Hulas Steels Industries Limited: [ICRANP] LBBB-/A3 assigned; ratings on watch with negative implications

June 29, 2020

Summary of rated instruments:

Instrument	Current Rated Amount (NPR million)	Rating action
Fund-based; long-term limits	240.8	[ICRANP] LBBB-@; assigned
Fund-based; short-term limits	5,702.5	[ICRANP] A3@; assigned
Non-fund based; short-term limits	1,825.8	[ICRANP] A3@; assigned
Non-fund based; short-term limits-within short-term funded limits	(3,069.2)	[ICRANP] A3@; assigned
Total	**7,769.1**	

** Instrument details are provided in Annexure-1*
@ denotes rating placed on watch with negative implications

Rating action

ICRA Nepal has assigned a long-term rating of [ICRANP] LBBB- (pronounced ICRA NP L triple B minus) to the fund-based long-term limits of NPR 240.8 million of Hulas Steels Industries Limited (Hulas). ICRA Nepal has also assigned a short-term rating of [ICRANP] A3 (pronounced ICRA NP A three) to the short-term fund-based limits of NPR 5,702.5 million (including embedded non-fund based limit of NPR 3,069.2 million) and short-term non-fund based limits of NPR 1,825.8 million. These ratings are kept on watch with negative implications amid the Covid-19 pandemic's impact and its likely implications on Hulas' liquidity position and debt coverage indicators.

Rationale

The watch on assigned ratings with negative implications is on account of the evolving situation following the global Covid-19 pandemic. Because of the lockdown[1] and the expected slowdown in post-pandemic economic environment, Hulas' revenue, and overall financial profile for FY2020[2] and FY2021, is likely to remain highly affected with concomitant pressure on its debt-servicing capacity. The business disruption created by the Covid-induced lockdowns is likely to strain the working capital cycle and business liquidity by affecting the inventory liquidation and debtor realisation period. Given Hulas' high working capital intensity in the last 12-18 months and its increasing reliance on bank loans, Hulas' liquidity cushion remains thin. Sustained deterioration in operating environment and demand, and the company's inability to resume normal operations without significant delay and/or depletion in profit margins could further exacerbate the strain on its liquidity position and its overall financials which could warrant a rating downgrade.

Nonetheless, the assigned rating derives comfort from Hulas' established track record of nearly four decades of operation and good market positioning with a strong product brand. The market positioning of the company is reflected in the healthy growth in revenues and operating profit (notwithstanding marginal moderation in FY2019 and Covid-induced moderation expected in FY2020) in the last two to three years. Despite recent moderation, the financial profile of the pipe and sheets manufacturers continues to remain better vis-à-vis their peers in the highly fragmented TMT[3] segment, because of the presence of a limited number of players in the former (which supports better bargaining power and pricing discipline), and duty protection provided by the Government of Nepal (GoN) to the domestic steel industry (which partly mitigates the threat of cheaper imports). Hulas' established supply chain and strong and diversified customer base also remains a rating strength.

[1] *Starting from 24 March 2020*
[2] *Ends on mid-July-2020*
[3] *TMT: Thermo Mechanical Treatment*

The ratings, however, are constrained by the Hulas' moderate financial profile stemming from its high working capital intensity leading to a moderate liquidity profile. The company's' growth in revenues in the last two to three years has come with a corresponding rise in debtor and inventory days, leading to an increased working capital requirement; mostly financed through the bank borrowings. At the same time, the profit margin has come down in the years after FY2017 amid competitive pressure, gradual weakening of demand and margin erosion in the pipe segment following the entry of new players. Coupled with the high interest rate environment prevailing since FY2017, this has led to an increase in the interest outlay and moderation in debt coverage ratios for the company. The coverage indicators and liquidity profile are likely to remain under pressure over the near term, given the expected impact of the pandemic on future demand as well as inventory liquidation and debtor recovery period. Hulas' liquidity cushion remains thin given the optimum utilisation of the working capital drawing power with not much headroom to accommodate a sustained liquidity stress, which remains a major rating concern. Rating concerns also arise because of high product concentration (~80% of FY2019 revenue coming from sheets). Although the high entry barriers and duty protection to the domestic players has been factored in while assigning the ratings, Hulas' financial profile and debt-servicing ability remains vulnerable to any depletion in the industry margins. Regulatory risk also remains a key factor as any reduction in import tariff by the Government will have an adverse impact on the profit margin and financial indicators of Hulas. Moreover, the rating also reflects the inherent cyclicality associated with the steel industry, exposing the company to volatile cash flows. Hulas is also exposed to the price fluctuation risk, given the volatility in steel prices and the US dollar exchange volatility. Forex risk though present, given the raw material purchases in US dollars and sales realisation made in Nepalese currency, are largely hedged through forward contracts.

