Pathibhara Steel Industries Private Limited: ratings reaffirmed at [ICRANP] LBB/A4+; remains under watch with negative implications

September 7, 2020

Summary of rated instruments

Instrument*	Previous Rated Amount (NPR million)	Current Rated Amount (NPR million)	Rating action
Fund-based; long-term limits- Existing	77.5	140.00	[ICRANP] LBB@; (reaffirmed for enhanced limit)
Fund/Non-fund based; short-term limits	722.5	600.00	[ICRANP] A4+@; (reaffirmed)
Total	**800.00**	**740.00**	

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

Rating action

ICRA Nepal has reaffirmed the long-term rating of [ICRANP] LBB@ (pronounced ICRA NP L Double B @) to the enhanced long-term loan limit NPR 140.00 million of Pathibhara Steels Industries Private Limited (PSI). ICRA Nepal has also reaffirmed the short-term rating of [ICRANP] A4+@ (pronounced ICRA NP A Four Plus @) to the NPR 600 million short-term limits (fund-based and non-fund based) of PSI. The ratings of PSI remain under watch with negative Implications.

Rationale

The ratings reaffirmed to the bank loan limits of PSI remain on watch with negative implications, given the uncertain economic environment created by Covid-19 pandemic and its probable impact on PSI's operation, business cashflows, liquidity and debt servicing ability. The company's revenues for FY2019 and FY2020 lagged the earlier estimates because of the increasing competition in the TMT segment, which was further exacerbated by business disruption created by the pandemic in FY2020. The muted revenues and profit margin caused by the aforesaid reasons, coupled with higher debtor and inventory days because of the pandemic, have strained the liquidity position of the company. Given the lack of liquidity cushion, PSI's ability to manage its liquidity and timely service its debt will remain a major challenge. To some extent, regulatory relaxations such as additional working capital limits by up to 10% without debt/equity cap and deferral of repayment for Covid-19-affected borrowers[1] are expected to support PSI's liquidity profile. Going forward, the continuation and severity of Covid-19 pandemic, its impact on the construction sector, PSI's ability to revive its business without any major delay, its ability to manage liquidity through recovery from the existing debtor and inventory, and the continuation of regulatory relaxations will be the key rating monitorables. ICRA Nepal will continue to monitor any change in these areas to ascertain whether further rating action is warranted.

Nonetheless, the rating reaffirmation continues to derive comfort from the strategic location of PSI's project, close to the core market area in Jhapa and the adjoining districts. ICRA Nepal also notes the lack of other competitors in the immediate vicinity, which could be a positive for growth prospects. This is also partly reflected in the healthy revenue growth of PSI (albeit on a low base) in the recent years. The ratings also factor in promoter's experience in the steel sector—both manufacturing and trading—and PSI's established supply chain in the region.

The ratings, however, are constrained by the company's small scale of operations and its limited track record and brand visibility in the recently introduced TMT bar segment. The segment has not performed as per the management expectation due to the capacity overhang in the domestic TMT industry, which has led to increased competition and erosion of margins in the last one to two years. This has forced the management to fall back on its original portfolio of steel sections and flats, which are relatively less competitive and have better margins. The gearing level and coverage

[1] *Upto mid-October 2020, mid-January 2021 and mid-April 2021 for less affected, medium affected and highly affected borrowers.*

ratios of PSI have deteriorated amid the debt-funded capex incurred to set up TMT line and its inability to generate targeted operating revenues. This has further exacerbated in H2 FY2020 because of the impact of Covid-19 pandemic on the sales and recovery. The working capital intensity sharply increased towards the end of FY2020 because of the slowdown in recovery from debtors and liquidation of stocks amid the lockdown. ICRA Nepal 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. This, coupled with limited to no headroom in the working capital drawing power, raises concerns on PSI's ability to remain liquid enough to timely service its debt over the near term. The ability of the management to make timely recoveries/secure additional funding to tide over the liquidity concerns will be essential for maintain timely debt repayment over the near term.

Key rating drivers

Credit strengths

Established supply chain and moderately diversified portfolio

In addition to the rolling mill operations (manufacturing of TMT and steel sections), PSI imports and trades in galvanised iron angles. The promoter's prior experience in wholesale/retail trading of construction materials (~12–15% of PSI's sales in FY2019 and FY2020 were made through the associated trading entities) and the company's traction in the region have helped PSI quickly develop its distribution network. Presence of a trading wing also remains a positive as it helps in revenue diversification and provides alternative earnings stream during manufacturing downtime.

Healthy revenue growth despite limited years of operation

In the last four years ending FY2020, PSI's revenue grew by CAGR 42% (albeit on a low base), aided by the addition of TMT production line towards the end of FY2018. The revenues growth of 94% in FY2019 after the addition of TMT production line indicates the promoter's ability to growth their business and the growth potential in PSI's area of operation. However, the ~33% YoY decline in sales in FY2020 (largely resulting from Covid-19 lockdowns) and the promoter's focus shifting from TMT to the steel section could result in muted revenues over next one to two years.

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

PSI's rolling mill is in Birtamode city of the Jhapa district, about 25 km from the Indo-Nepal border in Kakadvitta. 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. PSI is continuously trying to expand its sales and market area with focus on the adjoining hilly districts. The location of PSI's factory in Jhapa makes it well suited for the same as its products are more price competitive than other players because of the lower freight cost involved. However, the company remains exposed to the threat from large and established players with greater economies of scale and good brand traction.

