Rating Rationale

Sonapur Minerals & Oil Private Limited

Rating

Facility	Amount (Rs. In Million)	Rating[1]	Rating Action
Long Term Bank Facilities	3,046.90	CARE-NP BB+ [Double B Plus]	Assigned
Short Term Bank Facilities	3,203.00	CARE-NP A4+ [A Four Plus]	Assigned
Total Facilities	**6,249.90**		

Details of Facilities in Annexure 1

CARE Ratings Nepal Limited (CRNL) has assigned rating of 'CARE-NP BB+' to the long term bank facilities and 'CARE-NP A4+' to the short term bank facilities of Sonapur Minerals & Oil Private Limited (SMOPL).

Detailed Rationale & Key Rating Drivers

The ratings assigned to the bank facilities of SMOPL are constrained by financial risk profile marked by decline in revenue and profitability margins in FY19 (Audited, refers to 12 months' period ended mid- July 2019), project implementation and stabilization risk associated with planned capex for the enhanced capacity, foreign exchange fluctuation risk and raw material price volatility risk, albeit presence of backward integration. The rating is also constrained by working capital intensive nature of operations, leveraged capital structure and deterioration in the debt service coverage indicators, exposure to volatile interest rates, presence in highly fragmented with competitive and cyclical nature of cement industry, and impact of Covid-19 on the business of the company. The ratings, however, derive strength from established track record of operations and experienced promoters in manufacturing industries including cement, financial closure achieved for the majority of the proposed project cost, competitive advantage over the standalone grinding units and optimum utilization of installed capacity for clinker unit. The ratings also factor in demand of cement products in the country expected to grow in the long term, locational advantage of the project site and accessibility to limestone mines and established brand presence.

Timely completion of the proposed project within the cost estimates, and satisfactory operations and capacity utilizations thereafter are the key rating sensitivities. Satisfactory generation of operational cash flows from the existing plant to fund the equity component of the proposed expansion are the key rating sensitivities. Also, vulnerability with regard to raw material prices and demand dependent on construction activities and economy are the key rating sensitivities.

[1]*Complete definitions of the ratings assigned are available at www.careratingsnepal.com*

Detailed Description of the Key Rating Drivers

Key Rating Weaknesses

Financial risk profile of the company marked by decline in revenue and profitability margins in FY19

Clinker unit of the company has been operating at high capacity utilization of 90% in FY19 while the grinding unit was operating at lower capacity utilization of 42%. Total revenue of the company decreased by ~9 % in FY19 with decline in revenue from sale of both clinker and cement. The company achieved PBILDT margin of 20.41% during FY19 vis-à-vis PBILDT margin of 23.49% during FY18. PBILDT margin reduced in FY19 mainly on account of increase in production expenses and administrative expenses followed by decline in revenue of the company. Further, PAT of the company decreased significantly in FY19 by ~84% to Rs. 18 Mn mainly on account of decrease in the PBILDT which was partially offset by decrease in interest and depreciation expense. Further, SMOPL reported sales revenue of Rs. 1,471 Mn during 6MFY20 (provisional).

Project implementation and stabilization risk associated with planned capex for the enhanced capacity

Construction of the expansion project commenced in the beginning of FY18 with estimated construction period of 3 years. The new capacity is being constructed adjacent to the existing plant. The enhancement project is in the implementation stage as majority of the work has been completed and the company is exposed to moderate project implementation risk and satisfactory operations thereafter. The company has projected to achieve commercial operation date for its clinker unit in October 2020 and grinding unit in July 2020. Timely completion of the project within the cost estimates and satisfactory operations thereafter are the key rating sensitivities.

Foreign exchange fluctuation risk and raw material price volatility risk, albeit presence of backward integration

SMOPL currently uses coal, limestone, gypsum, clay, iron ore, fly ash and gypsum as major raw materials. Coal constituted around 44% of raw materials consumption during clinker and cement production in FY19. The coal requirements of the company are mainly met through import from South Africa or purchased locally. Invoicing of the imported coal is done in USD which exposes SMOPL to foreign exchange fluctuation risk. SMOPL has not taken any hedging mechanism to minimize the risk associated with fluctuation in foreign currency and incurred exchange loss of Rs. 5.58 Mn in FY19. Further, raw material cost continues to be the major cost component of SMOPL as direct material cost constitutes around 75% of total cost of goods sold. Hence, any adverse movement in raw materials price without any corresponding movement in finished goods price is expected to affect the profitability of the company. However, there is an added benefit of backward integration for the company since it procures limestone from its mines which is a major raw material required for clinker production. The ability of the company to pass through changes in raw material prices to the customers and managing the foreign exchange fluctuation risks related to raw materials will be the key rating sensitivities.