ICRA Nepal also takes note of the Hulas' contingent liability towards power charges (as demanded by the Nepal Electricity Authority-NEA) related to the load-shedding era[4]. If the liability materialises, this could further stress the liquidity position and debt-servicing capacity of the company. This too remains a rating sensitivity.

Key rating drivers

Credit strengths

Established track record, strong brand, and tested distribution network

Hulas has been in operation since 1981 and remains one of the established players in the domestic steel industry. Predominantly a sheet player, Hulas has a strong brand recall in the industry which, along with the established distribution network and traction among the stakeholders, augurs well for the future growth of the company.

Relatively healthy operating profit margin in consolidated and duty-protected sheets segment

Hulas is one of the limited players in the Nepalese domestic market, producing steel pipes, sheets, and an ancillary portfolio of extruded aluminium profiles. A limited number of players, duty protection against cheaper imports and good demand in the domestic market has supported the growth and margins of the company in the past. The relatively high capex requirement for sheet production and higher brand loyalty is likely to act as an entry barrier for new players over the short to medium term, which is expected to support Hulas' financial profile.

Healthy capitalisation and low gearing levels

Good profitability and retention of a major portion of profits and equity infusion over the years has boosted Hulas' net worth and brought down its gearing level from 3.4 times in FY2016 to 1.4 times in FY2019. The operating profit margins of Hulas remain good despite considerable decline from 17% in FY2016 to 12.2% in FY2019. The company has reported a good growth in OPBDITA in the last two to three years along with the growth in sales, notwithstanding a marginal moderation in FY2019 and an expected decline in FY2020 sales amid the Covid-impact. Accordingly, Hulas continues to maintain adequate debt coverage ratio despite its sizeable interest outlay (interest coverage and DSCR[5] of 2.8 times and 1.9 times respectively for FY2019). However, the coverage indicators could come under stress over the near term amid expected deterioration in revenue in the post-Covid era.

[4] *Period of prolonged power cut in the national grid until November 2017, given the demand-supply mismatch*

[5] *Debt Service Coverage ratio*

Credit Challenges

Near-term growth and margins to be challenged by Covid-induced externalities

Hulas has witnessed relative stabilisation of demand and moderation of operating profit margins in the last two to three years. This follows the gradual ebbing of earthquake-induced demand and industry capacity enhancement in the pipe segment with a corresponding rise in competitive intensity and erosion of margin. Amid moderation in demand growth and increasing competition, realisations have softened, negatively impacting the operating margins. The Covid-induced slowdown in business activities could weaken the demand and margin outlook for Hulas over the near term, which remains a concern to the incremental financial profile.

High working capital intensity resulting in stretched liquidity

The steel manufacturing and distribution business of Hulas remains highly working capital intensive as evidenced by the high cash conversion cycle of 161 days and 152 days in FY2018 and FY2019 respectively, resulting in a net working capital to operating income (NWC/OI) ratio of ~37% and ~43% respectively. Hulas' working capital intensity has risen in the last 2-3 years along with the rise in sales, increasing the need for working capital financing for which Hulas has remained highly dependent on bank financing. Hulas' liquidity position has come under pressure because of margin moderation as well as rising working capital intensity. The slowdown in the post-Covid business environment could weaken revenue and margin and could exacerbate the liquidity stress for Hulas, which remains a rating concern.

