Kwality Oil Refinery Private Limited

Rating

Facilities/Instrument	Amount (Rs. in Million)	Ratings[1]	Rating Action
Short Term Bank Facilities	2,750.00	CARE-NP A4+ [A Four Plus]	Reaffirmed
Total Facilities	2,750.00 (Two Thousand Seven Hundred and Fifty Million Only)		

** Details of Facilities in Annexure 1*

CARE Ratings Nepal Limited (CRNL) has reaffirmed the rating of 'CARE-NP A4+' assigned to the short term bank facilities of Kwality Oil Refinery Private Limited (KOPL).

Detailed Rationale & Key Rating Drivers

The rating assigned to the bank facilities of KOPL continues to remain constrained by volatile trend of its operational performance mainly on account of reliance on exports to India for significant portion of its income, which in turn is dependent on the tariff arbitrage between direct import of crude edible oil in India vis-à-vis import of refined oils from Nepal. This exposes KOPL to changes in tariff regimes by Government of India (GoI) for imports of various edible oils/crude leading to volatile operating performance, as seen in the past three fiscals (FY21-FY23; FY refers to the twelve-month period ending mid-July). The rating takes cognizance of the declining trend in KOPL's Total Operating Income (TOI) in 11MFY23 (Unaudited; refers to the eleven-month period ended mid-June 2023, FY ending mid-July) owing to substantially lower export sales which is expected to adversely impact the financial performance of the company over the near-term. Any further negative deviation in the financial risk profile resulting from a prolonged decline in operating performance beyond FY23 will remain key constraint from credit perspective. The rating also factors in susceptibility of KOPL's business to price fluctuation of seasonal agro products, foreign exchange fluctuation risk, exposure to volatile interest rates and regulatory risk.

The rating, continues to take comfort from reasonable domestic sales of the company with moderate capital structure and moderate operating cycle. The rating also factors in KOPL's established track record of operations with experienced promoters, locational advantage for both imports and exports and stable demand prospects for edible oils over the medium term, which however is offset to some extent by the volatility in export opportunities for Nepalese refiners.

Going forward, the ability of the company to manage growth in the operations by increased penetration in the domestic market leading to lesser dependency in the volatile exports business while maintaining profit margins will be the key rating sensitivities. Furthermore, 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 also be the key rating sensitivities. Also, prolonged unfavorable change in the regulatory framework pertaining to trade regulations and tariff differentials with India adversely impacting exports prospects for substantially longer periods leading to a material decline in operating profile of the company on a sustained basis will also be a key rating sensitivity.

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

Detailed description of the Key Rating Drivers

Key Rating Weaknesses

Volatile operating performance amid challenging business environment

KOPL generates its revenue from sale of refined sunflower, palmolein, soyabean and fatty acid oil, majority of which is through exports to India. During FY22 (Audited; FY refers to the twelve-month period ending mid-July), Total operating income (TOI) of the company had increased by ~132% year-on-year (y-o-y) to Rs. 6,508 Mn majorly on account of increased demand for exports to India. However, export sales have been impacted during FY23 due to reduced scope for arbitrage following the introduction of duty free import scheme for soybean and sunflower crude by Government of India (GoI) in May 24, 2022 followed by lowering of import duty on import of palmolein to 5% from 7.5% in February 13, 2022 to help curb exorbitantly high oil prices in India. Consequently, during 11MFY23, KOPL has achieved total income of Rs. 4,816 Mn out of which the export sales accounted ~52% of the total sales which decreased from ~73% during FY22. Until a positive revision in the import duty by GoI, exports prospects remain slim.

Furthermore, PBILDT margin declined to 6.81% in FY22 from 8.36% on account of increase in raw material prices in international market which the company was not able to fully pass through to its customers. Consequently, PAT margin declined to 4.55% during FY22 compared to 5.33% during FY21. Profitability is also likely to remain sluggish over the near term owing lower scale of operations, although likely to be offset to some extent by comparatively softer input prices in FY23. However, the overall financial risk profile of the company is expected to remain relatively stable with gearing levels and interest coverage remaining range bound, albeit likely with further moderation by FY23 end. Comfort is also taken from the reasonable domestic market share of the company with around Rs. 2,284 Mn income from domestic sales in 11MFY23 (FY22: Rs. 1,724 Mn).

