Sarbottam Steels Private Limited: [ICRANP] LB+/A4 (Assigned)

March 05, 2020

Summary of rated instruments:

Instrument*	Rated Amount (NPR Million)	Rating Action
Fund-based; long-term limits	NPR 1,645	[ICRANP] LB+ (Assigned)
Vehicle loan-within term loan	(NPR 2.65)	[ICRANP] LB+ (Assigned)
LC for capex-within long-term limits	(NPR 1,610)	[ICRANP] LB+ (Assigned)
Fund-based; short term limits	NPR 1,955	[ICRANP] A4 (Assigned)
Non-fund based; short term limits-within short-term funded limits	(NPR 1,955)	[ICRANP] A4 (Assigned)
Total	**NPR 3,600 million**	

* Instrument details are provided in Annexure-1

Rating action

ICRA Nepal has assigned a long-term rating of [ICRANP] LB+ (pronounced ICRA NP L B plus) to the NPR 1,645 million of long-term bank loan limits of Sarbottam Steels Private Limited (SSPL). ICRA Nepal has also assigned a short-term rating of [ICRANP] A4 (pronounced ICRA NP A four) to the short-term bank loan limits of NPR 1,955 million (interchangeable between fund-based and non-fund-based facilities).

Rationale

The rating factors in the promoter group's adequate track record in the steel and cement industry, which partly mitigates the project execution and offtake risk. The assigned rating also considers the positive long-term demand outlook for steel products in Nepal, despite the temporary capacity overhang situation existing in the industry. Duty protection accorded to the domestic steel industry by the Government of Nepal (GoN), through high import duties on finished steel products also remains a rating positive. SSPL's plan of in-house billet production vis-à-vis its import is likely to bring in cost efficiencies, which could aid the company's survival over the medium term in the intensely competitive TMT[1] segment. ICRA Nepal also notes the locational advantage available to SSPL from its proximity to the Indian border and the national (east west) highway for raw material import, primarily from India as well as product distribution (billet and TMT) across the country.

The rating is, however, constrained by the project execution and stabilisation risk associated with SSPL's manufacturing unit. The project is in the middle stages of development and any significant delay in its commissioning could adversely impact its cash flows. SSPL's gearing is expected to remain high over the medium term, given the debt-funded capex and working capital-intensive nature of business. This, coupled with the erosion in industry margin amid competitive pressure are likely to exert pressure on the debt coverage metrics of SSPL. The promoters' ability for timely infusion of fresh equity to support any cost-overrun and support the working capital requirement before project stabilisation will also have a bearing on SSPL's financial profile. Although backward integration of SSPL into billet manufacturing is expected to help SSPL's margins vis-à-vis standalone rolling mills, the company's ability to contain the conversion cost while producing billets and thereby generate cost efficiencies and improve the margins remains to be seen. Further, its exposure to regulatory risks also remains a key rating sensitivity, as any reduction in import tariff by the GoN on finished steel products will have an adverse impact on the profit margins as well as the financial indicators of SSPL. ICRA Nepal also takes note of the inherent cyclicality associated with the steel industry, thus exposing the company to cash flow volatility. SSPL will also remain exposed to forex risks, as raw materials are largely procured in US dollars while sales realisation is made in domestic currency.

[1] *Thermo Mechanical Treatment*

Key rating drivers

Credit strengths

Strong promoter Group and established track record in the manufacturing of iron and steels - SSPL is promoted by the Saurabh Group, a joint venture (JV) between the Neupane and Agrawal families. Both the families are among the established business houses in the country. Apart from its long experience in the steel and cement manufacturing industry, the Group has a stake in spinning mills, tea estates, synthetic packaging bags, plastic packaging manufacturing, etc. The Group's other units in the steel and cement industry (Jagadamba Cement, Sarbottam Cement, Laxmi Steels, etc) are expected to generate synergies in the production process and SSPL's supply chain.

Backward integration into billet production provides flexibility – SSPL's proposed TMT plant is an integrated unit with the capacity to produce steel billets as well as TMT through direct charging of billets. The management plans to use the billet for in-house consumption as well as external sales. Given the relatively less competitive billet segment (vis-à-vis TMT segment), the management plans to focus on billet sales in its early years until the TMT outlook improves. Also, the in-house production of billet is expected to generate cost efficiencies, which could boost margins for the TMT segment as well.

