Sarbottam Cement Limited[1]: [ICRANP-IR] BBB+ assigned; [ICRANP] LBBB+/A2 reaffirmed with removal of watch with negative implications

February 03, 2021

Summary of rated instruments

Facility	Instrument* (Amounts in NPR Million)	Last rated Limits	Current Rated Limits	Rating Action
Issuer rating	NA		NA	[ICRANP-IR] BBB+; assigned
Bank Loan rating	Long-term loans	3,742.74	2,993.36	[ICRANP] LBBB+; reaffirmed and watch with negative implications removed
	Short-term loan limits	4,757.60	3,360.00	[ICRANP] A2; reaffirmed and watch with negative implications removed
	Total	**8,500.34**	**6,353.36**	

** Rated instrument details are provided in Annexure-1*

Rating action

ICRA Nepal has assigned an issuer rating of [ICRANP-IR] BBB+ (pronounced ICRA NP issuer rating triple B plus) to Sarbottam Cement Limited (Sarbottam). ICRA Nepal has also reaffirmed the long-term rating of [ICRANP] LBBB+ (pronounced ICRA NP L triple B plus) and the short-term rating of [ICRANP] A2 (pronounced ICRA NP A two) to Sarbottam. The reaffirmed ratings have been removed from watch with negative implications.

Rationale

The rating action factors in the company's improved financial profile with reduced gearing levels (0.59 times as on mid-January 2021 against 1.65 times as of mid-July 2019) and strong operating margins (~24% for H1 FY2021) despite a gradual decline amid the increasing competition. ICRA Nepal also considers the company's strong operational profile with healthy volumetric sales growth in FY2020, despite the impact of the Covid-19 pandemic (~23% YoY growth; ~78% growth in 8M FY2020, i.e. prior to start of the pandemic). The ratings also derive comfort from the company's experienced promoter profile with ~62% stake held by individuals from the Saurabh Group, which has an established presence in manufacturing and selling of construction materials, among others. The company's debt service indicators remain comfortable with an interest coverage of 3.7 times and DSCR of 1.5 times for FY2020. These indicators have further improved in H1 FY2021 with good sales performance as well as reduced interest rate outlook in banking. Sarbottam's financial flexibility also remains healthy with low reliance on working capital borrowings (~51% of drawing power utilised as on mid-January 2021). The company's improving brand recall, extensive dealer network and the recent funding support by promoters with further similar commitments also remain rating positives.

Nonetheless, the ratings are constrained by the likely pressure on Sarbottam's near-term debt service indicators amid the shortened loan repayment tenure. The company plans to significantly lower the debt burden from the proposed initial public offer (IPO) proceeds (including sizeable share premium expected to be raised through book building IPO method). Hence, any unexpected timeline delays would remain critical as the operational cash flows might remain under pressure to serve the increased debt burden. Additionally, the evolving economic impact of the pandemic and the recent political turmoil has created challenges in the operating environment. The ratings are also constrained by the company's high working capital intensity (NWC/OI[2] of ~21% for H1 FY2021), despite the sharp improvement from ~48% in FY2019. ICRA Nepal also takes note of the company's increasing sales concentration with ~25% of the total cement sales and ~100% of the total clinker sales coming from the top 20 customers in the respective segments. The ratings are further impacted by the intense competition in the industry with many established players/brands as well as large upcoming

[1] *Earlier Sarbottam Cement Private Limited*

[2] *net working capital/operating income*

players in the field. Sarbottam's margins are also exposed to the cyclicality inherent in the cement industry and the volatility in interest rates, as seen in the recent years. Going forward, the company's ability to successfully complete its IPO issue as planned, judiciously manage its working capital levels as well as maintain healthy sales growth and comfortable debt coverage indicators would remain the key rating sensitivities.

Key rating drivers

Credit strengths

Strong operational profile as one of the larger greenfield units with competitive input costs – The company operates a greenfield cement plant with the current installed clinkerisation capacity of ~1 million metric tonnes per annum (MTPA) and similar grinding capacity after the recently completed grinding capacity enhancement. With the enhanced capacity, Sarbottam is among the large greenfield units in Nepal. Notably, its technology has enabled Sarbottam to lower limestone consumption for clinker production (in the range of 140–145% in the last few years). This, along with lower limestone transportation cost, has resulted in a relatively low raw material cost for clinker production (~NPR 4,400 per MT for FY2020). These advantages could help the company in maintaining a competitive position in the fragmented industry.

