Palpa Cement Industries Private Limited: Ratings reaffirmed; watch with negative implications removed

September 7, 2020

Summary of rated instruments

Instrument (Amounts in NPR Million) *	Previous Rated Amount	Current Rated Amount	Rating Action
Long-term loans; fund-based	5,440.54	5,309.22	[ICRANP] LBB; reaffirmed with removal of watch on rating
Short-term loans; fund-based	1,247.21	1,378.53	[ICRANP] A4+; reaffirmed with removal of watch on rating
Short-term loans; non-fund based	550.00	550.00	
Total	**7,237.75**	**7,237.75**	

** Instrument details are provided in Annexure-1*

Rating action

ICRA Nepal has reaffirmed the long-term rating of [ICRANP] LBB (pronounced ICRA NP L double B) assigned to long-term loans of Palpa Cement Industries Private Limited (PCIPL). ICRA Nepal has also reaffirmed a short-term rating of [ICRANP] A4+ (pronounced ICRA NP A four plus) assigned to the company's short-term loans. The ratings have been removed from rating watch with negative implications.

Rationale

The ratings reaffirmation and the removal of watch with negative implications factor in the company's ability to generate healthy revenues of ~NPR 3 billion in FY2020 (the first year of full operations for clinker, cement was operational only for six months) despite the operational disturbances caused by Covid-19-induced lockdowns in the last few months of FY2020. The rating action also considers the company's healthy operating margins (~26% for 9M FY2020), mainly supported by the relatively low limestone cost (~NPR 800/MT) and its consumption (1.46 times). With an increasing portion of cement sales, revenues and profitability are likely to improve further. ICRA Nepal also expects the operating margins to improve by 200–300 bps over the medium term, since cement sales offer relatively better margins. The ratings also take comfort from the promoter strength with the company being affiliated to the RMC Group, which has a long track record in the manufacturing industry.

Nonetheless, the ratings are constrained by the likely economic slowdown due to the ongoing pandemic, which could lower the demand for construction materials over the near to medium term, impacting the company's operating and financial profile. These concerns are aggravated by the fact that PCIPL's capitalisation and coverage indicators remain moderate, given the initial years of operation (gearing of 3.9 times as on mid-April 2020, total debt/OPBDITA of 8.0 times and interest coverage of 1.3 times for 9M FY2020). The ratings are further constrained by the intense competition in the industry with sizeable capacity additions/enhancements in the last few years. Hence, the resultant lowered pricing flexibility could impact the company's margins, especially in case of weak demand and unfavourable movement in raw materials/other input prices. The company's high working capital intensity (NWC/OI of ~47% in 9M FY2020) also remains an area of concern. Going forward, PCIPL's ability to attain higher capacity utilisation while withstanding the competitive pressures and judiciously managing its working capital would remain crucial. The company's ability to improve its capitalisation and debt coverage indicators along with its net margins will remain the key rating sensitivity.

Key rating drivers

Credit strengths

Healthy revenues in first year of full operation despite impact from Covid-19-induced lockdowns – The company achieved revenue base of ~NPR 3 billion in FY2020, which was the first year of full operations for clinker and partial operations (six months) for cement. Out of the same, ~60% accounted for clinker sales and the balance ~40% was from ordinary Portland cement (OPC) sales. With improving brand recognition, cement sales have been increasing in recent months. Hence, the revenues are expected to grow by moderate double digits in FY2021, notwithstanding the likely impact of the pandemic on economy and demand for construction materials. In addition, the Group has another grinding unit—R.M.C. Cement Private Limited (RCPL; rated at [ICRANP] A3)—with ~0.2 MTPA capacity, which is expected to support the clinker sales to an extent.

Competitive operational profile – PCIPL's operating margins remained healthy at ~26% for 9M FY2020 despite the comparatively low sales realisation per tonne (average of ~NPR 8,000/MT for clinker and cement sales in 9M FY2020). This was primarily supported by relatively lower consumption of limestone (~1.46 times for clinker production) at lower cost (~NPR 800/MT, aided by locational advantage of mines). Besides, the company has been using pet coke instead of coal for fuel, which has also helped to control its cost of production. Going forward, the operating profitability is expected to improve by 200–300 bps with increasing share of cement sales, which has better profitability than clinker sales. Also, the company is likely to avail more electricity from power grid shortly (currently available to the extent of ~50% of total power requirements), which would save on running costs for diesel generators. However, high finance costs are likely to remain a major drag to net profitability over the medium term.

Experienced/resourceful promoters from RMC Group – PCIPL is a part of the RMC Group, which is in the manufacturing and marketing of construction materials for more than two decades. The Group's flagship unit—Rajesh Metal Crafts (rated [ICRANP] A2)—has been in the manufacturing and selling of construction materials (mainly sheets and pipes) since 1993. Additionally, the Group has an operational grinding unit since 2011 (RCPL) that supports the clinker sales to an extent. The robust dealership and distribution channel of the RMC Group, along with its prior exposure in the cement industry, could result in operational synergies for PCIPL. The Group's long track record in the manufacturing sector and the experienced background of its promoters could help PCIPL maintain a modest business performance.