Raw material price volatility risk and foreign exchange fluctuation risk

KOPL's major raw materials are agro based commodities which include crude soyabean oil, crude sunflower oil and crude palm oil which are imported from various countries. The raw material cost contributed around 92% of the total operating income of the company during FY21. The prices of these raw materials are market linked and determined on a periodic basis, thus exposing the company to the volatility in input prices, which has a bearing on its profitability margins. Similarly, foreign exchange fluctuation risk also remains a major risk factor for a company like KOPL, with procurement predominantly in foreign currency (USD) whiles sales realization in domestic currency or Indian rupee. KOPL incurred foreign exchange loss of Rs. 32 Mn in FY22 due to foreign exchange fluctuations which increased from Rs. 6 Mn in FY21. 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 crucial from its profitability perspective.

Competitive nature of industry

Import and processing/refining of edible oils is highly fragmented due to presence of several organized/ unorganized players owing to low entry barrier and low technology and capital requirement. Low product differentiation of KOPL's product results in high competition from other players including traders. Considering the competitive nature of industry, the millers have low pricing power. Agro products are also seasonal in nature with production dependent on various factors such as monsoon and climatic condition, exposing the fate of the company's operation to vagaries of nature.

Exposure to volatile interest rate

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. Higher interest rates than envisaged could result in squeezed margins of the company. Hence, funding taken by the company is exposed to volatile interest rate.

Exposure to regulatory risk

The operations of the company is vulnerable to regulatory risk arising from various laws and policies of the importing and exporting countries coupled with the domestic policies of Nepal. KOPL's exports revenue (~73% of total sales in FY22), relies on the tariff arbitrage in India between direct imports of crude by Indian millers vis-à-vis imports of refined edible oil from Nepal. KOPL, like many millers in Nepal, tries to exploit the tariff differential, which keep changing for different edible oils every year as per the policies of the GoI. Furthermore, over the past few years, there have been several changes in government policies, either domestic or international regarding import/export of edible crude sometimes limiting and at other times enhancing refiners like KOPL's ability to export to India. KOPL's revenue profile is thus susceptible to regulatory policies relating to tariff barriers (differential trade tariffs among South Asian Free Trade Area), non-tariffs barriers (restriction on the quality of imports), international freight rates etc. Any sustained unfavorable change in policies by local governments impacting exports of refined oils or procurement of crude could have a bearing on the financial profiles of the refiners like KOPL.

Key Rating Strengths

Established track record of operations and experienced promoters

KOPL has been involved in processing of edible oil for around two decades and derives strength from experienced promoters. The company is managed under the overall guidance of its board of directors, which includes experienced businessmen/industrialists in the related field of manufacturing and trading. Mr. Ghanashyam Kabra, Managing Director has experience of around two decades in the food processing and trading sector. Bipin Kabra, Director, looks after overall operations of the company. Similarly, other directors of the company also have reasonable experience in the related business. The directors of the company are supported by a team of experienced professionals.

Moderate capital structure and operating cycle

KOPL imports its raw materials from various countries such as Argentina, Brazil, Malaysia, Indonesia etc through Letter of Credit. Being procurement of raw material is in the form of imports, KOPL is required to keep enough inventory for smooth operations which lead to reliance on working capital limits. The company generally receives advance payment from the customer (for export), which led collection period around 18 days during FY22 including domestic sales (FY21: 28 days). KOPL's average inventory period stood at 14 days in FY22 (FY21: 21 days). Similarly, Consequently, operating cycle of to the company stood at 23 days during FY22, improved from 36 days during FY21 aided by improved debtor collection and inventory holding at the end of FY22. Furthermore, the average utilization of working capital limits against sanctioned limit remains moderate around 50% of its working capital limits for the twelve-month period ended mid-June 2023.

