RATING REPORT

International Steels Limited

REPORT DATE:
October 20, 2020

RATING ANALYST:
Arsal Ayub, CFA
arsal.ayub@vis.com.pk

RATING DETAILS		
Rating Category	**Latest Rating**	**Previous Rating**
Entity	**A+/A-1**	**A+/A-1**
Rating Date	*October 20, 2020*	*June 21, 2019*
Rating Outlook	Rating Watch-Negative	Stable
Outlook Date	*October 20, 2020*	*June 21, 2019*

COMPANY INFORMATION	
Incorporated in 2007	**External auditors:** KPMG Taseer Hadi & Co.
Public Limited Company	**Chairman:** Mr. Towfiq H. Chinoy
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Mr. Yousuf H. Mirza
International Industries Limited- 56.3%	
Sumitomo Corporation- 9.1%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria ***Corporates (May 2016)***
https://www.vis.com.pk/kc-meth.aspx

International Steels Limited

OVERVIEW OF THE INSTITUTION	RATING RATIONALE

International Steels Limited (ISL) was incorporated in 2007 and is currently Pakistan's premium producer of flat steel products with an annual production capacity of 1,000,000MT. The primary activity of the company is manufacturing of cold rolled steel coils (CRC), hot dipped galvanized coils (HDGC), and color coated coils.

Major shareholders of the company are International Industries Ltd. (IIL) and Sumitomo Corporation with a shareholding of 56.3% and 9.1% in ISL respectively. The remaining shareholders include directors, financial institutions, mutual funds, foreign companies, and general public.

Profile of the CEO

Mr. Yousuf H. Mirza is a qualified professional with relevant experience holding a BSc degree in mechanical Engineering from NED University of Technology and also has an MBA degree from the Institute of Business Administration.

International Steels Limited (ISL) was incorporated in 2007 and is currently Pakistan's premium producer of flat steel products with an annual production capacity of 1m MTs. The primary activity of the company is manufacturing of cold rolled steel coils (CRC), hot dipped galvanized coils (HDGC), and color coated coils. Major shareholders of the company are International Industries Ltd. (IIL) and Sumitomo Corporation with a shareholding of 56.3% and 9.1% in ISL respectively. The remaining shareholders include directors, financial institutions, mutual funds, foreign companies, and general public. The company has made arrangements with a geographically diversified network of distributors who sell ISL's products. Its in-house co-generation plant is a competitive advantage for ISL; installed capacity of the plant is 19MW and is sufficient to cater to the power related needs of the company. Excess power generated is sold to K-Electric Limited.

Steel Sector Update

- During FY20, Global steel output was lower by 2%; China effectively increased its market share from 53% to 56%, during the period.

- Demand-weakening has been noted across all major economies, with both US & EU, i.e. major demand drivers, both undergoing a pandemic-induced recession

- Given a slowdown in demand, profit margins for steel producers, globally, have come under severe pressure.

- In Pakistan, the pandemic has further exacerbated the issues of the industry, which was already undergoing a downswing induced by the macroeconomic adjustments undertaken by the Government of Pakistan.

Table 1: Large-scale Manufacturing – Iron & Steel Subset

	FY19	FY20
Iron & Steel Products	**-11.21%**	**-17.36%**
- Billets/Ingots	-25.30%	-18.33%
- H/C.R.Sheets/Strips/Coils/plates etc	3.00%	-16.64%

- This downswing was reflected in the drop in Large-scale Manufacturing (LSM) index, as illustrated in table 1 above. Improvement has been noted in July'20, with the LSM picking up by 5% vis-à-vis SPLY.

- With the Government-mandated lockdown being eased in July/August'20, economic activity has picked up pace. However, industry capacity under-utilization issue is expected to persist in the short to medium term horizon.

Local market

- Local steel market comprises two players namely International Steel Limited (ISL) and Aisha Steel Limited (ASL). ISL and ASL with a capacity of 1m and 0.7M, respectively, create industry capacity of 1.7m MTs of steel. The latest development is the establishment of Hadeed Pakistan Limited (HPL), which has added 0.3m MTs to the industry capacity.

- **Cold Rolled Coil (CRC):** Subsequent to recording a downswing in industry sales for FY17, CRC industry sales have been growing in FY18 & FY19, posting an uptick of 7% and 11% respectively.
    - In terms of production capacity, ISL dominates the industry, given a name plate capacity of 1m MTs of CRC. The other industry participant, ASL, in FY19, has increased its CRC capacity to 700k MTs of CRC.

