# Pathibhara Steels Industries Private Limited:

# [ICRANP] L BB/ [ICRANP] A4+ assigned

**December 20, 2018**

## Summary of rated instruments:

| Instrument* | Rated Limit (NPR Million) | Rating Action |
|---|---|---|
| Fund-based - Long-term loans | 77.51 | [ICRANP] LBB (Assigned) |
| Fund-based - Short-term loans | 722.49 | [ICRANP] A4+ (Assigned) |
| **Total** | **800.00** | |

**Instrument details given in Annexure 1 below.*

## Rating action

ICRA Nepal has assigned the long-term rating of [ICRANP] LBB (pronounced ICRA NP L Double B) to the NPR 73.57-million long-term loans of Pathibhara Steels Industries Private Limited (PSI). ICRA Nepal has also assigned the short-term rating of [ICRANP] A4+ (pronounced ICRA NP A Four Plus) to the NPR 726.43-million short-term loans (including proposed limits) of PSI.

## Rationale

The rating considers positive demand outlook for steel products in Nepal and duty protection accorded to the domestic steel industries by the government of Nepal (GoN), through import barriers on finished steel products. This augurs well for growth and profitability of steel producers in Nepal, helping shield the local industry from the threat of cheaper finished steel imports. The ratings also factor in the strategic location of the project, close to the core market area in Jhapa and adjoining districts and lack of other competitors in the immediate vicinity. This remains a positive for future business growth prospect. The ratings also factor in promoter's experience in processing and trading steel products and their network in the construction hardware retailing (trading) segment, providing established supply chain for pushing incremental sales.

However, the rating remains constrained by PSI's small scale of operation and its lack of established track record, especially in thermo-mechanically treated (TMT) bar manufacturing. The ratings are also constrained by the company's limited geographical and product diversification, and the cyclical nature of the steel business, exposing the company to volatile cash-flows. PSI has enhanced its manufacturing capacity by adding higher-capacity machinery in its rolling mill in Q1 FY2018 and has started manufacturing TMT bars from Q4FY2018. PSI's turnover has reported marked increase in FY2018, on less than 3 months of TMT sales. However, being a new entrant to the TMT segment, the plant capacity utilisation has remained suboptimal thus far, and its ability to gain traction with customers, ramp-up production, and achieve targeted sales will be important. ICRA notes that PSI's operations remain highly working capital intensive, which adversely impacts its liquidity profile, and increases its dependence on external financing to fund capacity ramp-up. Therefore, beside scaling up the business, achieving stability (especially managing its cash cycle) and establishing adequate control mechanism also remains to be seen. On the funding side, PSI is yet to tie up its debt[1] to support higher working capital requirement. Its ability to timely secure working capital financing will be important to achieve targeted growth. Rating concerns also emanate from forex risk because of the purchase of steel billet in US Dollars and sales revenue in domestic currency.

## Key rating drivers

### Credit strengths

#### Positive demand outlook for steel products in Nepal

Nepal's import of steel products from India (including semi-finished products like Billet, Ingots, sponge iron, etc.) registered a sharp growth in FY2017 and FY2018 (96% and 15% year-on-year respectively). Between April and October 2018, Nepal was the largest importer of steel products from India (registering an annualized growth of 64% over FY2018). This indicates a growing demand for steel products in Nepal. The growth is expected to remain strong over the medium term, supported by the reconstruction drive following the earthquake in 2015. Moreover, recently concluded local/state election and the formation of local government are expected to provide impetus to infrastructural development across

[1] *The company is currently funding its working capital requirement through one-off excess over limit credit facility.*

the country. Given the higher custom tariff for most of the finished steel products (including TMT), import barriers remain high. Hence, Steel producers in Nepal are expected to benefit from strong domestic demand.

**PSI's trading portfolio diversifies reveneu stream & promoter's involvement in trading of construction hardwares strengthens distribution chain**

In addition to the rolling mill operation (manufacturing of TMT and steel sections), PSI also imports and trades in galvanized iron angles. From H2FY2019, the company plans to add mild steel wire to its trading (with minor processing) portfolio. The company's experience in trading and promoter's involvement in wholesale/ retail trading units (dealing in construction materials) have helped PSI establish traction with major traders in the region. Presence of trading wing also remains a positive as it helps in revenue diversification and provides alternative earnings stream during the period of any disruption in the manufacturing process. In FY2017 and FY2018, ~17% of total sales by PSI was made through the wholesale/retail trading units owned by the promoters, their relatives or business associates. Established sales channel of PSI (albeit on a small scale of operation) remains a comfort. However, adequacy of the current set-up to support the increased sales target of the company remains to be seen.