Working capital intensive nature of operations

The operations of the company are working capital intensive in nature. SMOPL is involved in manufacturing of clinker and cement from imported, self-manufactured and locally purchased raw materials. The company has to keep the inventory for smooth operations and extend credit to their dealers, which lead to reliance on working capital limits. The company generally allows one month's credit period for its clinker sale and three to four months' credit period for its cement sale to its dealers and maintain inventory for around three months. The operating cycle of the company was high at 161 days in FY19. This leads to high reliance of the company on the bank finance for meeting its working capital needs. The average month-end outstanding of fund-based working capital limit against drawing power was around 95% during last 12 months' period ended mid-January, 2020.

Leveraged capital structure and deterioration in the debt service coverage indicators

Debt equity ratio of the company was deteriorated to 1.80x at the end of FY19 from 1.31x at the end of FY18 due to availing additional term loan by the company in FY19 to fund the expansion project which was partially offset by debt repayment and increase in net worth due to accretion of profit and additional equity infusion by the promoters for funding expansion project. Total gearing ratio of the company was high at 2.63x at the end of FY19. Also, the company had below unity debt service coverage ratio in FY18 and FY19. The interest coverage ratio was moderate at 1.97x in FY19 with total debt/ gross cash accruals at 13.01x during FY19.

Exposure to volatile interest rate

Nepalese banking sectors are fixing interest rate on lending based on quarterly base rate and interest rate will be changed accordingly on quarterly basis. Due to tight liquidity in the market, the interest rate has been high and volatile during the last 12 months. Therefore, funding from Bank and Financial Institutions is subject to volatile interest rate.

Presence in highly fragmented with competitive and cyclical nature of cement industry

SMOPL is operating in a highly competitive market, dominated by the large cement manufactures with wide brand acceptability. Given the fact that the entry barriers to the industry are low, the players in the industry do not have pricing power and are exposed to competition-induced pressures on profitability. The demand of cement industry is considered cyclical as it depends upon the capital expenditure plan of major players in the end-user industry. Further, with increase in the capacities of the existing plants and new capacities coming into operation, competition has intensified that has resulted into substantial decline in profitability margins of the industry players. The producers of cement are essentially price-takers in the market, which directly expose their cash flows and profitability to volatility in the prices of cement.

Impact of Covid-19 on the business of the company

The outbreak of Coronavirus disease 2019 (Covid-19) which was recognized as Pandemic has affected Nepal as well. With lockdown imposed by the GoN, SMOPL has suspended all its manufacturing activities from March 24, 2020 but resumed business operations from May 08, 2020 onwards. Also, construction activities for the expansion project is also effected due to the lockdown. The company had to stall supply of cement to its dealers as well as direct sales since the nation-wide lockdown imposed, which may have a negative impact on the revenue, profitability, cash flow and debt service indicators of the company. However, Nepal Rastra Bank has provided time extension for the repayment of loans falling due in Mid-April 2020 and rebate in interest rate by 2% for the fourth quarter ending mid-July 2020 which is expected to provide some temporary relief. The company's ability to achieve sales and profitability as envisaged and maintain its debt coverage indicators would remain critical.

Key Rating Strengths

Established track record of operations and experienced promoters in manufacturing industries including cement

SMOPL has an operational track record of more than 7.5 years in cement manufacturing. SMOPL is promoted by industrialists and traders of Nepal, belonging to the members of the Tayal family, who are involved in collection of gumrosin and turpentine oil, cycles, papers, cosmetics, fibre cables, dairy products etc., along with other individual shareholders. The company is managed under the overall guidance of the company's board of directors (BOD) who possess wide experience in different business sectors. The company has three directors in its board. Mr. Ratanlal Tayal is the Chairman and Mr. Nipesh Tayal is the Managing Director of the company with long business experience and involvement in various business sectors. BODs are further supported by an experienced team across various functions/ departments.

Financial closure achieved for the majority of the proposed project cost

Initially envisaged project cost of the company was Rs. 1,385 Mn which was proposed to be funded at an at a debt equity ratio of 80:20. However, the project cost was escalated by Rs. 556 Mn to Rs. 1,940 Mn to be funded at a debt of Rs. 1,551 Mn and rest via equity infusion at a debt equity ratio of 80:20. The cost of the project increased mainly due to appreciation of USD against NPR leading to increase in cost of machineries/ equipment, increase in steel price, increase in minimum labour wage coupled with further additional engineering works resulting in increased civil cost, mechanical cost etc. Banks have already sanctioned Rs. 1,107 Mn term loan towards the project via consortium financing with additional Bridge Gap Loan of Rs. 400 Mn (proposed to be converted into term loan). Company's size of the project as a percentage of the networth at the end of FY19 is at 1.23 times. SMOPL has already incurred ~90% i.e. Rs. 1,743 Mn over the expansion project till mid- February, 2020 funded through debt of Rs. 1,391 Mn, equity share capital of Rs. 188 Mn and remaining amount of Rs. 164 Mn was utilized from internal accruals of the company.