Healthy sales volume growth despite Covid-19 crisis – Sarbottam was able to report healthy sales volume growth prior to Covid-19 at ~78% in 8M FY2020 compared to the 8M FY2019 levels. However, with the impact of the pandemic-induced lockdowns and disturbances in the last few months of FY2020, the overall volumetric sales increased only by ~23% in FY2020. The sales volume growth was mainly supported by the capacity enhancement in the clinkerisation unit from ~0.4 million MTPA to ~1 million MTPA in March 2019. Going forward, the company's sales volume is expected to be boosted by the recently completed grinding capacity enhancement (in January 2021). Though the sales trajectory has remained good in H1 FY2021, despite the challenges in operating environment (~12% volumetric growth and ~3% sales growth compared to H1 FY2020 levels), its ability to maintain adequate realisation in clinker and cement will remain crucial.

Healthy profitability indicators despite slight moderation –The company's operating and net margins remained healthy at ~24% and ~12%, respectively in H1 FY2021. The slight decline in operating margins was mainly due to the decrease in sales realisation of both clinker and cement, amid increasing competition. Besides, the share of clinker sales, which have relatively lower margin than cement, has also increased in the recent period (~65% of total sales volume in FY2020 against ~57% in FY2019). Nevertheless, the reported margins were aided by control over production costs. Hence, volatility in raw material prices also has a bearing on the company's profitability.

Improved financial profile – Sarbottam has gradually lowered its reliance on working capital debt, as is evident from its utilisation of only ~51% of its drawing power as of mid-January 2021 (~89% as of mid-July 2020 and ~100% as of mid-July 2019). This has also increased the company's financial flexibility. Further, the lower-than-anticipated usage of term loans in its capex has led to controlled capital structure with a gearing of 0.59 times as of mid-January 2021 (1.65 times as of mid-July 2019). Accordingly, the coverage ratios remained comfortable with interest coverage at 6.2 times and DSCR 1.8 times in H1 FY2021.

Experienced promoters/management; operational synergies as part of Saurabh Group – The company is a part of the Saurabh Group, which has a track record of more than 20 years in the cement industry, along with presence in other manufacturing and trading sectors. The Group's long track record and the experienced promoters/management helps Sarbottam maintain a modest business performance, mainly through a wide sales/logistics network and business relationships developed over the years. The company derives a major chunk of its clinker sales (~48% for FY2020) from two grinding units related to the Group, namely Jagdamba Cement (rated LBB+/A4+) and Subha Shree Jagdamba Cement (rated LBB+@[3]/A4+@), operating since 2001 and 2007, respectively in diverse locations. This provides assurance regarding clinker sales in the interim, until the demand for cement picks up.

[3] Under watch with negative implications

Credit challenges

Uncertain operating environment – The pandemic-induced lockdowns and disturbances severely impacted economic activity in Q4 FY2020. While the economic impact of the pandemic is still evolving in Nepal, political uncertainty is a big factor with the dissolution of the Parliament and announcement of mid-term elections in April 2021. With this, a significant portion of the Government expenditure is likely to be reallocated for the elections. Hence, both these developments would impact the operating environment for entities like Sarbottam, mainly through the likely demand constriction for construction materials, including cement.

High working capital intensity despite recent improvement – Sarbottam reported a sharp improvement in working capital intensity (NWC/OI) in FY2020 to ~29% as on mid-July 2020 (~48% for FY2019). While the sustainability of the improvement remains to be seen, the intensity remains high, mainly on account of the high debtor and inventory days of 67 and 90, respectively, as on mid-July 2020. Nevertheless, the debtor days are gradually improving in the recent period with increased focus on cash sales and hence the intensity has moderated to ~21% for H1 FY2021.

