# Arghakhanchi Cement Limited[1]: Ratings reaffirmed and removed from Watch with Negative Implications

**July 12, 2021**

## Summary of rating action

| Instrument* | Last Rated Limits (NPR million) | Current Rated Limits (NPR million) | Rating Action |
|---|---|---|---|
| Long-term loan limits | 4,009.0 | 2,475.0 | [ICRANP] LBBB+; reaffirmed and removed from Watch with Negative Implications |
| Short-term loan limits | 3,328.2 | 3,152.0 | [ICRANP] A3+; reaffirmed and removed from Watch with Negative Implications |
| **Total** | **7,337.2** | **5,627.0** | |

** Instrument details are provided in Annexure-1*

## Rating action

ICRA Nepal has reaffirmed the long-term rating of [ICRANP] LBBB+ (pronounced ICRA NP L triple B plus) for the reduced long-term loan limits of Arghakhanchi Cement Limited (ACL). ICRA Nepal has also reaffirmed the short-term rating of [ICRANP] A3+ (pronounced ICRA NP A three plus) for the company's short-term loan limits. The ratings have also been removed from Watch with Negative Implications.

## Rationale

The removal of the Rating Watch with Negative Implications mainly factors in the company's stable credit profile despite the impact of the Covid-19-induced lockdowns on sales in H2 FY2020. ACL's operating margins remained healthy at ~24% in FY2020 (although lower than the previous year) while its capitalisation and coverage indicators remained comfortable. Further, the company has witnessed a healthy increase in demand in recent months despite the ongoing pandemic. This is a positive for the company's medium-term revenue prospects. In the backdrop of the improved sales momentum along with similar expectations for the near term, ACL's financial profile is expected to remain comfortable.

The rating action further factors in the company's healthy volumetric sales growth in 11M FY2021 in both clinker (~28% growth compared to corresponding period in the previous year) and cement (~22%) despite the increasing competition. The ratings are also supported by the company's comfortable financial profile with a healthy operating margin of ~25% in H1 FY2021 despite the high competitive pressure. This has helped ACL maintain a low gearing level (1.07 times as of mid-January 2021) and comfortable debt service indicators (interest cover of 4.75 times and debt service coverage ratio (DSCR) of 1.66 times for H1 FY2021). ICRA Nepal also notes the company's long operational track record (since 1998) and its strong operational profile with a sizeable installed capacity of ~1 million metric tonnes per annum (MTPA) for clinker as well as cement, making it one of the large greenfield units. The rating action also derives comfort from ACL's experienced promoter profile comprising individuals from the reputed and established business houses of Nepal.

Nonetheless, the ratings are constrained by ACL's high working capital intensity (net working capital to operating income (NWC/OI) of ~41% in H1 FY2021) and modest liquidity profile as characterised by the high reliance on working capital borrowings (~96% of drawing power utilised as of mid-June 2021). The ratings also take note of the high dividend pay-outs in recent years, leading to weak cash accruals, along with the higher total debt/OPBDITA ratio of 2.5 times in mid-January 2021 (1.9 times in mid-July 2019). Hence, the company's stance on further dividend payments and its ability to maintain the sales momentum and margins would remain crucial.

Additionally, ACL's dependence on the top 10 dealers has increased further in H1 FY2021 to ~29% for cement and ~96% for clinker sales. The ratings are further constrained by the intense competition in the industry, with the presence of

[1] *Previously known as Arghakhanchi Cement Private Limited*

many established players/brands as well as large upcoming players in the field. ACL's margins are also exposed to the cyclicality inherent in the cement industry and the volatility in interest rates, as seen in recent years. Going forward, the company's ability to judiciously manage its working capital levels, maintain a healthy sales growth and improve the capitalisation/debt coverage indicators and liquidity profile would remain a key rating sensitivity.