Competitive advantage over the standalone grinding units

The company currently has mining license for two limestone mines located at same site. Further, the company also purchases limestone from another mine owned by sister concern of the company. It is estimated that the mines owned by the company (~42 kms from plant site) and mine owned by its sister concern (~16 kms from plant site) has sufficient limestone deposit to run 1,500 MTPD clinker unit for ~43 years based on 330 working days a year. Further, the clinker produced by SMOPL is of high quality resulting in bulk and repeated purchase of clinker from other cement factories in the area. Now, Nepal is manufacturing its own clinker and dependence upon the imports of the clinker has reduced substantially over the period. During 10MFY20, the import of clinker has been reduced by ~73% to Rs. 1.33 Bn as compared to Rs. 4.88 Bn import during 10MFY19. Clinker manufacturing units will have added cost competitive advantage over the standalone grinding units as the average manufacturing cost per MT of clinker is lower than the purchase price of domestically available clinker as well as imported clinker.

Optimum utilization of installed capacity for clinker unit but lower capacity utilisation of the Grinding Units

The company has optimum capacity utilization for its clinker unit at ~90% in FY19, but the capacity utilization of its grinding unit was at a low level at ~42% in FY19. The company had low capacity utilization for its grinding units as the company prioritized sale of its clinker as compared to cement since clinker produced by SMOPL is high quality, thus creating favourable demand of its product by other cement manufacturers coupled with timely realization of clinker sale which also helps the company to maintain liquid financial profile.

Demand of cement products in the country expected to grow in the long term

Nepalese economy is developing and growing, and is in phase of investment in infrastructure sectors, power sector and tourism sector. It is highly probable that the national economy will be in need of construction materials in developing public as well as private infrastructures, road, bridges and other public facilities. Further, the government’s high emphasis on infrastructure development, namely development of roads, hydropower, airports and other infrastructures and estimated GDP growth of 7.00% as included in the budget for FY20-21 is likely to benefit the cement manufacturers like SMOPL.

Locational advantage of the project site and accessibility to limestone mines

The plant site is well connected to East-West Highway with major cities and towns nearby. The majority of the sales of the company are concentrated at Western and Far-Western region of the country. Further, the mines are located close to the plant site which reduces logistics cost of the company.

Established brand presence

SMOPL sells its product all over Nepal with primary focus towards Western and Far-western part of the country, with main market being Banke District (~150 customers) and Dang District (~200 customers) of Nepal being nearest location from the factory and has more than 60 dealers. Further, company's established brand presence coupled with high quality clinker has supported healthy clinker and cement realizations over the years. With expansion, the company will be able to increase production of both cements and clinker that is expected to increase revenue profile in future.

About the Company

Sonapur Minerals & Oil Private Limited is a private limited company which was incorporated in June 13, 2008 and is one of the integrated cement manufacturing plant in the country located in Dang valley of Western Nepal. The company is presently engaged in manufacturing and selling cement with clinker capacity of 1,000 MTPD and grinding capacity of 1,000 MTPD and is undergoing expansion of clinker unit by 500 MTPD and grinding unit by 700 MTPD. The company is selling OPC under the brand name 'Sona Cement OPC' and PPC under the brand name 'Sona Shree PPC Cement' and 'Sonatech PPC Cement'.

Brief financials of SMOPL for last three years ending FY19 are given below:

(Rs. Million)

For the year ended Mid July	FY17 (Audited)	FY18 (Audited)	FY19 (Audited)
Income from Operations	2,921	3,557	3,223
PBILDT	655	835	658
PAT	80	111	18
Overall Gearing (times)	2.73	2.65	2.63
Interest Coverage (times)	2.63	2.26	1.97

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Annexure 1: Details of the Facilities rated

Nature of the Facility	Type of the Facility	Amount (Rs. In Million)	Rating
Long Term Bank Facilities	Term Loan	2,601.90	CARE-NP BB+
Long Term Bank Facilities	Term Loan (Proposed)	445.00	CARE-NP BB+
Short Term Bank Facilities	Working Capital Loan	2,101.00	CARE-NP A4+
Short Term Bank Facilities	Non-Funded Loan	1,102.00	CARE-NP A4+
Total		**6,249.90**	