Ambe Steels Private Limited: [ICRANP] LBB/A4+ assigned

April 12, 2021

Facility/Instrument*	Rated Amount (NPR Million)	Rating Action
Long-term limits; fund based	643	[ICRANP] LBB; assigned
Short-term limits; fund based	1,078	[ICRANP] A4+; assigned
Short-term limits; non-fund based	2,800	[ICRANP] A4+; assigned
Total	**4,521**	

**Instruments details are provided in Annex-1*

Rating action

ICRA Nepal has assigned a long-term rating of [ICRANP] LBB (pronounced ICRA NP L double B) to the fund-based long-term limits of NPR 643 million of Ambe Steels Private Limited (ASPL). ICRA Nepal has also assigned a short-term rating of [ICRANP] A4+ (pronounced ICRA NP A four plus) to the short-term fund-based limits of NPR 1,078 million and short-term non-fund based limits of NPR 2,800 million (including embedded fund-based limits).

Rationale

The ratings factor in ASPL's long track record in the industry, adequate market shares as well as its experienced promoter group and management team. The company is among the larger and established thermo-mechanically treated (TMT) steel manufacturing units in Nepal. ASPL also has backward integration into billet production to meet ~50% of its raw material requirement, which supports its operating margins and coupled with its economies of scale remains a positive for the company's long-term financial profile. ASPL's established supply chain and customer base coupled with synergy accruing from the Ambe Group's other units in steel and cement industry also remain rating strengths. The assigned ratings factor in the positive demand outlook for steel products in Nepal and the duty protection accorded to the domestic steel industry by the Government of Nepal (GoN) through import barriers on finished steel products. ICRA Nepal notes the locational advantage available to ASPL, given its proximity to the Indian border and the National (East–West) Highway, for the import of raw material from India as well as the distribution of products (TMT bars) across the country.

The ratings are, however, constrained by the sharp decline in ASPL's profit margin and rise in its working capital intensity, because of stiff industry competition in the last two years. ASPL continues to maintain high sales on a reduced margin and increased working capital cycle, which has increased the working capital requirement and strained the company's liquidity. At the same time, ASPL's reliance on bank loans has increased following sizeable dividend payment to its shareholders in FY2018 and FY2019. As a result, ASPL's gearing has increased to 3.4 times in FY2020 (versus ~1.7 times and ~2.8 times for FY2018 and FY2019, respectively). Increased gearing and moderation in margin have stretched ASPL's debt coverage metrices, which remains the key rating concern. The company's short-term liquidity profile also remains stretched on account of the use of short-term bank borrowings to finance its periodic capex. This has resulted in sustained overutilisation of working capital drawing power in the last two years ending in FY2020. Rating concerns also arise from the company's exposure to regulatory risk, as any reduction in the import tariff by the GoN will adversely impact ASPL's profit margin and financial indicators. The ratings are also constrained by the company's limited product diversification (~80% of revenue in FY2020 from TMT bar sales) and the inherent cyclicality associated with the steel industry, exposing the company to cash flow volatility. ASPL is also exposed to forex risks, given its raw material (billet) purchases in US dollars and sales realisation in the domestic currency.

Going forward, the ability of ASPL to streamline its working capital cycle, lower the gearing levels and improve its operating margins will have a bearing on its financial profile. This will, therefore, remain a key rating sensitivity.

Key rating drivers

Credit strengths

Strong promoter group and established track record with good brand traction – ASPL (operating since 2009) is promoted by the Ambe Group, one of the largest business conglomerates of Nepal established in 1982. The Group's presence in allied sectors (such as cement and real estate development) offers synergy in the areas of distribution, marketing, and receivable management. The ratings are also supported by the good brand recall of Ambe Steels, given the aggressive marketing initiatives (through print and electronic media) of ASPL.

Positive demand outlook for domestic players owing to infrastructural gaps and high import barriers – Notwithstanding the decline in FY2020, partly due to the slowdown caused by the Covid-19 pandemic, the import of steel products in Nepal has grown at a healthy pace (33%, 26% and 17% growth in FY2017, FY2018 and FY2019, respectively). As per the import statistics published by Nepal Rastra Bank, the Central Bank of Nepal, billet import in 8M FY2021 has surpassed the FY2020 level. This shows a robust long-term demand for steel products in Nepal. Given the country's significant infrastructural as well as household construction needs, the growth is expected to remain moderate to strong over the medium to long term. Moreover, empowerment of local government and increase in economic activities across the country are expected to provide an impetus to infrastructure development. Additionally, import barriers for most finished steel products are high because of custom tariffs, which benefit domestic steel producers, including ASPL.

In-house billet production provides cushion for operating margins – ASPL has an in-house billet production capacity of ~80,000 MT per annum. At present, the in-house production meets ~50% of the total billet requirement for TMT bar production. Lower cost of in-house billet production vis-à-vis the cost to purchase imported billet supports ASPL's operating margins and provides it with a competitive edge over other players lacking such backward integration avenues.

Strategic location – ASPL's factory at Bhairahawa district (western Nepal) has locational advantage, both in terms of importing raw materials from India and supplying final products all over Nepal. The nearest Nepal–India border at a distance of ~14 km limits logistics cost associated with raw materials import. Further, the factory area is located close to the national East–West highway, which supports easy supply of finished products across the country.

