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
29-Jul-2020	AA	A1+	Stable	Maintain	-
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	-

Rating Rationale and Key Rating Drivers

The ratings take account of sustained operations of Engro Fertilizers Limited (referred as "Engro"); capacity utilization at both plants remained good on the back of continued gas supply and plant efficiencies, evidenced from a record high production of urea in 1QCY20. In fertilizer Industry, Engro is among the companies that benefits from the incentivized gas pricing of 70 cents per mmbtu, under the fertilizer policy 2001, hence reaping strong margins. Lately, Pakistan's urea market has witnessed certain key changes on the pricing front.In January 2020, the Government reduced GIDC on the fertilizer sector to PKR 5/MMBTU in an attempt to improve farm economics by way of reducing urea prices. Welcoming the decision of the government to reduce GIDC, Engro Fertilizers Limited was the first company to have fully passed on the benefit by decreasing Urea prices by PKR 160/bag, given its gas mix. In addition to this, the Company volunteered to further reduce its prices by PKR 240/Bag in March 2020 to help alleviate the adverse impact of a global pandemic on the nation. The additional price cut resulted in an overall price reduction of PKR 400/Bag since the beginning of the year.Subsequently, the Industry experienced a wave of price disparity due to varying price cuts in 1QCY20; though, it did not hold longevity. As a result, Engro's market share took a dip in 1QCY20, which is expected to revive in the coming periods. By end of march the price disparity was eliminated in the industry, in order to benefit the farmer community at large. On the flip side, the Industry's urea offtake reflected an uneven Month-on-Month (MoM) trend, majorly owing to the outbreak of COVID-19 pandemic and the consequential lockdown. Overall demand remained largely stable. Moreover, proactive strategies are necessitated to prevent the risk of locust swarms to the agricultural industry. Engro's financial risk profile is characterized by moderate leveraging, which has turned out to be a function of management strategy for balance sheet efficiency. Engro continues to derive strength from its association with Engro Corporation Limited (ECorp) – a corporate conglomerate. The Company is also diversifying its product portfolio into other agri based products.

The ratings are dependent on sustainability of operations and upholding of the Company's market share in the urea industry. Any constraint to perceived ability to keep the business and financial risks 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	Methodology | Corporate Ratings(Jun-20),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria | Rating Modifier(Jun-20)
Related Research	Sector Study | Fertilizer(Jan-20)
Rating Analysts	Shazia Afzal | shazia.afzal@pacra.com | +92-42-35869504

Profile

Legal Structure Engro Fertilizers Limited (EFert), incorporated in 2010, with its head office in Karachi, is a public listed company

Background Continual expansions and diversifications in the Company's enterprises necessitated a broad restructuring in Engro Chemical Pakistan Ltd. which demerged to form a new Engro subsidiary – Engro Fertilizers Limited in the year 2010. 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 urea producers, is primarily in the business of manufacturing and marketing of urea and deals in other fertilizers. The product line of EFert comprises Urea sold under the brand name of Engro Urea, NPK – complex fertilizer – as Zarkhez, Phosphate-based products – DAP and MAP as Engro DAP, and Zorawar respectively, and zinc based fertilizers as Zingro and also includes Crop & Seeds division and logistics business . DAP is imported and sold in the local market through its wholly owned subsidiary. EFert has a strong country wide distribution network

Ownership

Ownership Structure EFert is ~56% owned by Engro Corporation (ECorp), a corporate conglomerate with a consolidated asset base of PKR 581bln and consolidated revenue base of PKR~45bln as at March 31st '2020.

Stability The ownership structure of EFert is strong, backed by two corporate entities –ECorp and DHCorp – wherein the propensity and ability to provide support, through equity and debt, is relatively high.

Business Acumen ECorp is majority owned by Dawood Group (DG). As at Dec '19, Dawood Group holds a major stake of 45% in Engro Corp mainly through Dawood Hercules Corporation Limited (37%) and the rest through other corporate entities (7%)%) and individuals (1%). 14% is held by financial institutions and 41% is held by other corporate entities, general public and others.

Financial Strength 1 Engro Corporation Limited, being a holding company, has a well-diversified business portfolio spanning across various sectors. The fertilizer business operates through Engro Fertilizers Limited, food business(Associate company) under the name FrieslandCampina Engro Pakistan Limited (previously as Engro Foods Limited), power generation as Engro Energy Limited, etc .

Governance

Board Structure EFert's Seven-member board comprises three Engro Corp's executives, one non-executive and three independent directors.