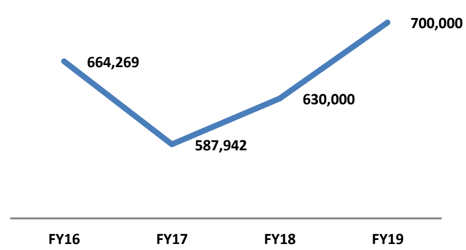


Figure 1: CRC Sales (in MTs)

- **Hot Dipped Galvanized Steel:** Akin to the CRC market, The Galvanized Coils (GC) market, has also posted steady growth in FY18 and FY19, coming in at 9% and 7% respectively.
    - In terms of production capacity, ISL is the industry leader, given production capacity of 462k MTs. The other industry participant, ASL, features a capacity of 250k MTs of GC.

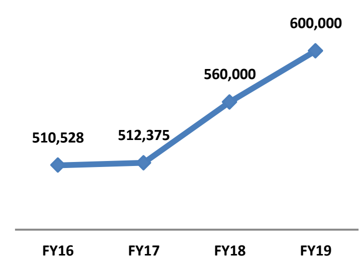


Figure 2: GC Sales (in MTs)

- **Color Coated Steel:** This is a small segment in the local market. ISL is the main player in this segment with a capacity of 84k MTs.

- The pricing of steel in the international nose-dived during 1H'2020, from a high of $600/ton to $200/ton, but has subsequently recovered to $530/ton in Aug'20.

- Price competitiveness of domestic producers has benefited from the rupee devaluation. As per industry players, after accounting for import duties, the price for locally processed steel is roughly Rs. 1-2k/MT lower than imported alternative.

- However, in view of the prevailing demand dynamics and excess capacity, the pressure on margins is likely to continue.

Business Update – ISL

- As illustrated in table 2, capacity utilization for both GC and CRC has dropped in FY20. A contrary trend has been noted for the color-coated segment.

Table 2: Capacity Utilization

	FY19	FY20
Galvanizing		
- Production Capacity	462,000	462,000
- Actual Production	330,350	230,023
- Capacity Utilization	71.5%	49.8%
CRC		
- Production Capacity	1,000,000	1,000,000
- Actual Production	584,408	424,355
- Capacity Utilization	58.4%	42.4%
Color Coated		
- Production Capacity	84,000	84,000
- Actual Production	15,789	21,166
- Capacity Utilization	18.8%	25.2%

- In the outgoing year, the company has established a service center located at National Industrial Park, Bin Qasim, over an area of 15 acres. The service center provides cutting and slitting services catering to the auto industry, the white goods industry, and other consumers.

- The rolling production during the year was lower by 27%, while total saleable production was lower by 26%.

Table 3: Sales & Gross Margin (In PKR' millions, unless stated otherwise)

	FY18	FY19	FY20
Sales (net)	**47,621**	**57,484**	**48,082**
Market-wise Sales Breakup			
- Domestic	92.5%	93.9%	83.8%
- Export	7.5%	6.1%	16.2%
Product-wise Sales Breakup			
- CRC	33.4%	36.6%	38.8%
- Galvanized	65.3%	58.1%	57.5%
- By-Product	1.3%	5.3%	3.7%
Gross Profit	**7,573**	**6,449**	**4,213**
Gross Margin	**15.9%**	**11.2%**	**8.8%**

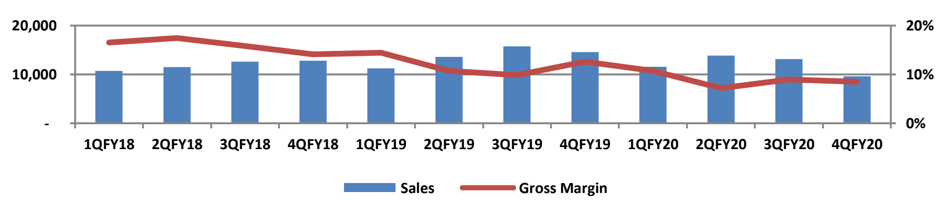
- **Sales:** In FY20, ISL's sales contracted by 16%. This is largely attributable to the pandemic-induced economic slowdown, with sales in 1H'FY20 remaining comparable to SPLY. In the latter half, the sales revenue was ~25% lower than SPLY.

