Aarti Strips Private Limited

Ratings

Facilities	Amount (Rs. in Million)	Ratings[1]	Rating Action
Long Term Bank Facilities	**2,489.40**	**CARE-NP BBB- [Triple B Minus]**	**Reaffirmed**
Short Term Bank Facilities	**9,280.00**	**CARE-NP A3 [A Three]**	**Reaffirmed**
Total Facilities	**11,769.40 (Eleven Billion Seven Hundred Sixty-Nine Million and Four Hundred Thousand Only)**		

Details of instruments/facilities in Annexure 1

CARE Ratings Nepal Limited (CRNL) has reaffirmed the ratings of 'CARE-NP BBB-' assigned to the long term bank facilities and 'CARE-NP A3' assigned to the short term bank facilities of Aarti Strips Private Limited (ASPL).

Detailed Rationale & Key Rating Drivers

The ratings assigned to the bank facilities of ASPL continue to derive strength from its long track record of operations with experienced management team, steady operational performance of the company in FY22 (Audited, refers to the twelve-month period ending mid-July), and moderately leveraged capital structure and debt service coverage indicators. The ratings also take cognizance of the improved business profile after commencement of full operations of the backward integrated Cold Rolling Mill (CRM), making the company self-reliant in making Cold Rolled sheets. Apart from cost savings, the CRM plant also opens prospects of exports to India. Consequently, despite industry headwinds leading to sluggish domestic demand, the company's revenue momentum has continued in 9MFY23 (Unaudited, refers to the nine-month period ended mid-April 2023) supported by sustained demand for exports. The ratings positively factor in the improved business profile of the company post completion of the backward integration which has broadened the company's revenue base. Also, gleam prospectus of exports of its products is likely to boost the revenue scope and enhance profitability. Although near-term industry dynamics remain challenging amid sluggish demand scenario, the backward integration is expected to be margin accretive for the company leading to improved financial profile over medium term. The ratings also factor in established brand with country wide market presence and diverse product range catering to wide spectrum of industries.

The ratings are however, continue to be constrained by working capital intensive nature of operations leading to elongated operating cycle, foreign exchange fluctuation risk and exposure to fluctuations in raw material price volatility. The ratings also factor in its presence of the company in highly competitive and cyclical nature of steel industry and exposure to volatile interest rates.

Going forward, the ability of the company to improve capacity utilization levels and derive envisaged benefits from the backward integrated CRM plant would be key rating sensitivities. Also, ability of the company to profitably scale up its operations coupled with rationalization of its debt levels though efficient working capital management.

Detailed Description of the Key Rating Drivers

Key Rating Strengths

Established and long track record of operations in Nepal with experienced management team

ASPL has an operational track record of more than 17 years in manufacturing galvanized and color coated iron sheets and has been manufacturing MS black pipes for more than 7 years. The company is promoted by four Indian investment companies which has been primarily incorporated for promoting ASPL and are core investment companies. ASPL is

[1]*Complete definitions of the ratings assigned are available at www.careratingsnepal.com and in other CRNL publications*

managed under the overall guidance of its two-member Board of Directors (BoD) who are qualified professionals with wide experience in the manufacturing industry. Mr. Vishal Gupta, Director, has an overall experience of over two decades in the steel industry and looks after day-to-day operations of the company.

Steady financial performance in FY22, likely to sustain in FY23 despite industry headwinds

During FY22, ASPL's Total Operating Income (TOI) increased by ~5% year-on-year (y-o-y) to Rs. 14,273 Mn. The growth was mainly on account of higher price realization as quantity sold had declined by 19% y-o-y. Despite higher input prices, the company has been able to maintain a steady PBILDT margin of ~12% during FY22 and FY21. However, PAT margin decreased slightly to 5% during FY22 from ~6% during FY21 on account of higher interest expenses. Although domestic demand has been impacted by slower pace of economic growth, the company has been able to offset the sluggish domestic sales through increasing exports. The company's TOI from exports increased to Rs. 2,973 Mn (21% of TOI) in FY22 from Rs. 680 Mn (~5% of TOI) in FY21. The revenue momentum has sustained in 9MFY23, supported by increasing demand for exports. The company has already achieved sales of Rs. 10,623 Mn in 9MFY23. The firm's ability to achieve sustained growth in operations with a stable margin profile will remain critical from credit perspective.

