

Zuari Agro Chemicals Limited

February 22, 2019

Summary of rated instruments

| Instrument* | Previous Rated Amount (Rs. crore) | Current Rated Amount (Rs. crore) | Rating Action |
|---------------------------------------|-----------------------------------|----------------------------------|----------------------------------------------------------------|
| Long Term Fund Based | 1,200.0 | 1200.0 | [ICRA]BBB+ reaffirmed; Outlook revised to Negative from Stable |
| Long Term Fund Based Interchangeable# | (75.0) | (75.0) | [ICRA]BBB+ reaffirmed; Outlook revised to Negative from Stable |
| Long Term un-allocated limits | 265.0 | 265.0 | [ICRA]BBB+ reaffirmed; Outlook revised to Negative from Stable |
| Short Term non-fund-based limits | 2,750.0 | 2750.0 | [ICRA]A2+; reaffirmed |
| Total | 4215.0 | 4215.0 | |

*Instrument details are provided in Annexure-1

Rs 75 crore of long-term limit is fully interchangeable with short term non-fund-based limits

Rationale

The revision in the outlook reflects the pressure on the credit profile of Zuari Agro Chemicals Limited (ZACL) owing to large losses posted in 9M FY2019 and expectation of a continued subdued performance in the near term. The weak performance has been a result of significant agri distress in key operating areas of the company along with the rise in the raw material prices which the company was not able to pass on to the farmers resulting in lower contribution from sales. The weakness in performance was further accentuated by a 53-day maintenance shutdown undertaken for the urea plant resulting in lower production and loss of market share. The shutdown was a planned shutdown for maintenance and commissioning of certain energy savings equipment to improve energy efficiency of the urea plant. ZACL's main marketing territories include Maharashtra, Karnataka and Andhra Pradesh which witnessed deficient monsoon and low reservoir levels during the year resulting in significant agri-distress and a decline in sales volume for the industry and the company. The price of key raw material i.e. phosphoric acid and ammonia, which are entirely imported by the company, increased during the year which coupled with significant depreciation in the INR vis-à-vis US dollar led to increase in the raw material costs of the company. While the company had undertaken increase in the retail price for P&K fertilisers during the year, discounts provided subsequently, owing to the competitive pressures resulted in significantly lower contribution from P&K sales vis-a-vis last year. As a result, the company posted a net loss of Rs. 82.9 crore in 9M FY2019 vis-à-vis a net profit of Rs. 57.0 crore in 9M FY2018. The interest coverage of the company declined to 0.5x for 9M FY2019 vis-à-vis 1.3x in 9M FY2018 as the operating profit declined but the interest costs witnessed a sharp increase. ICRA also takes note of the revision in the plans related to the reduction in the energy consumption from FY2021 onwards. Earlier ZACL had planned revamp of its urea operations with a total capital outlay of Rs. 1300 crore. However, due to a delay in receipt of environmental clearance the company revised its capex plan and will be implementing energy savings project to reduce its energy consumption to around 6.1-6.2 Gcal/MT from FY2021 onwards vis-à-vis pre-set norm of 6.5 Gcal/MT. The total capital outlay for the new project is around Rs. 380 crore. Though with reduction in the energy savings from FY2021 the project will not be value accretive it will have to be undertaken to meet the regulatory requirements. The company along with other industry participants has requested GoI for extension of the current energy norms beyond FY2021 which if materialises would result in improving the returns from the project and also aid

profitability of the company. The company is also planning to monetise some of its assets the proceeds from which will be used for deleveraging of the balance sheet. ICRA also takes note of the capital raising plans of the company through a rights issue through which the company plans to raise ~Rs. 500 crore which will be used to deleverage the balance sheet. The timely infusion of funds will remain a key rating sensitivity.

The ratings continue to factor in the established position of the company in the fertiliser and other agri-businesses, diversified product portfolio and healthy operating efficiency and its strong marketing network and leading market position in Karnataka and Maharashtra. The ratings also factor in the financial flexibility because of being part of the Adventz Group (part of the erstwhile K.K. Birla Group). ICRA notes that the Adventz Group is also looking to consolidate its fertiliser operations by the integration of different departments of ZACL and group companies MCFL and PPL and derive operational and financial synergies, which may be favourable for the companies in the medium to long term.