- In quantitative terms, sales volume of galvanized and cold rolled products was lower by 23% and 17% respectively.

- Given notably weaker demand in the domestic market, the management increased its export sales, which constituted 16% of gross sales for FY20 (FY19: 6%). In absolute terms, export grew from Rs. 4b to Rs. 9b and in volumetric terms from ~35k tons to ~84k tons.

- In line with other industry players, ISL's gross margin has come under pressure, as illustrated in the figure below.

Table 4: Sales & Gross Margin (Quarter-wise)



Liquidity

Table 7: Liquidity Indicators (In PKR' millions, unless stated otherwise)

	FY18	FY19	FY20
FFO (in Rs. Millions)	5,738	3,876	1,017
FFO to Long Term Debt (x)	0.72	0.53	0.16
FFO to Debt (x)	0.35	0.22	0.06
DSCR (x)	3.75	2.14	1.03
Operating Cycle (Days)			
Inventory Turnover (A)	129	110	126
Debtor Turnover (B)	5	5	7
Creditor Turnover (C)	27	16	32
Operating Cycle (A+B-C)	107	98	101

- The contraction in sales translates in notable reduction in FFO, as a result of which FFO/Debt ratios have declined notably.

- The outstanding short term debt, as of Dec'20, is adequately covered by inventory and trade debts to the tune of 1.4x.

- The operating cycle has not depicted any significant change. ISL's trade debts increased to Rs. 1.0b as of Jun'20 (Jun'19: Rs. 0.9b). The aging analysis of the trade debts is indicative of an increase in credit risk.

Table 5: Aging of Trade Debtors & Receivable from KE (In PKR' millions, unless stated otherwise)

	FY19		FY20	
Not past due	906	99.8%	692	65.6%
Past due 1-60 days	1	0.1%	278	26.3%
Past due 61+ days	1	0.1%	85	8.1%
Total	907		1,055	

Profitability

Table 6: Profitability Indicators

	FY19	FY20
Gross Margin	11.2%	8.8%
Operating Margin	8.6%	5.7%
Net Margin	4.6%	1.0%
ROAE	23.7%	4.3%

- The company's gross margin dropped notably in FY20. As per management, this was largely on account of Gas Infrastructure Development Cess (GIDC) charge levied in accordance with Supreme Court of Pakistan decision. In this regard, an amount of Rs. 1,240 million was recognized against the self-consumption and has been classified as payable.

- GIDC component of Rs. 737m, has been recognized as contingent liability against K-Electric. The management has gauged this as consumption by the capacitive plant, which also provides power to K-Electric. The amount is recoverable from K-Electric during the course of next 24 months.

- Finance cost for the year amounted to Rs. 2.3b, increasing from Rs. 1.3b in the preceding year. Based on a two-point average, this translates in cost of debt of 13.0% (FY19: 7.6%). Given higher export sales in the preceding year, ISL has been allotted additional LTFF availability, up to Rs. 4.2b. This should allow the company to keep the cost of debt for FY21 below 7%.

- As the sales recoups in the ongoing year and the cost of debt remains expectedly lower, the company's RoAE is likely to return to its long term trend (>20%).

Capitalization

- Given an uptick in trade creditors and debt, ISL's leverage & gearing has both trended up. In view of the upcoming repayments, the company's leverage is projected to fall to 2.5x by Sep'20, as per management.

	Jun'19	Jun'20
Net Equity	11,590	11,472
- Paid-up Capital	4,350	4,350
- Retained Profits	7,240	7,122
Surplus on Revaluation of PPE	1,288	1,254
Debt	17,468	18,067
- Short-Term	10,191	11,520
- Long-Term	7,277	6,457
Gearing	1.51	1.57
Leverage	2.32	2.62
Dividend Payout (%)	49%	-

Table 8: Capitalization (In PKR' millions, unless stated otherwise)

- In view of the prevailing economic conditions and business challenges, ISL decided to abstain from any dividend payout in FY20.

Rating Rationale

…Sizable market share in the flat steel industry and operational track record

The assigned ratings are supported by ISL's dominant market positioning in the flat steel industry, representing half of the industry capacity. With operational track record of more than a decade, ISL is a renowned brand in the domestic market.