Furthermore, overall gearing of the company has been on an improving trend over the last 3 financial years (FY20-FY22). It improved to 1.09x at the end of FY22 from 2.11x at the end of FY21 supported by increased net worth base due to accretion of profit to reserves coupled with additional equity infusion of Rs. 50 Mn. Furthermore, interest coverage ratio of the company remained adequate at 8.69x in FY22, improved from 7.64x in FY21 on account of increased PBILDT of the company. Similarly, total debt/GCA improved to 2.09x during FY22 from 4.03x during FY21.

Essential part of cooking leading to stable demand and steady growth in the revenue

The demand prospect of edible oil industry in Nepal is growing as oil is one of essential commodity for cooking. Further, with demand being higher than domestic production and slowdown in domestic agriculture production, large volume of edible as well as crude oil is being imported in Nepal giving importers like KOPL a favorable business environment. Despite decline in export sales, comfort is taken from the decent scale of KOPL’s domestic business although a near-term decline in profitability exacerbated by intense competition, the company’s credit risk profile is expected to remain resilient enough to ride out the near term dip in scale of operations and profitability.

Locational advantage for both imports and exports

KOPL’s plant site is located in Morang, Nepal near to Nepal-India boarder. Since all of the raw materials requirements of KOPL imported from various countries are unloaded on Indian ports, the factory’s proximity to the border leads to savings in freight cost. Close proximity to Indian boarder is also beneficial from the company’s exports perspective as it exports majority of its products to India which accounted for 73% of total revenue in FY22.

Industry Outlook

Amid change in duty structure (lower/zero import duty) by Government of India (GoI) on imports of various crude edible oils, Nepalese refiners’ income levels in FY23 are expected to drop substantially compared to the high growths reported over FY21-FY22 which was supported by surging exports to India of palmolein and soybean oil. Nepal's exports of edible oil to India has declined substantially compared to previous years. According to Department of Customs and the Trade and Export Promotion Center (TEPC), exports of edible oils to India from Nepal have declined by 68% year-on-year (y-o-y) in 11MFY23. Hence, refiners like KOPL are likely to remain impacted over the near term as export opportunities to India remain slim. However, refiners with a decent domestic presence are expected to fare better than the majorly export oriented player. KOPL’s domestic sales of over Rs. 2,000 Mn sales annually is likely to support the earning profile of the company to some extent in the interim.

Although, upward revision in import duty of various crude edible oils in India, when that happens, is likely to again open opportunities for Nepalese refiners. Nonetheless, exports will remains contingent upon the intermittent changes in related policies of GoI, resulting in a volatile income levels for refiners like KOPL going forward as well.

About the Company

Kwality Oil Refinery Private Limited (KOPL) is a private limited company incorporated on March 1, 2004 under the flagship of Kabra G Group for processing/refining of edible oils, having plant in Katahari, Morang, Nepal. It is involved in the production of Vanaspati Ghee, Refined Vanaspati Oil like Soyabean, Sunflower, Palmolein, Palm, Rapeseed, Ground Nut, Corn and many more satisfying the needs of customers and trends. The company has total installed capacity for refined oil is 320 Metric Ton Per Day.

Financial Performance

(Rs. In Million)

Particulars	FY20 (A)	FY21 (A)	FY22 (A)
Income from Operations	1,847	2,809	6,508
PBILDT Margin (%)	7.32	8.36	6.81
Overall Gearing (times)	5.51	2.11	1.09
Interest coverage (times)	3.64	7.64	8.69
Current Ratio(times)	1.43	1.17	1.25
Total Debt/Gross Cash Accruals(times)	11.50	4.03	2.09

A: Audited

<u>**Annexure 1: Details of the Facilities Rated**</u>

Nature of the Facility	Type of the Facility	Amount (Rs. in Million)	Rating
Short Term Bank Facilities	Fund Based Limit	2,750.00	CARE-NP A4+ [A Four Plus]
Total		**2,750.00**	

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About CARE Ratings:

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