Moderately leveraged capital structure and debt service coverage indicators

Capital Structure of the company is moderately leveraged with Debt-Equity ratio and overall gearing ratio of 0.39x and 1.56x, respectively, at the end of FY22 and remained almost stable over previous year. Interest coverage ratio of ASPL stood moderate, however, declined to 2.45x in FY22 from 2.86x in FY21 on account of increased interest expenses and Total debt/Gross Cash Accruals has deteriorated to 10.22x in FY22 from 7.81x in FY21 on account of increase in loans. However, gearing levels are likely to improve sequentially over the medium term with steady accretion of profits and likely moderation in debt levels.

Backward integration of flat sheets provides flexibility, boost product portfolio, revenue scope and enhance profitability over the medium term

The company has completed a brownfield expansion project by setting up a 150,000 MTPA of Cold Rolling Mill (CRM) Plant at the end of FY22. The expansion was done to reduce its dependence on import of CR Coil from India and China and become self-reliant in making Cold Rolled sheets of desired thinness from HR Coil. Furthermore, the in-house production of Cold Rolled Sheets is expected to generate cost efficiencies and improve profitability margins. Furthermore, the company also will be able to explore sales opportunities for CR products both domestically and to India. Similarly, ASPL had two galvanize line of capacity of 55,000 MTPA each, out of which one was converted to Galvalume with capacity of 100,000 MTPA. Galvalume line started commercial production from mid-sept, 2021. Scope of margins is higher in Galvalume sheets compared to galvanized sheets, which will also add up to the company's profitability profile going forward.

Established brand with country wide market presence

ASPL sells color coated sheets under the brand name "Aarti Spectra" and galvanized sheets and MS pipes under the brand name "Aarti Suraksha" which are an established brand in the Nepal market on account of its long-standing presence in the construction industry. TMT bars are sold under the brand name of "Aarti Perfect" and "Aarti Tiger". Galvalume Sheets are sold under the brand "Aarti Silver". The company is into the business for more than 16 years and is one of the major players in the country. This provides leverage to the company in front of new players entering the industry. Established brand image ensures customer loyalty and aid in the differentiation of products with the competitors. Additionally, the company markets and sells its entire range of products through a well-established network of around 200 dealers across all major cities in the country which provides a ready market for its product.

Diverse product range catering to wide spectrum of industries and strong marketing setup

ASPL manufactures an array of flat products ranging from Galvanized Plain/Galvanized Corrugated, ridge Galvanized Iron & Color Coated with Zinc Based Pre-Printed Galvanized Iron (PPGI), Profile Sheets, MS Tube and Shutter Patti. ASPL has further expanded its portfolio by entering into manufacturing Galvaume Plain/Galvalume Corrugated from September, 2021 onwards. The products manufactured by the company find applications in varied industries such as construction and infrastructure, white goods and automotive industry. Further, ASPL has created a less competitive market for its color coated products and multi-color sheets etc. The wide application not only diffuses the risk of dependency on a single industry but also allows the company to cater to a larger market with a broad customer base.

Demand of steel products in the country expected to grow in the long term, however muted in the short term

Demand of steel products in the country is 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. Sustained demand for steel is likely given the need of construction materials in developing public as well as private infrastructures, road, bridges and other public facilities. Furthermore, the government's continued emphasis on infrastructure development, namely development of roads, hydropower, airports and other infrastructures etc. is likely to benefit the steel manufacturers like ASPL. However, with the construction sector in Nepal impacted by slower pace of economic growth coupled with relatively lower infrastructure spending by the government, the outlook of steel industry in Nepal is challenging in the near term. Also, in the recent budget presented by finance minister of Nepal for FY23, Government of Nepal allocated Rs. 161.56 Bn in the infrastructure sector, which was Rs. 2 Bn less compared to the previous fiscal year. While the government's long term emphasis on infrastructure development, namely development of roads, hydropower, airports and other infrastructures is likely to benefit the TMT bar manufacturers like VSPL in the long term, the demand for steel is expected to be muted in the short term.

