The Pakistan Credit Rating Agency Limited

Rating Report

Engro Fertilizers Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
30-Jul-2019	AA	A1+	Stable	Maintain	-
28-Jan-2019	AA	A1+	Stable	Maintain	-
27-Jul-2018	AA	A1+	Stable	Upgrade	-
30-Dec-2017	AA-	A1+	Stable	Maintain	-
20-Apr-2017	AA-	A1+	Stable	Maintain	-
18-Nov-2016	AA-	A1+	Stable	Maintain	-
18-Nov-2015	AA-	A1+	Stable	Upgrade	-
08-Jan-2015	A+	A1	Stable	Upgrade	-
27-Jan-2014	A	A1	Stable	Upgrade	-

Rating Rationale and Key Rating Drivers

The ratings takes account of sustained operations of the company; capacity utilization at both plants remained good on the back of continued gas supply, despite the plant’s turn-around period. The company has been able to secure sustainable gas supply. Efert is among the companies that benefits from the incentivized gas pricing of 70 cents under the fertilizer policy 2001, hence translating into strong margins. Plus, the domestic supply/demand scenario during 2018 was favorable - increased urea prices - provided additional cushion to the business in enhancing its profitability. The future demand supply scenario depends upon the economic dynamics of the farmer community, given input price escalation, and production from the stand-by plants (Agritech and Fatima Fert). Recovery of sale tax refunds and subsidy is an important milestone, which should be seen in the context of pending issue related to GIDC. GIDC related developments are expected to crystallize over the shorter horizon, which are likely to provide benefit to industry players generally. Currently, price parity with the international market for urea is quite favorable. The financial risk profile of the company is characterized by moderate leveraging, which has turned out to be more a function of its strategy for balance sheet efficiency. Efert continues to derive strength from its association with Engro Corporation – a corporate conglomerate. Efert is expanding its operations into other agri based products. Moreover, the company has now spun-off its DAP trading activity to a separate 100% owned subsidiary; named Efert Agritrade.

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

Disclosure	
Name of Rated Entity	Engro Fertilizers Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	PACRA_Methodology_Corporate_FY19(Jun-19),PACRA_Crtieria_LT ST Relationship_FY19(Jun-19)
Related Research	Sector Study | Fertilizer(Jan-19)
Rating Analysts	Raniya Tanawar | raniya.tanawar@pacra.com | +92-42-35869504

Profile

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

Background Formerly registered under the name - Engro Chemicals Pakistan Limited, a broad restructuring took place in 2009 with the aim of continuous expansion which subsequently resulted in demerger of the company to form a new Engro subsidiary – Engro Fertilizers Limited. The shareholding was gradually reduced from 100% as part of strategic re-alignment to explore new opportunities in other promising sectors involved.

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

Ownership

Ownership Structure EFert is ~56.3% owned by Engro Corporation (ECorp), a prominent corporate conglomerate of the country. Free float as at Dec’18 was ~45%.

Stability The ownership structure of EFert is strong, backed by two corporates – ECorp and DH-Corp – wherein the propensity and ability to provide support, through equity and debt is formidable.

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

Financial Strength The company’s prominent and long presence in the fertilizer industry has enabled it to sustain a strong financial outlook. The main sponsor - Engro Corp. has equity stakes in diversified portfolios of cash generating businesses which assures ample comfort on the sponsor financial strength.

Governance

Board Structure EFert has an eight member Board of Directors; two Engro Corp’s executives and four independent directors.

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

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

Financial Transparency The External Auditors of the company, A.F. Ferguson & Co. rated ‘A’ on the SBP panel, have expressed an unqualified opinion on the financial statements for the year Ended Dec, 2018.

Management

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

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

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

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

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

Business Risk

Industry Dynamics The industry benefits from the demand of its major product urea and oligopolistic market conditions. The fertilizer industry has been facing volatility in past two years with respect to i) gas availability and price fluctuation ii) shutdown of LNG based urea plants iii) rain shortage, removal of subsidy and Iv) Urea prices hike. This compelled the GoP to resume the closed LNG based plants on subsidized gas (Fatimafert & Agritech). Also, the country has imported 100KT urea in Dec'18 to avoid urea shortfall. On the pricing front, recent gas price notification from OGRA has depicted a wholesome increase in the gas price for the sector. However, since the Industry players and Government are in resolution for the GIDC matter, fertilizer prices are not expected to increase in the same ratio in the coming months. The future demand supply scenario depends upon the economic dynamics of the farmer community, given input price escalation.