Debt service indicators likely to remain under pressure – Given the healthy sales growth outlook in the recent years, the company shortened its term loan repayment tenure from eight years to about two to three years for a major chunk of the loans. However, with the onset of the pandemic and ensuing uncertainty, the sales trajectory has been impacted to an extent. While the debt service indicators have remained comfortable in the past, the increased debt repayment burden is likely to create pressure on the company's operational cash flows. Nonetheless, the declining borrowing rates in the recent periods along with the promoter's recent interest-free injections (~NPR 528 million) have provided some support. While ICRA Nepal takes a positive note of the promoter's commitment to continue funding support until the IPO, the company's ability in timely raising the IPO (along with premium) as planned would remain critical. Any major reductions in debt levels from the IPO proceeds and a sustained operating performance could have a positive bearing on the rating outlook.

Intense industry competition and increasing sales concentration – The cement industry in Nepal is highly fragmented, comprising several players and stiff competition from other large/established cement manufacturers. As of mid-July 2020, ~55 cement manufacturing units and ~20 clinker manufacturing units were already operational; some large greenfield units are in the pipeline at present. Additionally, many older players have undergone sizeable capacity enhancements in the recent years. Hence, the pricing flexibility might be lower going forward, as the capacity creation within the country 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 hence, the challenges in passing the price increases to the final customers.

The company's sales concentration also increased in FY2020 with ~25% of the total cement sales coming from the top 20 customers (~13% in FY2019). Similarly, the sales concentration in clinker was also high with ~100% of the clinker sales coming from the top 20 customers. The major buyers of clinker for Sarbottam are its own Group companies viz. Jagdamba Cement Industries Pvt Ltd. and Subha Shree Jagdamba Cement Mills Pvt Ltd., which accounted for ~48% of the total clinker sales in FY2020.

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 Sarbottam. This may impact the company's capacity utilisation, revenues, and profit margins. Volatility in cash flow due to this could pose challenges, especially during periods of weak demand. Moreover, the cement industry in Nepal is insulated from cheaper imports with duty safeguards and a substantial freight cost is involved in the import of cement. Any changes in Government policies may have a bearing on the performance of the industry players. Any other regulatory change 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 methodologies as indicated below.

Links to applicable criteria

Issuer Rating Methodology

Corporate Credit Rating Methodology

About the company

Incorporated in October 2010 as a private limited company, Sarbottam Cement Limited was converted into a public limited company in August 2019. It is involved in producing and selling of clinker and cement. Initially established as a plant with capacity of ~0.4 million MTPA, the capacity currently stands at ~1 million MTPA for clinker as well as grinding. The shares of the company are held by 17 individuals, of which the major shareholding is from the Saurabh Group (~62% stake), a prominent business house in Nepal. Its factory is located at Ramnagar VDC-05, Nawalparasi district. The company mainly manufactures ordinary Portland Cement (OPC) and Portland pozzolana cement (PPC) under the brand Sarbottam.

Key financial indicators

	FY2017 (Audited)	FY2018 (Audited)	FY2019 (Audited)	FY2020 (Audited)	H1FY2021 (Provisional)
Operating income-OI; sales (NPR million)	4,813	6,268	7,047	7,375	3,923
OPBDITA/OI (%)	38%	32%	28%	27%	24%
Total debt/Tangible net-worth-TNW (times)	1.68	1.51	1.65	0.96	0.59
Total outside liabilities/ TNW (times)	2.05	1.77	1.98	1.22	0.99
Total debt/OPBDITA (times)	2.23	2.56	3.12	2.29	1.76
Interest coverage (times)	5.94	5.21	4.78	3.72	6.24
DSCR (times)	1.94	1.88	1.22	1.45	1.78
Net-working capital/OI (%)	44%	58%	48%	29%	21%
Current ratio	1.11	1.38	1.17	1.03	1.16

Source: Company data

Annexure-1: Instrument details

Instrument (Amount in NPR Million)	Previous rated Limit	Current rated Limit	Rating Action
Fund-based, long-term Loans (A)	**3,742.74**	**2,993.36**	[ICRANP] LBBB+; reaffirmed and watch with negative implications removed
Short-term Loan Limits			[ICRANP] A2; reaffirmed and watch with negative implications removed
Working capital loan limits (WCL)	3,460.00	3,360.00	
Bridge gap loans (within term loans)	297.60	-	
Letter of credit	900.00	(750.00)	
Bank guarantee	100.00	(20.00)	
Total short term loans (B)	**4,757.60**	**3,360.00**	
Grand total (A+B)	**8,500.34**	**6,353.36**	

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About ICRA Nepal Limited

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For more information, visit www.icranepal.com

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