Credit challenges

Economic slowdown due to ongoing pandemic could prove to be a challenge – The evolving impact of the pandemic on the economy could have a bearing over the revenue performance over the near to medium term. However, the company's ability to continue operations even during the peak lockdown provides some comfort. The annualised capacity utilisation for clinker and cement is low so far at ~65% and ~30% in 9M FY2020 due to which the company is still in net loss. The sales volume (clinker and cement) was ~3,50,000 MT in FY2020, which is expected to grow at least by ~30% in FY2021, given the modest scale of operations in the first year of operations. The demand growth outlook in the current scenario and the company's ability to improve its operational level would remain a key monitorable.

High working capital intensity – PCIPL's business is highly working capital intensive as reflected in the NWC/OI ratio of ~47% as on mid-April 2020. This was on account of high debtor days (79 days) and high inventory days (123 days), partly owing to the impact of strict lockdowns during this period. Given the stock depletion in the market due to elongated lockdowns, recent sales are mostly on cash basis and hence, this indicator has improved to an extent towards the end of FY2020. PCIPL's ability to manage the working capital levels would remain critical for its liquidity profile.

Moderate capitalisation and coverage indicators – Being in the initial year of operations with sizeable debt burden, the company's coverage and capitalisation indicators are weak with total debt/OPBDITA of ~8.0 times and interest coverage of ~1.3 times for 9M FY2020, while the gearing was ~3.9 times as on mid-April 2020. The principal repayment of long-term debt is starting from FY2021, which would create further pressure on the liquidity profile. On an as-is basis, PCIPL's free cash flows are likely to remain inadequate to serve the debt obligations for FY2020 and FY2021. PCIPL's working capital borrowings also usually leave no cushion against the drawing power, which accentuates the concerns on liquidity. ICRA Nepal expects timely support from the promoter in case of financial exigencies. Additionally, the company can avail the rescheduling relaxations availed by the banking sector regulator, in case of distress.

Intense competition – The cement industry in Nepal is highly fragmented, comprising several players with stiff competition from other large/established cement manufacturers. Around 55 cement manufacturing units were operational, as of mid-April 2020, while some large cement manufacturing units are in the pipeline. Additionally, many older players have undergone sizeable capacity enhancement in recent periods. Hence, pricing flexibility might be lower, going forward, as the capacity creation is much higher than the current demand levels. Any significant upward movements in input prices could further impact the company's margins amid the competition and in turn, the challenges in passing the price increases to final customers.

Vulnerability to cyclicality and seasonal demand; risk of regulatory changes – The cyclical/seasonal nature of the cement industry creates uncertainty over demand and cash cycles for PCIPL. This could impact the company's capacity utilisation, revenues, and profit margins. Volatility in cash flow due to this could pose challenges, especially during the periods of weak demand. The cement industry in Nepal is also insulated from cheaper imports with duty safeguards and a substantial freight cost involved in the import of cement. Any changes in Government policies could have a bearing on the performance of the industry players. Any other regulatory changes affecting raw material prices and availability could also impact the overall cement industry.

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 2009, Palpa Cement Industries Private Limited (PCIPL) has a greenfield cement manufacturing unit, which started commercial operations of clinker from April 2019 and cement from January 2020. The company's plant is in Sunuwal VDC, Nawalparasi district, while the mines are located ~30 km from the factory in Rahawas VDC, Palpa district. The plant has a manufacturing capacity of 0.59-MTPA clinkers and 0.73-MTPA cement, based on the vertical rolling mill (VRM) technology. PCIPL belongs to the RMC Group, which is a renowned business house in Nepal with extensive experience, primarily in the manufacturing sector. The company's registered office is in Central Business Park, Thapathali, Kathmandu, Nepal.

Key financial indicators

	FY2019 (Audited)	9M FY2020 (Provisional)
Operating Income-OI (Sales; in NPR Million)	628	2,181
OPBDITA[1]/OI (%)	26.1%	26.0%
Total debt/Tangible net worth-TNW (times)	3.25	3.91
Total Outside Liabilities/ TNW (times)	3.50	4.34
Total Debt/OPBDITA (times)	32.61	7.99
Interest Coverage (times)	3.69	1.32
DSCR (times)	3.77	1.33
NWC[2]/OI (%)	1.43	47%
Current Ratio	1.19	0.97

Source: Company data

Annexure-1: Instrument details

Instrument (Amount in NPR Million) *	Previous rated amount	Current rated amount	Rating Action
Fund based; Long-term loans (LTL) - (A)	**5,440.54**	**5,309.22**	**[ICRANP] LBB; reaffirmed with removal of watch on rating**
Fund-based facilities; Short term (Working capital loans) – (B)	**1,247.21**	**1,378.53**	**[ICRANP] A4+; reaffirmed with removal of watch on rating**

[1] *Operating profit before depreciation, interest, tax, and amortization*
[2] *Net Working Capital*

Instrument (Amount in NPR Million) *	Previous rated amount	Current rated amount	Rating Action
Non-fund based facilities; Short term			
Letter of credit	350.00	350.00	[ICRANP] A4+; reaffirmed with removal of watch on rating
Bank guarantee	200.00	200.00	
Total non-fund based (C)	**550.00**	**550.00**	
Grand total (A+B+C)	**7,237.75**	**7,237.75**	

** There are some fund-based as well as non-fund based facilities within the above rated limits.*

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About ICRA Nepal Limited

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