Key Rating Weaknesses

Working capital intensive nature of operations

The company has working capital intensive nature of operations as reflected by low current ratio of 0.96x at the end of FY22. ASPL is involved in manufacturing of wide range of steel products and is required to maintain adequate inventory of raw material for smooth running of its production processes and meet immediate demand of customers. Also, being a highly competitive business, the company has to extend credit period to its dealers which is upto 100 days whereas company has to make immediate payment to its suppliers. The company had net- operating days of 244 days in FY22 on account of high levels of inventory holding for smooth running of its production processes. Furthermore, being a manufacturer, it is critical for the company to maintain minimum inventory levels to meet immediate demand of its customers; all this led to high working capital requirements which were largely met through bank borrowings.

Foreign exchange fluctuation risk and raw material price volatility risk

ASPL currently uses HR coils, Paints, aluminium, etc as major raw materials and the raw materials are majorly imported from India and China. The prices of the HR Coils & Sheets, Paints and aluminium are market linked and determined on a periodic basis. The company keeps inventory of around three months, thus exposing the company to the volatility in the prices of raw materials which has a bearing on its profitability margins. The cost of raw material consumed as % of the total cost of production of the company was around 77% in FY22, thus, any volatility in prices of the same impacts the profitability of the company. Further in FY22, majority of its raw material requirements is met through imports and the price of the same are linked to USD, for which it is exposed to the foreign exchange fluctuation risk. However, after establishment of own CRM plant, imports have been reduced. To prevent the impact of foreign exchange fluctuation on profitability, ASPL does forward contract for all forex transactions on regular basis, however the cost of hedging has also gone up significantly. The ability of the company to pass through of changes in raw material prices to the finished products and managing the foreign exchange fluctuation risks related to raw materials by hedging will be crucial for maintaining its profitability margins.

Presence in highly fragmented and competitive nature of steel industry

The iron and steel industry is intensely competitive and fragmented marked by the presence of both larger players and numerous smaller players in the unorganized segment. 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 iron & steel products is considered cyclical as it depends upon the capital expenditure plan of major players in the end-user industry. Furthermore, the value addition in the steel products like MS. Black Pipe, TMT bar & related products is low, resulting into low product differentiation in the market. ASPL is one of the leading player in Nepal market in galvanized, galvalume and color coated sheet segment and also has dominant position in manufacturing ultra-thin flat products which reduces competition to certain extent.

Exposure to volatile interest rate risk

Sustained requirement for short-term working capital borrowings has led to a high interest expense for TBC (Rs.142 Mn during FY22) leading to direct impact in the company's net profitability. The company's interest rates are based on a floating interest rate regime, where a certain premium is added to the quarterly base rate and interest rate is changed accordingly on quarterly basis. The base rates of the banks and financial institutions (BFIs) in Nepal remain quite volatile as they are impacted by available liquidity in the system which leads to change in interest rates. Therefore, funding taken by the firm from BFIs is subject to volatile interest rate.

About the Company

Aarti Strips Private Limited (ASPL) is a private limited company which was incorporated on January 21, 2001 for setting up a wet flux galvanized plain and corrugated sheets manufacturing facility at Biratnagar, Nepal. The company is into manufacturing wide range of steel products with total installed plant capacity of 381,000 Metric Tons Per Annum (MTPA) in FY22 and is one of the leading player in the industry.

Brief financials of ASPL for last three years ending FY22 are given below:

Financial Performance

(Rs. Million)

For the year ended mid-July	FY20 (A)	FY21 (A)	FY22 (A)
Income from Operations	12,320	13,617	14,273
PBILDT Margin (%)	5.87	12.25	11.99
Overall Gearing (times)	1.59	1.59	1.56
Total Outstanding Liabilities/Tangible Net worth (times)	2.01	2.04	2.18
Interest Coverage (times)	2.55	2.86	2.45
Current Ratio (times)	1.04	1.04	0.96
Total Debt/Gross Cash Accruals (times)	25.76	7.81	10.22

A: Audited

Annexure 1: Details of the Facilities Rated

Nature of the Facility	Type of the facility	Amount (Rs. In Million)	Ratings
Long Term Bank Facilities	Term Loan/Bridge Gap Loan	2,489.40	CARE-NP BBB-
Short Term Bank Facilities	Fund Based Limits	6,530.00	CARE-NP A3
Short Term Bank Facilities	Non–Fund Based Limits	2,750.00	CARE-NP A3
Total		11,769.40	

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About CARE Ratings Nepal Limited:

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