. Descon has expanded its footing in diversified business avenues with a sizable portfolio of strategic investments. The group's business portfolio spans across various sectors including engineering, power and Chemicals.

Governance

Board Structure Descon Oxychem's board comprises eight-members, dominated by three family members, followed by two group executives, and two independent directors. With resignation of one group executives/CEO of the company, one position is vacant at the board.

Members' Profile Descon oxychem's board comprises highly qualified members, mostly from foreign universities. It has a blend of business studies, engineering and finance professionals. Mr. Taimur Dawood, Chairman, earned his Bachelor Degree in Industrial Engineering from Purdue University, USA and MBA from Columbia University, New York, USA, and has over 15 years of work experience in a variety of fields.

Board Effectiveness The board has formed four committees to ensure effectiveness. The board ensures effective governance through its committees, namely, (i) Enterprise Risk Management Committee, (ii) Audit Committee, (iii) Human Resource &Remuneration Committee and (iv) Compliance Committee.

Financial Transparency A.F.Ferguson & Co., a member firm of PWC, is the auditor of the company. They expressed an unqualified opinion on the company's financial statements at end-Jun18. The company has also well-defined internal audit department which ensures strong financial efficacy.

Management

Organizational Structure The company operates through seven departments, each headed by an experienced manager. The departments are 1) Plant Management 2) Investments 3) Marketing & Sales 4) Finance & Accounts 5) Human Resource 6) Quality & Assurance 7) Sourcing & Planning.

Management Team Descon Oxychem has an experienced management team. Mr. Imran Qureshi is the newly appointed CEO of the company, joined Descon Oxychem in May 2018. Mr. Imran is foreign qualified, having overall experience of ~20 years in his portfolio.

Effectiveness The company's professional management and organizational structure bodes well with the effectiveness of the management .The management reviews daily MIS reports to review the company performance. There are no formal management meetings though key management personnel meet on daily and weekly basis to discuss key issues.

MIS The company has implemented R12 version of the Oracle E-business suite application, which is also used at other associated companies of DESCON. The ERP solution is capable of generating various MIS related to production, inventory management, sales and trade receivables/payables. Oracle Financials, Manufacturing and Project modules are in place.

Control Environment Hydrogen Peroxide being a chemical industry needs special quality and environmental controls. Descon Oxychem has engaged international consultants to ensure quality and enhance plant's production capabilities. To improve operational reliability the company has implemented Quality hygiene Safety Model and Reliability Centre Management.

Business Risk

Industry Dynamics H2O2 (Hydrogen Peroxide - HPO), industry presently has two players (a) DOL and (b) Sitara Peroxide (SPL) with an installed capacity of 28,000 MT and 30,000 MT respectively. The domestic demand currently stands close to 66 K tons. Out of the country's total demand ~13%-15% is met through imports while the rest is being catered by two players i.e. DOL and SPL. Anti-dumping duty has been imposed on multiple international players.

Relative Position Currently Descon Oxychem is the market leader with Share of ~53% followed by Sitara Peroxide Limited with 34%. With Engro Polymer's announcement of entry into Hydrogen Peroxide business, Descon Oxychem's market share may diminish going forward. However, with expected increase in economic activty in the country Descon Oxychem expects to maintain its market share.

Revenues During FY18, the topline of company has improved to 2,088 mln (FY17: PKR 1,961mln; FY16: PKR 1,582mln), up by ~6.5%. This improvement has been seen on back of increased selling price and meagre increase in the volumes. During 1QFY19, topline of company decreased increased on the back of increased selling price and higher international prices of Hydrogen Peroxide in International prices.

Margins Due to increase in power cost and raw material cost, production cost has increased. However, the company was able to transfer this cost to end consumers on the back of higher selling prices in international market. Resultantly gross margins have increased in FY18 to 29.5% (FY17: 25.8%). Gross margins increased significantly in 1QFY19 on the back of higher international prices, though margins are expected to normalize at the year end. The company expects to increase its gross margins to ~30% in coming years.

Sustainability Going forward, management of the company is planning to expand its current production capacity by ~25%. New capacity is expected to come online by FY20. After incorporating expansion, new capacity will be set out to be at 35,000 MT (Current: 28,000 MT). DOL has a capacity utilization of ~122% with the actual production of ~34,300 MT. Post expansion, DOL's actual production would reach to approx. 43,000 MT, replicating strong demand of Hydrogen Peroxide.

Financial Risk

Working Capital Descon Oxychem's cash cycle remained robust as almost all sales are on cash basis while the company is offered a credit period of 90 days by its sourcing partners. Over the years, Descon Oxychem's working capital management has improved which is evident from continuous reduction in net working capital days (FY18: -3 days, FY17: 6 days). Due to increase in payables Net cash cycle increased in 1QFY19 though expected to normalize by year end.