… Notable contraction in sales revenue

In FY20, the pandemic-induced demand slowdown affected several industries, including ISL. This resulted in domestic sales revenue dropping by 26%. Nevertheless, the management proactively grew its sales in the export market, thus limiting the contraction in topline to 16%, while also diversifying the topline, as export contribution to gross sales increased from 6% to 16%. Given the increase in export sales, the lending capacity, under SBP's LTFF scheme, has increased.

… Gross margins have been on a negative momentum on a timeline, which have pulled down the cash flow coverage; these have declined below the threshold for the assigned rating

Akin to the industry, gross margins have come under pressure, which is also partly on account of GIDC charge. However, this is in continuation of a negative momentum noted in gross margins noted over the past 4-year year period. Going forward, in view of the market dynamics, the pressure on margins is likely to continue

As a result of the lower margin, the cash flow coverage ratios such as FFO-Debt and DSCR have notably declined. Some comfort is derived from the coverage of short-term debt by stock of inventory and trade debts, which stands at 1.4x. Cash flows are likely to normalize in the ongoing year, as demand picks up and on the back of lower finance cost. This should support the low debt service coverage as of end-Dec'20 (Dec'20: 1.0x; Dec'19: 2.1x).

…Gearing & leverage are on the higher side, but are projected to decline

ISL's capitalization ratios have trended up and considered to be on the higher side, relative to the assigned rating. In view of the coming debt repayments, the ratio is expected to post a slight dip.

International Steels Limited — Appendix I

FINANCIAL SUMMARY				*(amounts in PKR millions)*
BALANCE SHEET	**Jun'17**	**Jun'18**	**Jun'19**	**Jun'20**
PPE	13,639	18,263	19,862	20,638
Stock-in-Trade	9,538	14,133	14,648	15,132
Trade Debts	764	645	868	1,016
Cash & Bank Balances	53	100	403	106
Total Assets	26,371	35,593	39,762	42,861
Trade and Other Payables	6,134	4,504	5,612	8,921
Long Term Debt	4,818	7,970	7,277	6,585
Short Term Debt	5,039	8,462	10,191	11,520
Paid-up Capital	4,350	4,350	4,350	4,350
Core Equity	7,596	10,883	11,590	11,472
Net Worth	8,554	11,825	12,878	12,726
INCOME STATEMENT	**FY17**	**FY18**	**FY19**	**FY20**
Net Sales	33,733	47,621	57,484	48,082
Gross Profit	5,906	7,573	6,449	4,213
Admin Expenses	215	285	284	263
Selling & Distribution	334	434	702	894
Profit Before Tax	4,609	5,803	3,679	442
Profit After Tax	3,044	4,365	2,664	495
RATIO ANALYSIS	**Jun'17**	**Jun'18**	**Jun'19**	**Jun'20**
Gross Margin (%)	17.5%	15.9%	11.2%	8.8%
Net margin (%)	9.0%	9.2%	4.6%	1.0%
Current Ratio (x)	1.0	1.1	1.1	0.9
FFO	5,413	5,738	3,876	1,017
FFO to Total Debt (x)	0.55	0.35	0.22	0.06
FFO to Long Term Debt (x)	1.12	0.72	0.53	0.16
DSCR (x)	5.17	3.75	2.14	1.03
Gearing (x)	1.30	1.51	1.51	1.57
Leverage(x)	2.34	2.18	2.32	2.62
ROAA (%)	12.9%	14.1%	7.1%	1.2%
ROAE (%)	44.2%	47.2%	23.7%	4.3%

ISSUE/ISSUER RATING SCALE & DEFINITIONS — Appendix II

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details. www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

REGULATORY DISCLOSURES	Appendix III
Name of Rated Entity	International Steels Limited
Sector	Steel
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
		RATING TYPE: ENTITY		
20-Oct-20	A+	A-1	Rating Watch-Negative	Maintained
21-Jun-19	A+	A-1	Stable	Reaffirmed
04-Apr-18	A+	A-1	Stable	Reaffirmed
13-Jan-17	A+	A-1	Stable	Initial

Instrument Structure	N/A
Statement by the Rating Team	VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.
Probability of Default	VIS' ratings opinions express ordinal ranking of risk, from strongest to weakest, within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.
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Due Diligence Meetings Conducted	

Name	Designation	Date
Mr. Mujtaba Hussain	CFO	September 1, 2020