## Key rating drivers

### Credit strengths

**Strong operational profile as one of the large greenfield units** – ACL operates a greenfield cement plant, which currently manufactures Ordinary Portland Cement (OPC) and Portland Pozzolana Cement (PPC). With the current installed capacity of ~1 million MTPA for both clinker and cement, ACL remains one of the largest players in the industry, providing scale advantage. It reported relatively lower limestone consumption for clinker production (~145-147% in last few years), resulting in a comparatively low cost of raw materials (~NPR 4,600 per MT for H1 FY2021, including the cost of coal). These advantages could help the company maintain a competitive position in the fragmented industry.

**Comfortable financial profile** – The company's operating margins remained healthy at ~25% in H1 FY2021 despite the slight decline since the last rating (~29% in FY2019). The decline was mainly due to the decrease in sales realisation in both clinker and cement amid increasing competition. While the reduced cost for most other raw materials provided comfort, the cost of limestone increased to ~NPR 1,358/MT in H1 FY2021 (NPR 1,115/MT in FY2019) as the recent limestone excavation was conducted at a further distance. Nevertheless, the reported margins were aided by the reduction in other production-related costs such as power and fuel costs. The healthy profitability, coupled with the company's low gearing (1.07 times as of mid-January 2021), resulted in a comfortable interest coverage ratio and DSCR at 4.7 times and 1.7 times, respectively, in H1 FY2021.

Nevertheless, the volatility in raw material prices could have a bearing on the company's profitability. Over the medium term, ICRA Nepal expects ACL's capitalisation and coverage indicators to improve further with a gearing of ~1 times and total debt/OPBDITA of ~2 times, reflecting a DSCR of ~1.5 to 2 times.

**Long operational track record and healthy sales growth** – The company has a long track record of operations (since 1998) and has gradually enhanced its capacity over the years. Although ACL's clinker sales volume declined in FY2020 due to the pandemic-induced lockdowns in the last few months of the fiscal, it was able to maintain the cement sales volume in FY2020 despite the pandemic. Moreover, the sales volume improved significantly in 11M FY2021 for both clinker and cement by ~28% and ~22%, respectively, compared to the same period in FY2020 due to increased momentum in construction activities post the initial lockdowns. The company's ability to maintain the sales momentum amid the pandemic will remain crucial.

**Experienced promoters/management** – ACL is mainly promoted by three business groups, namely the Siddhartha Group (36% share), Kedia Organisation (18% share) and the Murarka Group (30% share). These Groups have extensive experience in the cement industry along with a diverse presence in other manufacturing sectors, trading, banking and insurance, among others. The Groups' extensive track record and experienced promoters/management help the company maintain a modest business performance, mainly through an extensive sales/logistics network and business relationships developed over the years. ACL derives a major chunk of its clinker sales (~70% in H1 FY2021) from three grinding units related to the Groups, namely Siddhartha Cement, Brij Cement and Supreme Cement. This provides assurance regarding clinker sales in the interim until the demand for cement picks up further.

### Credit challenges

**High working capital intensity and modest liquidity profile** – ACL has witnessed an increase in the debtor days (81 in H1 FY2021 against 69 in FY2019) which, along with its high inventory days (79 in H1 FY2021), has led to a high working capital intensity of ~41%. The increase in the debtor days was mainly on account of the increasing credit period to grinding units for clinker sales. The company also declared a dividend of 80% and 70% for FY2019 and FY2020, respectively (while

cancelling the earlier proposed dividend of 150% for FY2019), commensurate with a pay-out ratio of ~41% and 93%, respectively. The stretched working capital cycle along with the high dividend pay-outs has necessitated high working capital debt and hence a modest liquidity profile as seen in the low cushion in terms of drawing power (96% of drawing power utilised as of mid-June 2021). However, increasing focus on cash sales in case of cement and the company's plans to retain further profits over the near term could provide support.

**Intense industry competition and increasing sales concentration** – The cement industry in Nepal is highly fragmented, comprising several players with stiff competition from other large/established cement manufacturers. As of mid-January 2021, ~55 cement manufacturing units and ~20 clinker manufacturing units were already operational while a few large greenfield units were in the pipeline. Additionally, many older players have undergone sizeable capacity enhancements in recent years. This has gradually impacted pricing flexibility and might create further pressure as capacity creation within the country is much higher than the current demand levels. Any significant upward movement in input prices could further impact the company's margins amid the competition and hence the challenges in passing on the price increases to the final customers. ACL's sales concentration also increased in H1 FY2021 with ~29% of the total cement sales coming from the top 10 customers (~21% in FY2019). Similarly, the sales concentration in clinker was also high with ~96% of clinker sales coming from the top 10 customers, mostly its own group companies.