Coverages In FY18, FCFO of the company has increased to PKR 591mln (FY17: PKR 546mln) owing to improvement in profitability, consequently, coverages improved attributing to continuous reduction in finance cost. Nevertheless, incorporating cumulative preference dividend (bearing character of interest), interest coverage stand at 4.5x in FY18, though decreasing in 1QFY19 to 2.2x.

Capitalization The company has re-paid its long-term borrowing so it has a deleveraged capital structure. Descon Oxychem's planned expansion of its production facility by 7,000 MT with an estimated project cost of PKR ~1.2bln; will be financed through debt. With the new debt to be acquired leveraging is expected to increase to ~40% by FY20.

Descon OxychemLimited

BALANCE SHEET	30-Sep-18	30-Jun-18	30-Jun-17	30-Jun-16
	3M	FY	FY	FY
Non-Current Assets	**1,430**	**1,455**	**1,625**	**1,836**
Investments (incl. Associates)	**-**	**-**	**-**	**-**
Equity	-	-	-	-
Debt Securities (incl. income funds)	-	-	-	-
Current Assets	**877**	**585**	**535**	**712**
Inventory	81	26	48	33
Trade Receivables	59	39	67	54
Others	736	519	420	625
Total Assets	**2,307**	**2,039**	**2,160**	**2,547**
Debt/Borrowings	**-**	**-**	**42**	**407**
Short-Term	-	-	42	50
Long-Term (incl. Current Maturity of Long-Term Debt)	-	-	-	357
Other Short-Term Liabilities	300	264	401	628
Other Long-Term Liabilities	-	-	-	-
Shareholder's Equity	**2,007**	**1,776**	**1,717**	**1,513**
Total Liabilities & Equity	**2,307**	**2,039**	**2,160**	**2,547**
INCOME STATEMENT				
Turnover	**732**	**2,088**	**1,961**	**1,582**
Gross Profit	337	616	507	343
Other Income	(18)	(6)	(9)	9
Financial Charges	(1)	(5)	(12)	(77)
Net Income	**231**	**322**	**205**	**45**
Cash Flow Statement				
Free Cash Flows from Operations (FCFO)	296	591	541	384
Net Cash changes in Working Capital	(125)	54	(44)	34
Net Cash from Operating Activities	170	449	217	366
Net Cash from InvestingActivities	(13)	(51)	(52)	(44)
Net Cash from Financing Activities	92	(306)	(364)	(175)
Net Cash generated during the period	249	91	(200)	146
Ratio Analysis				
Performance				
Turnover Growth (v.s same period last year)	63.2%	6.5%	24.0%	12.2%
Gross Margin	46.0%	29.5%	25.8%	21.7%
Net Margin	31.6%	15.4%	10.4%	2.8%
ROE	15.4%	24.2%	11.9%	3.0%
Coverages				
Debt Service Coverage (times) (FCFO/Gross Interest+CMLTD+Uncovered STB)*	2.2	4.3	3.8	0.8
Interest Coverage (times) (FCFO/Gross Interest)	2.2	4.3	3.8	1.8
Debt Payback (Total LT Debt Including Uncovered Total STBs) / (FCFO - Gross Ir	0.1	0.1	0.1	2.0
Liquidity				
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	10	-3	6	3
Leveraging (Total Debt/Total Debt+Equity)**	0.0%	0.0%	2.4%	21.2%

Rating Scale

Credit Rating Scale & Definitions

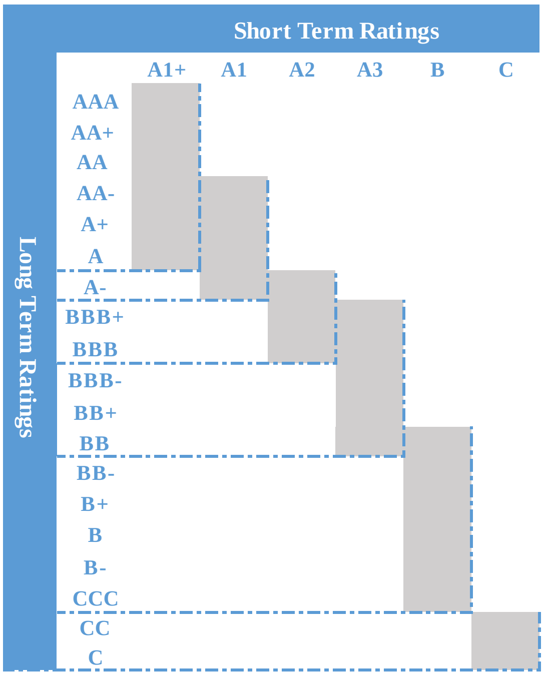
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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.

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