The ratings continue to be constrained by the continuing high debt levels due to significant subsidy delays by the Government of India and the resulting weak debt coverage indicators and modest core profitability metrics. The ratings also factor in the decline in gas costs for the company following the implementation of gas pooling for the urea sector by the Government of India, although the company has also lost out on energy savings to some extent. Besides the already high debt levels owing to subsidy delays and the debt funded acquisition of MCFL resulted in further increase in the debt levels of the company. Further, the MCF acquisition may not generate any major returns for ZACL in the medium term, although long-term synergies and growth opportunities exist.

The ratings are also constrained by the vulnerability of profitability of the industry to agro-climatic conditions, regulated nature of the industry and seasonality associated with the fertiliser business. The performance of the non-urea sector is relatively more vulnerable to regulatory (subsidy) as well as economic variables (such as supply-demand, commodity prices and currency movements); profitability for the segment can be volatile depending upon ruling international prices of raw materials as well as ability to raise retail prices in an adequate manner. Demand for the segment has also been affected in recent years due to high retail prices of these fertilisers resulting in a significant price differential with urea. The subsidy inflow post implementation of Direct Benefit Transfer (DBT) for the fertiliser sector has been affected by initial operational hiccups leading to elongation in the working capital cycle in the recent months. However, these issues are expected to be transitional in nature and as the system stabilises the subsidy inflow is expected to stabilise.

Outlook: Negative

ICRA believes the profitability and cash generation to remain under pressure in the near term for ZACL given the significant agri-stress in its operating territories. The credit profile will continue to remain subdued as working capital borrowings are expected to remain high driven by the delay in subsidy receivables from GoI.

The outlook may be revised to Stable if there is material improvement in the profitability of the company and/or timely infusion of funds through a rights issue.

Key rating drivers

Credit strengths

Established track record of the company in fertiliser and other agri-businesses: ZACL has had an established track record in the fertiliser and other agri-business since 1967. ZACL through its subsidiaries and joint ventures is engaged in manufacturing of fertilisers, seeds, and other agri-inputs.

Diversified product portfolio including urea, DAP and NPK complexes as well as traded products: ZACL is engaged in manufacturing of urea as well as DAP/NPK fertilisers at its Goa manufacturing facility along with water soluble fertilisers (WSF) and Single Super Phosphate (SSP) manufactured at other plants of the company. It also undertakes trading of

various fertilisers to provide wide range of agri products to the farmers. ZACL also benefits from access to the DAP/NPK fertilisers manufactured by its JV Paradeep Phosphate Limited (PPL).

Favourable long-term demand outlook for fertilisers in India due to scarcity of nutrients in the soil: Indian soil remains deficient in nutrient content which has resulted in lower agri-productivity. With increasing population, the demand for food will increase which will make productivity improvement imperative for the agri sector. Thus, the demand outlook for fertilisers remains positive in India.

High operating efficiency of the plants, although the company has faced certain operational issues in recent years: Though ZACL's plants had faced operational issues in the past, the operational efficiency has improved over the last few years. Urea as well as DAP/NPL plant has shown healthy capacity utilisation in last few years. Urea plant has witnessed improving capacity utilisation and energy efficient operations post implementation of gas pooling for the fertiliser sector resulting in lowering of gas costs for ZACL.

Strong marketing network and leading market position in Karnataka and Maharashtra: ZACL caters to the southern and western part of India and enjoys leading market position in Karnataka and Maharashtra. ZACL along with PPL enjoy a major part of the DAP/NPK market in south –western part of India and a strong marketing network.

Gas pooling has significantly reduced gas costs and hence, subsidy receivables: ZACL used to operate on R-LNG before implementation of gas pooling which resulted in high cost of production of urea for the company. Post implementation of gas pooling the gas costs for production of urea has declined significantly leading to lower subsidy receivables which in turn has resulted in lower working capital borrowings for the company. ZACL's urea production also became competitive against urea imports as the cost of production declined.

Financial flexibility on account of being part of the Adventz Group (part of the erstwhile K.K. Birla Group): ZACL derives financial flexibility on account of being part of the Adventz Group (erstwhile K.K. Birla Group) which was instrumental in the company getting indirect support through purchase of land to counter the losses during FY2014. ICRA notes that the Adventz Group is also looking to consolidate its fertiliser operations by the integration of different departments of ZACL and PPL to derive operational and financial synergies, which may be favourable for the companies in the medium to long term.