**Strategic location of the factory increases price competitiveness over peers in local arena**

PSI's rolling mill is in Birtamode city of Jhapa district, about 25 km from the Indo-Nepal border in Kakadvitta[2]. Since import of steel billet is made from Durgapur in West Bengal, India, the factory's proximity to the border remains a positive leading to savings in freight cost. Jhapa and adjoining two districts in Terai (viz. Morang and Sunsari) were the core market area for PSI in the past two years (generating >80% sales). With the PSI looking to expand its sales and market area, company plans to focus on the adjoining hilly districts as well. Location of PSI's factory in Jhapa makes it the closest steel manufacturer for the hilly districts like Illam, Panchthar, Terathum and Taplejung. Stronghold in Jhapa and adjoining Terai districts with increased focus on the nearby hilly region is likely to provide PSI with adequate market for its product and is expected to aid the company to steadily ramp-up capacity utilization levels. Proximity of PSI to these area makes PSI's products more price competitive over other players because of lower freight cost involved. However, the ability of the company to compete with existing products having longer track record and established brand, remains to be seen.

## Credit challenges

**Limited geographical and product diversification along with and low entry barriers**

PSI's business is concentrated in and around Jhapa district in Eastern Nepal. This exposes the company to geographical concentration risk. Moreover, the industry has relatively simple business model and lower capital expenditure requirement, which creates low entry barriers. This remains a concern from the long-term growth and sustainability of revenue. Risk also arises because of limited diversification in product and customer profile. The product profile and scale of operation offers limited scope for PSI to cater to the demand from large corporates and projects. Therefore, PSI's business growth will depend on the outlook of construction sector in retail segment.

**PSI's small scale of operation exposes the company to pricing pressure from established large-scale players**

Despite the industry potential, the TMT segment in Nepal remains competitive with older and established brands competing for the same market. Large scale players operating in the industry have the benefit of economies of scale and accordingly could exert pricing pressure on small-scale players like PSI. At the same time, competition in the TMT segment is also increasing with new rolling mills proposed in the eastern region of the country by established local business houses. This could intensify competition and hit margins of all players. For small players like PSI, reduction in margin could have a greater impact vis-à-vis large-scale players with economies of scale on their side.

**Highly working capital intensive nature of operations; untied working capital limits remains a concern**

PSI's operations remain highly working capital intensive, as reflected by an NWC/OI of 36.5% in FY2018. PSI has been availing working capital facilities in excess of regular limits, because of sharp increase in the business size following enhancement of plant capacity and addition of TMT-bar portfolio. Although the company is in discusion with bankers for

*[2] Kakadvitta borders with West Bengal of India. However, because of limited IT infrastructures at Indian customs office at Kakadvitta, billet is imported through Jogbani customs in Morang which is ~100 km from PSI's factory location. Process is underway to upgrade the capacity of the Indian custom office at Kakadvitta.*

the enhancement of limits, it remains to be tied up through firm agreement. Given the working capital-intensive nature of business, timely securing the working capital limits will be critical for achieving targeted business growth.

### Weak capitalization and high gearing level puts pressure on debt servicing ability

PSI's equity capitalization remains low vis-à-vis the scale of operation, resulting in high gearing level (TOL/TNW[3] ratio of 7.70 times in mid-July 2018 and total debt/OPBDITA[4] 6.50 times as of mid-July 2018). In the current regime of high-interest rates, high gearing level could put pressure on PSI's debt protection metrics over near term, until the company is able to ramp-up operations and achieve stability.

### Scalability and stability of business remains to be seen

PSI's operating income saw marked rise in FY2018 after the increased plant capacity and introduction of TMT portfolio. The revenues are likely to be supported by addition of MS wire to the trading portfolio from H2 FY2019. The ability of the promoters to scale up business and achieve stability (especially in the cash cycle) remains to be seen. The company's Management information system (MIS) and control system is evolving from the earlier days of operation as a partnership firm. Strengthening the control processes along with the growth in scale will be important for incremental financial profile of PSI.

### Inherent cyclicality of the industry

Cyclical nature of the steel industry creates uncertainty about the demand and cash cycles for PSI. This could have an impact on the capacity utilization, revenue and profit margins of the company. Volatility in the cash flow due to cyclicality in cash cycle could pose challenges, especially during the period of weak demands.

### Forex risk

PSI is exposed to forex risk because of the mismatch in the currency for purchase of raw materials (US Dollar) and that of revenue realization from sales of finished goods (Nepalese Rupees). Although the quantum of risk remains low at present due to small order lot and limited timespan between purchase order and final payments for raw material (billet). However, PSI's increase production capacity could mean larger order lot and consequent higher forex exposure, especially in the current regime of foreign exchange volatility.