Thrust in infrastructure development; domestic players benefit from high import barriers - The amount of steel products (mainly semi-finished steel from primary steel producers) imported by Nepal increased by ~17% in FY2019 following a ~36% growth in FY2018 and a ~33% growth in FY2017. The import statistics depict a growing demand for steel products in Nepal. The growth is expected to remain moderate to strong over the medium term, given the country's large infrastructural as well as household construction needs. Moreover, improvement in political outlook, empowerment of local government and increase in economic activities across the country are expected to provide an impetus to infrastructure development. Given the higher custom tariffs for most finished steel products (including TMT), import barriers remain high, which are beneficial to the domestic steel producers like SSPL.

Credit Challenges

Project execution and stabilisation risk – SSPL's project implementation is at the mid-stage with ~40% financial progress as of mid-January 2020. However, any significant delay in completion of the balance portion of the project beyond the scheduled date of commencement of commercial production[2] and/ or delay in stabilisation of the facility as per the expected operating parameters, post-commissioning, may have a bearing on SSPL's revenues, cash flows and debt servicing ability.

Fragmented and competitive nature of the industry - The steel industry in Nepal is highly competitive and fragmented, with multiple rolling mills in operation. Further, low entry barriers to the new players as well as capacity expansion by older players intensified the competition in the segment. This could expose new players like SSPL to margin pressure and cash flow volatility. However, SSPL's backward integration into billet manufacturing is expected to aid its competitive positioning to some extent.

High gearing could stretch the debt-coverage indicators - The estimated project cost of SSPL's manufacturing facility is ~NPR 2,194 million, which is ~75% debt-funded. High debt-funded capex coupled with the working capital-intensive nature of business is expected to keep the gearing level high for the company over the medium term. This could stretch the debt coverage indicators and liquidity of the company, necessitating infusion of fresh fund from the promoters.

Regulatory risk - Being a duty-protected industry, SSPL remains exposed to the risk of regulatory changes to import tariffs. SSPL's projected profitability and financial indicators are aided by the import barriers on finished steel products like TMT (up to 30% of custom duty) and billet (5% custom duty). Reduction or removal of import duty/ tariff could have a significant impact on the company's revenue, profitability and debt coverage indicators.

[2] *Scheduled by the end of December 2020*

Inherent cyclicality of the industry - The cyclical nature of the steel industry could have a significant impact on the capacity utilisation, revenue and profit margins of the company. Volatility in the cash flows due to the cyclicality could pose challenges, especially during periods of weak demand, given significant debt service obligations of the company.

Forex risk - SSPL will remain exposed to forex risks as a significant portion of its raw materials (especially sponge iron) are likely to be imported, whereas sales is to be derived from the domestic market. Such risks are likely to be accentuated by the lumpiness in the volume of raw material import.

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

Incorporated in 2017 and promoted by the Saurabh Group, Sarbottam Steels Private Limited (SSPL) is a closely held company. Mr. Bishnu Prasad Neupane, chairman and the managing director of the company, holds 52% of the paid-up capital while the rest is held by 12 individual shareholders, each holding less than 6% of the paid-up capital.

SSPL is setting up a factory for manufacturing billets and TMT with an installed capacity of ~264,000 MT (metric tonne) and ~235,000 MT respectively. The production facility will use locally purchased scrap iron and imported (mainly from India) sponge to produce the finished goods (billets and TMT). SSPL's production facility, in Beluwa of Parsa district, is at the mid-stage of commissioning and is expected to commence operations by the end of December 2020.

Annexure-1: Instrument Details

Instrument	Limit (Amount in NPR Million)	Rating Action
Long-term, Fund-based (Term loan)	1,645.00	[ICRANP] LB+
LC for capex-within long term limits	(1,610)	[ICRANP] LB+
Total long-term, fund-based/non-fund based (A)	**1,645.00**	
Short Term		
Fund-based, (Import loan/ Demand loan/Trust Receipts)	1,955.00	[ICRANP] A4
Non-fund based, (Letter of credit/Bank Guarantee)- (within funded limits)	(1,955.00)	[ICRANP] A4
Total short term, fund based/non-fund based (B)	**1,955.00**	
Grand total (A+B)	**3,600.00**	

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:

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For more information, visit www.icranepal.com

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

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