Credit challenges

Vulnerability of profitability to agro-climatic conditions, regulatory risks and seasonality of the fertiliser business: Agriculture sector in India remains vulnerable to the vagaries of monsoon as the area under irrigation remains low which exposes fertiliser sector to volatility as well. The sector being highly regulated also remains vulnerable to changes in the regulations by Gol.

Performance of non-urea fertilisers is relatively more vulnerable to regulatory and economic variables: Non-urea fertiliser demand is relatively more volatile as the preference for urea is driven by the price differential. In case of weak monsoon, the non-urea fertilisers have seen more impact on demand relative to that on urea. The domestic manufacturers are also affected by movement in international prices of end products as well as raw material which impact the profitability. Post implementation of Nutrient Based Subsidy (NBS) for P&K fertilisers, the price differential between urea and P&K fertilisers has widened which has adversely impacted demand for P&K fertilisers. The profitability of the companies depends on the movement of international prices of raw material as majority of these are imported. The ability of the company to pass on any increase in raw material prices to end-consumer through revision of retail price also plays a crucial role in protecting profitability which may be constrained by high level of stocks or poor monsoon etc.

Imports expose ZACL to forex risk; partly mitigated by the hedging policy of the company: ZACL imports its entire requirement of phosphoric acid, ammonia and MOP for production of DAP/NPK fertiliser which exposes it to foreign

exchange risks. The risk is however partly mitigated as the company leaves very small amount of its foreign exchange exposure as unhedged.

Debt funded capex to meet energy norms under NUP-2015: ZACL will be undertaking significant debt funded capex to meet energy consumption norms applicable under NUP-2015 from FY2021 onwards. The capex for the project is around Rs. 380 crore and is to be funded in a debt-equity ratio of 70:30. The capex is expected to keep the credit metrics subdued in the near term.

Subdued capital structure characterised by low capitalisation, high debt and low core profitability: Capital structure of the company has weakened since demerger from Zuari Industries Limited. Low capitalisation, high debt due to subsidy receivable driven working capital borrowings along with weak core profitability over the past few years has resulted in weak capital structure. Going forward the debt funded capex will keep the capital structure subdued unless equity infusion is completed in a timely manner by the company.

High working capital intensity due to subsidy delays and high trade receivables resulting in high borrowings: As the subsidy receivables from GoI continue to remain outstanding for as long as 4-5 months working capital borrowings to fund the receivables keep the borrowing levels elevated. The high receivable days also lead to high working capital intensity for the business and high interest costs for the company impacting profitability.

MCF acquisition leading to cash outflow: ZACL had acquired 53.03% ownership in MCFL through its subsidiary Zuari Fertilisers & Chemicals Limited (ZFCL, now merge with ZACL) with a total cash outflow of Rs. 510 crore. The acquisition was majorly debt funded and ZACL continues to service the debt leading to cash outflows in the form of interest and debt repayments.

Liquidity Position:

Liquidity position of the company remains moderate owing to delay in the subsidy receivables from the GoI which leads to elongation of the working capital cycle. The weak profitability of the company in the current fiscal has also put pressure on the liquidity. However, given the financial flexibility it derives from being part of the Adventz Group the company is able to raise funds at short notice. ZACL has also refinanced its term loans and has low repayments in the near term. Additionally, the company is raising funds through a rights issue and has certain asset monetisation plans which will help in improving the liquidity position of the company.

Analytical approach:

| Analytical Approach | Comments |
|---------------------------------|------------------------------------------------------------------------------------------------------------------------------------|
| Applicable Rating Methodologies | Corporate Credit Rating Methodology Rating Methodology for Construction Equipment Manufacturers |
| Parent | NA |
| Consolidation / Standalone | The ratings are based on standalone financials of the company |

About the company:

Zuari Agro Chemicals Limited (erstwhile Zuari Holdings Limited) constitutes the fertiliser operations of the Adventz Group following the demerger of Zuari Industries Limited (ZIL). It is also the holding company for the other agri-business operations of the Adventz Group. The group has interests in agri-inputs, engineering, infrastructure, real estate, consumer durables and services sectors. It was a part of the erstwhile K.K. Birla Group. In April 2011, the Bombay High Court (Goa bench) approved the demerger of ZIL's fertiliser business into Zuari Holdings Limited (later renamed as ZACL),

while the residual entity ZIL (later renamed as Zuari Global Limited) retained the non-fertiliser business operations and investments. The demerger scheme was applicable w.e.f July 1, 2012.