Relative Position Efert has been significantly contributing in the urea market and takes the liberty of being the second largest player in the fertilizer industry with a total installed capacity of 2.3mln M.tons which accounts for ~27% of industry’s demonstrated capacity. The company recorded a market share of ~32% in Urea and 43% in DAP during 1QCY19, largely stable since the last period. Moreover, the company has now spun-off its DAP trading activity to a separate 100% owned subsidiary; named Efert Agritrade.

Revenues Efert CY18 urea sales volumes were recorded at ~1.9mln MT, up 14% YoY (CY17:~1.7mln MT). Urea sales volume dropped by 12% from same period last year owing to lower production levels as the plant remained shut for turnaround. Despite lower urea sale volumes, urea sales in value terms for 1QCY19 increased to PKR 17bln up by ~13% owing to sanguine prices. In CY18, EFert’s topline observed a moderate growth by ~5% YoY, clocking in at PKR~66bln (CY17: PKR ~63bln) excluding the subsidy (CY18: PKR~1.3bln (CY17: PKR~5bln).

Margins The domestic supply/demand scenario remained favorable during CY18 due to increased urea prices which provided additional cushion to the business in enhancing its profitability.The finance cost of the company declined on an overall basis during CY18; PKR~2bln (CY17 - PKR~2.5bln) with the debt obligations being loaded off. However, as witnessed since 2HCY18 - the hike in interest rates, company's finance cost inflated to PKR~816mln during 1QCY19 (1QCY18: PKR~503mln). Profitability stood at PKR~17bln (CY17: PKR~10bln) translating into improved net margins CY18; ~24% (CY17: ~15%). The rise in margins is mainly attributable to the increased prices during CY18 and emanates from the gross margin level,.

Sustainability The Company continues to explore new avenues particularly in pesticides and agri farming sectors. These are expected to yield positive results in the long run. With an aim of diversifying product, portfolio Efert’s Specialty Fertilizer Business has started marketing 4 new products; Zoron, Power Potash, SSP+Zn and Zabardast Urea in CY18. Additionally, the company is undergoing 2 pilot projects; logistic and crop solutions.

Financial Risk

Working Capital During CY18, Efert’s working capital requirement remained comfortable (~7 days), in line with the industry which opened the year (CY18) with 260KTons of urea inventory. The company majorly meets its working capital needs through internally generated cashflows (cash generated from operations: PKR~22bln) and the rest is financed through short term borrowing - PKR ~637mln as at End-Dec'18.

Coverages Efert ably generates sound free cash flows from operations (FCFO); PKR~24bln in CY18 (CY17: PKR~19bln), reflecting an increase of ~26% YoY, on the backdrop of fine profit before tax PKR~21bln (CY17:~15bln, CY16: PKR~13.bln). As a result, interest coverages strengthened to 12 times (CY17: 7.4 times). Offloading long term debt, with no major borrowing plans, current maturity of long term debt (CMLTD) dropped to PKR~5bln (CY17: PKR~8bln),

Capitalization Efert has been aptly managing its capital structure by keeping debt levels optimum: CY18:~42% (CY17: ~46%). Total borrowings, comprises, CMLTD, Short term borrowings, long term borrowings and debt instruments, which have been continuously reducing; CY18: PKR~31bln (1QCY19: PKR~30bln, CY17: PKR~33bln). The company has had in issue a Sukuk of PKR~3,200mln since Jul-14 which has completed its tenor of 5 years in June-19. Efert strategizes on keeping its leveraging low.