Regulatory risk

Being a duty-protected industry, Hulas remains exposed to the risk arising from the change in regulations related to import tariffs. Hulas' healthy profitability and financial indicators are aided by the high import barriers on finished steel products like sheets and pipes (up to 30% of custom duty). Reduction or removal of import-duty/ tariff could have a significant impact on the company's incremental revenue profile, profit margin and debt coverage indicators.

Inherent cyclicality of the industry

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

Pricing and exchange volatility risk

Steel prices are prone to volatility, given the fluctuation in global steel prices and the volatility in the US dollar exchange rate, given the dollar-denominated purchase of steel. The risk becomes pronounced due to the lumpiness in procurement of raw materials. Hulas is also exposed to forex risk because of the mismatch in the currency for purchase of raw materials (US dollar) and that of revenue realisation from sales of finished goods (Nepalese rupees). However, hedging through forward contracts minimises the risk to a large extent for Hulas.

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

Hulas Steel Industries Limited was established in 1981 as a private limited company and converted into a public limited company in 2006. At present, Charnley Development Company Limited holds 50.0% stake in Hulas while the balance stake is held by the Golchha family viz. Mrs. Jayshree Golchha (~24.5%), Hulas Metal Craft (~7.7%), and Mr. Dinesh Kumar Golchha (~3.9%) among others.

Hulas is a secondary steel producer, which manufactures steel sheets (galvanised and colour coated) and pipes among other products. It mainly imports hot rolled (HR) steel sheets as raw material input, from primary steel manufacturers in India. Hulas also imports zinc used for galvanisation and occasionally the cold-rolled (CR) sheets. The company has in-house cold-rolling mills to convert the HR sheets into CR sheets which largely meets its requirement for sheet products. It mainly caters to the domestic market.

Hulas currently has an annual installed capacity of ~399,100 metric tonnes, including ~20,000 metric tonnes per annum capacity for pipes (black and galvanised), ~329,400 MT of sheets (plain and corrugated/GPI/GCI) and balance 49,700 MT comprising other ancillary products such as aluminium structures, welded structures, pipe fittings, etc. Pipes and sheets jointly account for ~88% of the installed capacity and ~93% of FY2019 sales for Hulas. Moreover, the Galvalume project, for sheets production with a capacity of 330 metric tonnes per day is in the final stage of commissioning with the commercial production planned for the beginning of FY2021.

Key financial indicators of Hulas

	FY2017 (Audited)	FY2018 (Audited)	FY2019 (Audited)
Operating Income-OI (NPR Million)	6,638.2	8,837.2	8,546.7
OPBDITA/OI (%)	16.3%	13.0%	12.2%
Total Debt/Tangible Net Worth TNW (times)	1.7	1.6	1.4
Total Outside Liabilities/ TNW (times)	2.8	2.2	1.8
Total Debt/OPBDITA (times)	2.2	2.6	3.0
Interest Coverage (times)	3.0	4.3	2.8
DSCR (times)	1.8	2.4	1.9
Net Working Capital/OI (%)	32%	37%	43%

Source: Company data

Annexure-1: Instrument Details

Instrument	Current Rated Amount (NPR Million)	Rating Action
Fund-based, long-term (Term loan)	240.8	[ICRANP] LBBB- @(Assigned)
Fund-based, Short-term (Demand loan/Trust receipt loan/Overdraft/ short term loan)	5,702.5	[ICRANP] A3 @(Assigned)
Non-fund based, Short-term (Letter of credit)	1,825.8	[ICRANP] A3 @ (Assigned)
Non-fund based, Short-term-within short term funded limits (Letter of credit)	(3,069.2)	[ICRANP] A3 @ (Assigned)
Total	**7,769.1**	

@ denotes rating under watch with negative implications

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.

Our parent company, ICRA Limited, was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies.

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