The erstwhile ZIL was promoted in 1967 in financial and technical collaboration between the K.K. Birla Group and the U.S. Steel Corporation to manufacture urea, compound nitrogenous fertilisers and phosphates in Goa. In 1985, ZIL promoted Chambal Fertilisers & Chemicals Limited (CFCL, rated [ICRA]A1+) to produce urea using natural gas at Gadepan, Rajasthan. In 2002, ZIL acquired Paradeep Phosphates Ltd (PPL - rated [ICRA]A(Stable)/[ICRA]A1) through a JV company, as part of the disinvestment process of Gol. PPL manufactures DAP and NPK fertilisers, with its plant located at Paradeep, Orissa. While the equity shareholding of ZIL in PPL is now held by ZACL (40.225% of entire shareholding of PPL through the JV company), the 13.3% shareholding of ZIL in CFCL continues to be held by ZGL.

ZACL's plant is located in Goa and comprises of a urea plant of 0.4 MMTPA capacity, complex (NPK) plant of 0.36 MMTPA capacity and DAP-cum-Complex plant of 0.36 MMTPA capacity, which is capable of manufacturing a range of complexes. ZACL completed its feedstock conversion project and is now using gas as a feedstock for manufacturing urea (it was earlier using naphtha). For complexes and DAP, it uses imported ammonia and phosphoric acid. As of end-June 2017, 66.08% of the shareholding of ZACL was held by the promoter group, while the rest is held by domestic and foreign institutional investors and public.

Key financial indicators (audited)

| | FY2017 | FY2018 |
|------------------------------|--------|--------|
| Operating Income (Rs. crore) | 4076.5 | 4647.6 |
| PAT (Rs. crore) | -60.4 | 30.3 |
| OPBDIT/OI (%) | 6.3% | 7.3% |
| RoCE (%) | 6.6% | 9.8% |
| Total Debt/TNW (times) | 4.7 | 4.7 |
| Total Debt/OPBDIT (times) | 12.1 | 9.2 |
| Interest coverage (times) | 0.8 | 1.1 |

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

| Instrument | Type | Current Rating (FY2019) | | Chronology of Rating History for the Past 3 Years | | | | | | |
|-------------------------------------------|------------|--------------------------|--------------------------------|---------------------------------------------------|----------------------------|----------------------------|----------------------------|------------------------------|----------------------------|----------------------------|
| | | Amount Rated (Rs. crore) | Amount Outstanding (Rs. crore) | Date & Rating | | Date & Rating in FY2018 | | Date & Rating in FY2017 | | Date & Rating in FY2016 |
| | | | | February 2019 | August 2018 | September 2017 | August 2017 | December 2016 | October 2016 | September 2015 |
| 1 Fund Based | Long Term | 1200.0 | - | [ICRA]B BB+ (Negative) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Negative) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Stable) |
| 2 Fund Based Interchangeable [#] | Long Term | (75.0) | - | [ICRA]B BB+ (Negative) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Stable) | - | - | - | - |
| 3 Un-allocated limits | Long Term | 265.0 | - | [ICRA]B BB+ (Negative) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Negative) | [ICRA]B BB+ (Stable) | [ICRA]B BB+ (Stable) |
| 4 Non-fund-based limits | Short Term | 2750.0 | - | [ICRA]A 2+ | [ICRA]A 2+ | [ICRA]A 2+ | [ICRA]A 2+ | [ICRA]A 2+ | [ICRA]A 2+ | [ICRA]A 2+ |

Complexity level of the rated instrument:

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument Details

| ISIN | Instrument Name | Date of Issuance / Sanction | Coupon Rate | Maturity Date | Amount Rated (Rs. crore) | Current Rating and Outlook |
|------|--------------------------------------------|--------------------------------|----------------|------------------|--------------------------------|-------------------------------|
| - | Fund Based | - | - | - | 1200.0 | [ICRA]BBB+ (Negative) |
| - | Fund Based Interchangeable [#] | - | - | - | (75.0) | [ICRA]BBB+ (Negative) |
| - | Un-allocated limits | - | - | - | 265.0 | [ICRA]BBB+ (Negative) |
| | Non-fund-based limits | - | - | - | 2750.0 | [ICRA]A2+ |

Rs 75 crore of long term limit is fully interchangeable with short term non-fund-based limits

Source: Zuari Agro Chemicals Limited

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