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Financial Summary
PKR mln

Engro Fertilizers Limited	Mar-19	Dec-18	Dec-17	Dec-16
Fertilizer	3M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	71,948	72,833	73,533	74,740
2 Investments	12,050	6,335	7,083	143
3 Related Party Exposure	12,015	14,238	2,629	568
4 Current Assets	22,198	20,743	23,087	26,977
a Inventories	*3,033*	*2,960*	*3,528*	*6,820*
b Trade Receivables	*2,048*	*2,375*	*3,485*	*7,585*
5 Total Assets	118,211	114,148	106,333	102,428
6 Current Liabilities	37,938	32,301	23,067	16,917
a Trade Payables	*5,983*	*5,697*	*4,149*	*7,461*
7 Borrowings	30,291	31,499	32,626	36,510
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	7,164	7,352	9,627	7,718
10 Net Assets	42,817	42,996	41,013	41,283
11 Shareholders' Equity	42,818	42,996	41,013	41,283
B INCOME STATEMENT				
1 Sales	16,640	67,413	67,990	77,397
a Cost of Good Sold	*(10,167)*	*(38,232)*	*(42,538)*	*(52,408)*
2 Gross Profit	6,473	29,181	25,452	24,989
a Operating Expenses	(1,653)	(7,915)	(7,761)	(7,591)
3 Operating Profit	4,820	21,266	17,691	17,398
a Non Operating Income or (Expense)	*1,013*	*2,189*	*(136)*	*(887)*
4 Profit or (Loss) before Interest and Tax	5,833	23,455	17,556	16,511
a Total Finance Cost	*(816)*	*(2,055)*	*(2,560)*	*(3,136)*
b Taxation	*(1,189)*	*(4,731)*	*(4,859)*	*(4,351)*
6 Net Income Or (Loss)	3,828	16,669	10,137	9,025
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*5,219*	*24,188*	*18,833*	*17,986*
b Net Cash from Operating Activities before Working Capital Changes	*4,032*	*19,303*	*16,165*	*14,615*
c Changes in Working Capital	*1,073*	*8,602*	*12,047*	*(13,839)*
1 Net Cash provided by Operating Activities	5,105	27,905	28,212	775
2 Net Cash (Used in) or Available From Investing Activities	9,400	(15,080)	(5,136)	(2,422)
3 Net Cash (Used in) or Available From Financing Activities	(660)	(14,751)	(15,062)	(10,748)
4 Net Cash generated or (Used) during the period	13,845	(1,925)	8,013	(12,395)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-1.3%	-0.8%	-12.2%	-8.9%
b Gross Profit Margin	38.9%	43.3%	37.4%	32.3%
c Net Profit Margin	23.0%	24.7%	14.9%	11.7%
d Cash Conversion Efficiency (EBITDA/Sales)	39.0%	43.0%	32.4%	27.8%
e Return on Equity (ROE)	35.7%	39.7%	24.6%	21.5%
2 Working Capital Management				
a Gross Working Capital (Average Days)	29	33	57	56
b Net Working Capital (Average Days)	-3	7	26	10
c Current Ratio (Total Current Assets/Total Current Liabilities)	0.6	0.6	1.0	1.6
3 Coverages				
a EBITDA / Finance Cost	8.0	14.1	8.6	6.9
b FCFO / Finance Cost+CMLTB+Excess STB	1.5	1.9	1.8	2.2
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	1.9	1.7	1.9	2.3
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	41.4%	42.3%	44.3%	46.9%
b Interest or Markup Payable (Days)	0.0	0.0	0.0	0.0
c Average Borrowing Rate	10.6%	6.4%	7.4%	7.7%

#	Notes
D-1a	**The sales growth for the quarter hass been annualised for quarters**
B-1	**Sales includes the subsidy received from GoP**
A-7	**Borrowings includes CMLTD, L.T borrowings, S.T borrowings and Debt instruments (if any)**
-	-

Rating Scale | Corporate

2019

Credit Rating Scale & Definitions

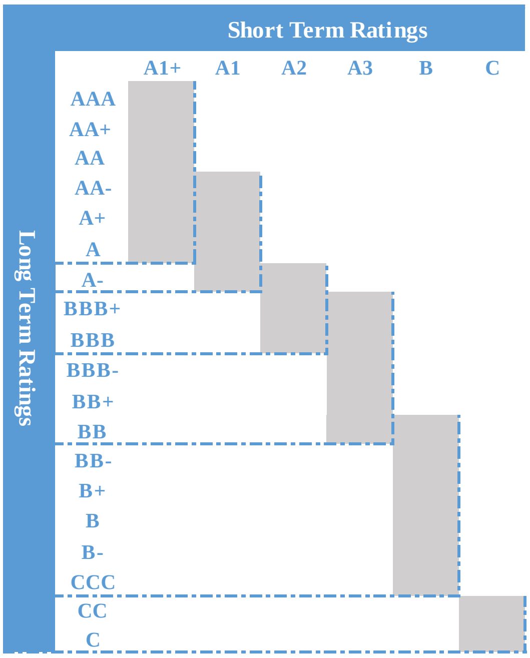
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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