Members' Profile The Company's board is chaired by a seasoned professional Mr. Ghias Khan. He is the CEO of the holding company-Engro Corp, with a long association with Engro Group. Mr Nadir Salar Qureshi ,a seasoned professional ,previously Chief Strategy Officer at ECorp ,is the President and CEO of Engro fertilizers. Overall members profile is considered strong

Board Effectiveness EFert has two board committees viz. Board Audit Committee and Board Peoples Committee while ECorp's Board Investment Committee oversees the investment related matters of EFert and other subsidiaries as well.

Financial Transparency A. F. Ferguson & Co Chartered Accountants, categorized as 'A' category in SBP's Auditor's list, are the auditors of EFert.

Management

Organizational Structure The operations of the company are divided into five major departments, headed by able professionals, who report directly to the CEO Mr Nadir Salar Qureshi. Mr. Imran Ahmed, is the CFO of the company, with a previous experience with Shell (Pak Arab Pipeline company Limited) in the similar capacity

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

Effectiveness The company has three principal operation committees, – i) Management Committee – 6 members, ii) Corporate Health, Safety and Environment Committee – 10 members, iii) Committee for Organizational and Employee Development –9 members .

MIS EFert utilizes completely integrated and real time ERP solution – developed by SAP – 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 EFert maintains an effective control environment with clear reporting lines, predefined authority limits and well defined policies and procedures. The review and accountability function runs through the entire organizational structure.

Business Risk

Industry Dynamics The industry benefits from the demand of its major product urea and oligopolistic market conditions. Urea and DAP share ~70% and ~20% of the total fertilizer industry offtake, respectively. Pakistan's agriculture sector is currently under threat from Locust invasion.an acceleration is expected after monsoon, which could turn out to be a major issue for economy and fertilizer sector. Fertilizer sales have already been under pressure due to delay in subsidy announcement . Urea industry sales for 1QCY20 clocked in at 1,017 KT, down by 25% vs 1,348 KT in 1QCY19, because of significant channel inventory at the start of year; and market disruption due to lockdown in March20. Phosphate industry sales stood at 229KT vs 197KT in 1QCY19 (up 16%). This positive change is attributed to the lower channel inventory at the start of this year, coupled with lower prices.

Relative Position Urea production of the company during 1QCY20 stood at 527KT vs 446KT in 1QCY19. Sales took a steep dip to 169KT vs 435KT during 1QCY19 down by 60% due to price disparity issue within the Industry, making EFert's urea market share drop to ~17% (from ~32%).

Revenues In 1QCY20, EFert's topline decreased to PKR 8bln (1QCY19: PKR 16bln) and CY19: PKR~79bln; predominantly led by low offtakes on the back of price disparity. A revived situation is expected in the coming periods with the settlement of different price issue.

Margins The company's finance cost increased to PKR~1,224mln during 1QCY20 (PKR~3,688mln during CY19 vs PKR~2,055mln during CY18) due to increase in borrowing rates and currency devaluation. Short term borrowings stood at 1QCY20: PKR~1.3blnln vs 1QCY19:PKR~55mln . Net profit margin, therefore, dropped to ~17% during 1QCY20 vs ~25% during 1QCY19.

Sustainability The Company continues to explore new avenues particularly in pesticides and agri farming sectors, which are currently at an Initial stage. These are expected to yield positive results in the long run.

Financial Risk

Working Capital The company met its working capital needs through internal sources (cash generated from operations: PKR~5.7bln during 1QCY20) and through short term borrowings of PKR~1.3bln.

Coverages Free cash flows from operations (FCFO) stood at PKR~3bln in 1QCY20 (vs PKR~4.6bln), a decrease of 33%, in line with a decrease in profit after tax to PKR~1.3bln during 1QCY20 (1QCY19: PKR~3.8bln). Resultantly, interest coverage decreased to 2.6 times from 6.4 times . Cautious management approach is necessitated.

Capitalization EFert has been aptly managing its capital structure within levels of 40-43% band: 1QCY20 ~40%, vs 1QCY19 ~41%. Borrowings have remained stable while standing at PKR~29bln as at End-March'20 in comparison to PKR~30bln as at End-Dec'19.