**Analytical approach:** For arriving at the ratings, ICRA Nepal has applied its rating methodology as indicated below**:**

**Links to applicable criteria:**
Corporate Credit Rating Methodology

## About the company

Pathibhara Steel Industries Private Limited (PSI) was incorporated in December 2012 as a partnership firm having six individual partners. The firm was converted into a private limited company in July 15, 2018; with same set of partners as shareholders. As of mid-July 2018, major promoters of PSI include Mr. Arjun Mainali, Mr. Kapil Bimali, Mr. Manorath Bhetwal, Mr. Hem Raj Sangraula and Mr. Om Prakash Bimali.

PSI is involved in iron and steel processing and trading activities since 2013. PSI's rolling mill operation started in 2013 with installed capacity of 10 metric tonne per day (MTPD). Back then, PSI manufactured steel sections from locally purchased steel byproducts, in its plant located at Birtamode, Jhapa District. PSI replaced the old plant with a higher-capacity plant during Q1 FY2018. From Q4 FY2018, the company started producing TMT bars (8-20 mm in diameter), after obtaining Nepal Quality Standard (NS) in June 2018. At present, the manufacturing portfolio of PSI comprises of TMT bars (under the brand name PSI TMT) and steel sections, using billets imported from vendors in Durgapur, West Bengal. The current installed capacity of rolling mill is ~70,000 metric tonnes[5] per annum (MTPA).

[3] *total outside liabilities to tangible net worth*
[4] *Operating profit before depreciation, interest, taxation & amortization*
[5] *At the rolling capacity of 8 metric tonne per hour, assuming 24 hours and 365 days of operation*

PSI also has a trading portfolio which comprises iron angles and mild Steel (MS) wires (with simple processing). Steel wire processing is to commence from early H2FY2019. The installed processing capacity of MS wire is ~13,000 MTPA[6]. PSI's customer base mostly includes individual end users in and around Jhapa district, where the key promoters have established reputation. PSI uses supply chain of wholesale/retail trading units in the region to market its products.

## Key financial indicators of PSI:

| Year ending | FY2016 | FY2017 | FY2018 |
|---|---|---|---|
| **Amount in NPR million** | **Audited** | **Audited** | **Provisional** |
| Operating income (OI) | 190.71 | 215.62 | 592.39 |
| Profit after tax (PAT) | -1.16 | 2.56 | 7.69 |
| OPBDITA/OI (%) | 2.96% | 6.22% | 7.37% |
| Return on capital employed (ROCE) (%) | 4.64% | 10.60% | 15.29% |
| Total Debt/ Net worth (times) | 26.63 | 1.05 | 5.51 |
| Total outside liabilities/Tangible net worth (times) | 28.65 | 2.61 | 7.70 |
| Total Debt/ OPBDITA (times) | 19.93 | 3.44 | 6.50 |
| Interest coverage (times) | 1.13 | 1.60 | 1.91 |
| DSCR (times) | 0.59 | 1.60 | 1.32 |
| Net working capital/ Operating income | 46.20% | 8.63% | 36.53% |

## Annexure 1: Instrument details:

| Instrument | Rated Limit (NPR Million) | Rating Action |
|---|---|---|
| Fund-based - Long-term loans (Existing) | 77.51 | [ICRANP] LBB (Assigned) |
| Fund-based - Short-term loans (Existing) | 270.00 | [ICRANP] A4+ (Assigned) |
| Fund-based- Short-term loans (proposed/ unallocated) | 452.49 | [ICRANP] A4+ (Assigned) |
| **Total** | **800.00** | |


### Analyst Contacts:

**Mr. Kishor Prasad Bimali,** (Tel No. +977-1-4419910/20)
kishor@icranepal.com

**Mr. Sailesh Subedi,** (Tel No. +977-1-4419910/20)
sailesh@icranepal.com

### Relationship Contacts:

**Ms. Barsha Shrestha,** (Tel No. +977-1-4419910/20)
barsha@icranepal.com


### About ICRA Nepal Limited:

ICRA Nepal Limited, the first Credit Rating Agency of Nepal, is a subsidiary of ICRA Limited (ICRA) of India. It was licensed by the Securities Board of Nepal (SEBON) on October 3, 2012. ICRA Nepal is supported by ICRA Limited through a technical support services agreement, which envisages ICRA helping ICRA Nepal in areas such as rating process and methodologies, analytical software, research, training, technical and analytical skill augmentation.

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[6] *At the rate of 1.5 metric tonne per hour, assuming 24 hours and 365 days of operation*

**ICRA Nepal Limited,**
Sunrise Bizz Park, 6th Floor, Dillibazar, Kathmandu-33, Nepal.
**Phone:**+977 1 4419910/20
**Email:** info@icranepal.com
**Web:** www.icranepal.com



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