Credit challenges

Intense competition in industry affects margins – The TMT bar production capacity of the Nepalese steel industry has significantly increased in the last two to three years, following the commissioning of new manufacturing units and capacity expansion by the existing TMT players. The fresh capacity creation/expansion was driven by the healthy growth in the steel segment between FY2016 and FY2018, as the post-earthquake reconstruction drive and commencement of a few large infrastructure projects boosted demand. With the event-induced demand moderating, the industry is currently witnessing a capacity overhang. Amid moderation in demand and increasing competition, realisations have softened, negatively impacting the operating margins. The pandemic-induced slowdown in business activities could further weaken the demand and margin outlook for ASPL over the near term and hence, remains a concern for the financial profile.

Moderate financial profile characterised by high gearing and weakening debt coverage indicators – ASPL's net worth and liquidity position deteriorated after the dividend pay-outs in FY2018 and FY2019. The resultant increase in short-term debt to meet the funding gap led to higher gearing levels (~3.4 times as of mid-July 2020). At the same time, ASPL's operating margin sharply declined to ~7% in FY2019 and FY2020 from ~15% in FY2018, supressing the interest coverage ratio to ~1.9 times in FY2019 and ~1.2 times in FY2020 compared with ~5 times in FY2018. Further, the company's DSCR moderated steadily to ~1.4 times in FY2019 and 0.9 times in FY2020 from ~3.1 times in FY2018.

Stretched liquidity because of high working capital intensity – ASPL's business remains highly working capital intensive, as evidenced by high cash conversion cycle. The global pandemic has interrupted business, delaying debtor's realisation and increasing the inventory holding period. The cash conversion cycle increased to 231 days in FY2020 from 133 days in FY2019, resulting in NWC/OI ratio of ~56% in FY2020 against ~33% in FY2019. The liquidity position came under pressure after the dividend distribution in FY2018 and FY2019 and weakening of revenue and profitability position since then. The near-term liquidity also remains under stress due to the utilisation of short-term bank borrowings by ASPL to finance its periodic capex, resulting in the sustained overutilisation of working capital drawing power in the last two years ending in FY2020. The slowdown in the post-Covid-19 business environment could weaken revenues and margins and could exacerbate the liquidity stress.

Limited product diversification and regulatory risk – TMT bar sales accounted for ~80% of ASPL's revenues in FY2020 with the remaining sales mostly coming from products like GI wire, gabion box and binding wire. This exposes ASPL to product-concentration risks, especially in view of the increased competition in the TMT bar industry.

Moreover, being a player in duty-protected industry, ASPL remains exposed to the risk arising from the change in regulations related to import tariffs. The profitability and financial indicators of players in the TMT segment, including ASPL, are aided by the high import barriers on TMT bars (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.

Vulnerability to inherent cyclicality of industry and forex risk – The cyclical nature of the steel industry is likely to keep ASPL's profits and cash flows volatile. 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 is exacerbated by the lumpiness in procurement of raw materials. ASPL is also exposed to forex risk because of the mismatch in the currency for purchase of raw material (US dollar) and that of revenue realisation from sales of finished goods (Nepalese rupees).

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

Links to applicable criteria:
Corporate Credit Rating Methodology

Company Profile

Ambe Steels Private Limited (ASPL) is one of the large and established players in iron and steels products manufacturing industry. It was established in 2009 as a private limited company with production unit at Bhairahawa. The company is owned by the Neupane and Agrawal families under the Ambe Group. The Group, established in 1982, is one of the leading manufacturing conglomerates in Nepal.

ASPL is a secondary steel manufacturer of TMT bars, binding wires, and GI wires under the brand name Ambe Steels and billets for TMT production. The raw materials, mainly iron billets, pig irons, sponge irons are imported from India. The company also has an in-house capacity of producing iron billets that currently meets ~50% of the total requirement.

The ownership of the company is held jointly by the Neupane, Agarwal and Poudyal families. Mr. Shovakar Neupane holds ~60% of the stake, the Agarwal family (through Mr. Ramesh Kumar Agrawal and Mr. Sajjan Kumar Agrawal) hold ~25% stake and the rest ~15% stake is held by Mr. Purna Bahadur Poudyal.

Key financial indicators

Amount in NPR million	FY2018 (Audited)	FY2019 (Audited)	FY2020 (Audited)
Operating Income-OI (Sales; NPR million)	8,097	8,818	6,376
OPBDITA/OI (%)	14.8%	7.0%	7.4%
Total debt/ tangible net worth TNW (times)	1.7	2.8	3.4
Total Outside Liabilities/TNW (times)	2.4	3.4	4.2
Total Debt/OPBDITA (times)	2.0	5.5	8.8
OPBDITA/Interest (times)	5.1	1.9	1.2
DSCR (times)	3.1	1.4	0.9
NWC/OI (%)	30%	33%	56%
Current ratio	1.1	1.1	1.0

Annexure-1: Instrument Details

Facility/Instrument*	Rated Amount (NPR Million)	Rating Action
Fund based, long term (Term Loan)	643	[ICRANP] LBB; assigned
Fund based, short term (Demand Loan, Overdraft Loan)	1,078	[ICRANP] A4+; assigned
Non-Fund based, short term (Letter of Credit)	2,800	[ICRANP] A4+; assigned
Fund based, short term - within short term non-funded limits (Trust Receipt Loan, Short Term Loan)	(2,520)	[ICRANP] A4+; assigned
Total	**4,521**	

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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 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, and technical and analytical skill augmentation.

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