**Vulnerability to cyclicality and seasonal demand; risk of regulatory changes** – The cyclical/seasonal nature of the cement industry creates uncertainty regarding demand and cash cycles for ACL. 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 the substantial freight cost involved in the import of cement/clinkers. 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 methodology as indicated below.

**Links to applicable criteria**

Corporate Credit Rating Methodology

## About the company

Incorporated in July 1998 as Dynasty Industries Nepal Private Limited and renamed Arghakhanchi Cement Private Limited in June 2011, the company recently converted into a public limited company and its name was changed to Arghakhanchi Cement Limited on July 02, 2021. The company is involved in the production and selling of clinker and cement with a current installed capacity of ~1 million MTPA for both clinkerisation and grinding.

Its shares are held by eight individuals from three business groups viz. Siddhartha Group (36%), Kedia Organisation (18%), Murarka Group (30%) and one Indian company viz. Uma Cement International (18%). Its factory is in Mainahiya (Rupandehi district). The company currently manufactures OPC and PPC cement under the brand 'Arghakhanchi Cement'.

## Key financial indicators

| | FY2017 (Audited) | FY2018 (Audited) | FY2019 (Audited) | FY2020 (Audited) | H1 FY2021 (Provisional) |
|---|---|---|---|---|---|
| Operating income (OI; NPR million) | 4,336 | 5,895 | 9,817 | 7,379 | 3,982 |
| OPBDITA/OI (%) | 34% | 37% | 29% | 24% | 25% |
| Total debt/Tangible net worth (TNW; times) | 1.22 | 1.10 | 1.13 | 1.16 | 1.07 |
| Total outside liabilities/TNW (times) | 1.63 | 1.39 | 1.39 | 1.39 | 1.39 |
| Total debt/OPBDITA (times) | 2.05 | 2.09 | 1.88 | 3.12 | 2.48 |
| Interest coverage (times) | 13.23 | 14.59 | 5.71 | 3.42 | 4.75 |
| DSCR (times) | 3.08 | 6.03 | 2.53 | 1.76 | 1.66 |
| Net working capital/OI (%) | 43% | 49% | 34% | 47% | 41% |

| | FY2017 (Audited) | FY2018 (Audited) | FY2019 (Audited) | FY2020 (Audited) | H1 FY2021 (Provisional) |
|---|---|---|---|---|---|
| Current ratio (times) | 1.26 | 1.22 | 1.14 | 1.05 | 1.02 |

*Source: Company data*

## Annexure-1: Instrument details

| Instrument | Last Rated Limits (NPR million) | Current Rated Limits (NPR million) | Ratings |
|---|---|---|---|
| **Long-term loan limits – Fund based; term loans (A)** | **4,009.0** | **2,475.0** | [ICRANP] LBBB+; reaffirmed and removed from Watch with Negative Implications |
| | | | |
| **Short-term loan limits (B)** | **3,328.2** | **3,152.0** | [ICRANP] A3+; reaffirmed and removed from Watch with Negative Implications |
| Working capital loan limits | 2,728.2 | 2,552.0 | |
| Customer acceptance (within short-term limits) | (150.0) | (150.0) | |
| Trust receipt loans (within short-term limits) | (400.0) | (600.0) | |
| Bridge gap loan (within fund-based limits) | - | (442.0) | |
| Letter of credit | 600.0 | 600.0 | |
| Bank guarantee (within short-term limits) | (100.0) | (100.0) | |
| | | | |
| **Grand total (A+B)** | **7,337.2** | **5,627.0** | |

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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.

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. The international credit rating agency, Moody's Investors Service, is ICRA's largest shareholder.

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