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Engro fertilizers Agriculture	Mar-20 3M	Dec-19 12M	Dec-18 12M	Dec-17 12M
A BALANCE SHEET				
1 Non-Current Assets	70,077	71,158	72,833	73,533
2 Investments	6,969	5,502	6,335	7,083
3 Related Party Exposure	8,019	16,246	14,238	2,629
4 Current Assets	38,198	36,202	20,743	23,087
a Inventories	*10,932*	*3,569*	*2,960*	*3,528*
b Trade Receivables	*4,975*	*10,010*	*2,375*	*3,485*
5 Total Assets	123,263	129,108	114,148	106,333
6 Current Liabilities	36,769	41,264	32,301	23,067
a Trade Payables	*11,688*	*13,192*	*5,697*	*4,149*
7 Borrowings	29,999	32,555	31,499	32,626
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	12,255	12,437	7,352	9,627
10 Net Assets	44,240	42,853	42,996	41,013
11 Shareholders' Equity	44,240	42,853	42,996	41,013
B INCOME STATEMENT				
1 Sales	8,058	79,237	67,413	67,990
a Cost of Good Sold	*(4,751)*	*(46,524)*	*(38,232)*	*(42,538)*
2 Gross Profit	3,308	32,713	29,181	25,452
a Operating Expenses	(1,249)	(7,971)	(7,915)	(7,761)
3 Operating Profit	2,059	24,742	21,266	17,691
a Non Operating Income or (Expense)	*1,128*	*7,340*	*2,189*	*(136)*
4 Profit or (Loss) before Interest and Tax	3,186	32,083	23,455	17,556
a Total Finance Cost	*(1,372)*	*(4,847)*	*(2,055)*	*(2,560)*
b Taxation	*(427)*	*(8,673)*	*(4,731)*	*(4,859)*
6 Net Income Or (Loss)	1,388	18,563	16,669	10,137
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*3,166*	*25,368*	*24,188*	*18,833*
b Net Cash from Operating Activities before Working Capital Changes	*3,166*	*21,136*	*19,303*	*16,165*
c Changes in Working Capital	*(8,931)*	*1,957*	*8,602*	*12,047*
1 Net Cash provided by Operating Activities	(5,765)	23,093	27,905	28,212
2 Net Cash (Used in) or Available From Investing Activities	8,357	3,374	(15,080)	(5,136)
3 Net Cash (Used in) or Available From Financing Activities	(3,412)	(22,096)	(14,751)	(15,062)
4 Net Cash generated or (Used) during the period	(821)	4,370	(1,925)	8,013
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-59.3%	17.5%	-0.8%	-12.2%
b Gross Profit Margin	41.0%	41.3%	43.3%	37.4%
c Net Profit Margin	17.2%	23.4%	24.7%	14.9%
d Cash Conversion Efficiency (EBITDA/Sales)	49.2%	44.2%	43.0%	32.4%
e Return on Equity (ROE)	12.7%	43.2%	39.7%	24.6%
2 Working Capital Management				
a Gross Working Capital (Average Days)	167	44	33	57
b Net Working Capital (Average Days)	26	0	7	26
c Current Ratio (Total Current Assets/Total Current Liabilities)	1.0	0.9	0.6	1.0
3 Coverages				
a EBITDA / Finance Cost	3.2	9.5	14.1	8.6
b FCFO / Finance Cost+CMLTB+Excess STB	0.9	1.9	1.9	1.8
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	3.7	1.5	1.7	1.9
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	40.4%	43.2%	42.3%	44.3%
b Interest or Markup Payable (Days)	0.0	0.0	0.0	0.0
c Average Borrowing Rate	15.6%	11.5%	6.4%	7.4%

Credit Rating

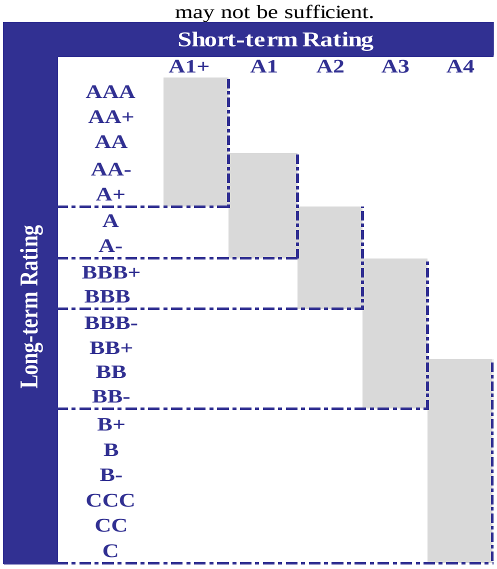
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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):

Entities
a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments
a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk 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.

(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