Credit challenges

Fragmented industry and low entry barriers causing margin erosion

The TMT and section industry remains highly fragmented, given the presence of ~30 rolling mills across the country. The relatively simple business model and lower capital expenditure requirement results in low entry barriers, which has led to a rise in the number of rolling mills established in the country in the recent years, causing increased competition and industry-wide margin erosion. As a result, the new entrants such as PSI have failed to meet the projected revenues and cashflows.

Geographical concentration and small small scale of operation could be competitive disadvantages

PSI is in early years of operations and its business remains largely concentrated in and around the Jhapa district of eastern Nepal. This exposes the company to geographical-concentration risk. At the same time, the current scale of operation offers limited scope for PSI to cater to the demand from larger customers and projects. This exposes it to pricing pressure from other large industry players with greater economies of scale. For growing companies like PSI, reduction in margin could have a greater impact vis-à-vis large-scale players with favourable economies of scale. With the increasing marginrelated pressure, scalability of the operation will be essential. PSI's ability to scale up its operations remains to be seen, given the promoter's know-how limited to the eastern market.

High working capital intensity and no headroom in drawing power raises liquidity concerns

PSI's operations remain highly working capital intensive. The situation has deteriorated further due to the sharp rise in inventory and debtor days in FY2020 as evidenced by NWC/OI ratio rising to 62% in FY2020 from 34% in FY2019. At the same time, PSI has fully utilised its drawing power on the currently sanctioned working capital limits, leading to low or no liquidity cushion available with the business, which remains a major rating concern.

Weak capitalisation and high gearing level exerting pressure on debt servicing ability

PSI's capital base remains modest vis-à-vis its scale of operation, resulting in a high gearing level (Total debt/TNW[2]) of ~3.4 times as on mid-July 2020 (~2.9 times as on mid-July 2019). This is in spite of an improvement of over ~5.5 times as of mid-July 2018 due to equity infusion in FY2019. With the decline in sales and operating revenues in FY2020, total debt/OPBDITA[3] weakened to ~10.3 times from ~8.4 times and ~6.5 times in FY2019 and FY2018, respectively. The debt coverage metrices for FY2020 remained modest with interest coverage ratio (ICR) at ~1.4 times and debt service coverage ratio (DSCR) at ~1.2 times (~1.2 and ~0.9 times in FY2019).

Forex risk and Inherent cyclicality of the industry

PSI is exposed to forex risk as the steel billets are purchased in US dollar while domestic sales realisations are in local currency. The risk remains further exacerbated using unhedged US dollar-denominated trust receipt loans for working capital financing.

Also, the cyclical nature of the steel industry creates uncertainty about the demand and cash cycles for PSI. This could impact the capacity utilisation, revenues, and profit margins of the company. Volatility in the cash flow due to cyclicality in cash cycle could pose challenges, especially during the periods of weak demand.

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

Link to the applicable rating criteria:
Corporate Credit Rating Methodology

About the company

Pathibhara Steel Industries Private Limited (PSI) was incorporated in December 2012 as a partnership firm with six individual partners. The firm was converted into a private limited company on July 15, 2018, with the same set of partners as shareholders. As of mid-July 2020, major promoters of PSI included 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 an installed capacity of 10 metric tonnes per day (MTPD). The company started producing TMT bars (8–20 mm in diameter) from Q4 FY2018. At present, the manufacturing portfolio of PSI comprises TMT bars (under the brand name of PSI TMT) and steel sections. The current installed capacity of the rolling mill is ~70,000 metric tonnes[4] per annum (MTPA). PSI's customer base mostly includes individual end users in and around the Jhapa district, where the key

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

promoters have established reputation. PSI uses its supply chain of wholesale/retail trading units in the region to market its products.

Key financial indicators of PSI

Amount in NPR million	Audited			Provisional
	FY2017	FY2018	FY2019	FY2020
Operating Income-OI (Sales; in NPR Million)	215.6	592.4	1,149.6	768.8
OPBDITA[5]/OI (%)	6.2%	7.4%	4.5%	6.5%
Total debt/Tangible net worth-TNW (times)	1.1	5.5	2.9	3.4
Total Outside Liabilities/ TNW (times)	2.6	7.7	3.5	4.0
Total Debt/OPBDITA (times)	3.4	6.5	8.4	10.3
Interest Coverage (times)	1.6	1.9	1.2	1.4
DSCR (times)	1.6	1.3	0.9	1.2
NWC[6]/OI (%)	9%	37%	34%	62%
Current Ratio	0.8	1.0	1.1	1.1

Annexure 1: Instrument details

Instrument (Amounts in NPR million)	Previous rated amount	Current rated amount	Ratings Actions
Long term limits (A)	**77.5**	**140.0**	**[ICRANP] LBB@ (reaffirmed for enhanced limit)**
Fund Based; Term loans (existing)	77.5	100.0	
Fund Based; Term Loans (proposed)	-	40.0	
Short term Limits (B)	**722.5**	**600.0**	**[ICRANP] A4+@ (reaffirmed)**
Fund Based; Overdraft	20.0	50.0	
Fund/Non-fund Based; Working Capital loans (LC/TR/WCL/DL/STL) *	702.5	550.0	
Bank Guarantee (within LC)	-	(20.00)	
Grand total (A+B)	**800.0**	**740.0**	

** Interchangeable between fund-based and non-fund-based limits, includes proposed limit of NPR 100 million for current year and remains unallocated*

@ denotes rating under watch with negative implications

[5] *Operating profit before depreciation, interest, tax and amortization*

6 Net working capital intensity

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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 licenced 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, and technical and analytical skill augmentation.

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