

PRESS RELEASE

NEPAL EKARAT ENGINEERING COMPANY PRIVATE LIMITED

February 2023

Ratings

Instruments/ Facilities	Amount (NPR. Mn)	Ratings	Rating Action
Long Term Bank Facilities	136.98	IRN BB	Assigned
Short Term Bank Facilities	220.00	IRN A4	Assigned
Long Term/Short Term Bank Facilities	3,643.02	IRN BB/ A4	Assigned
Total	4,000.00		

Details of facilities are in Annexure 1 below

Infomerics Credit Rating Nepal Limited (Infomerics Nepal) has assigned the long term rating of IRN BB (Double B) to the long term facilities of NPR 136.98 Mn, short term rating of IRN A4 (A Four) to the short term bank facilities of NPR 220.00 Mn and IRN BB (Double B) /A4 (A Four) to the long term/short term bank facilities of NPR 3,643.02 Mn.

Detailed Rationale

The ratings assigned to the bank facilities of Nepal Ekarat Engineering Company Private Limited (NEEK) derives strength from NEEK's long track record of operations, supported by experienced directors and a proficient management team with experience in the transformer manufacturing industry leading to the better understanding of the market dynamics. The ratings also factor in the NEEK's moderate order book position, moderate counter-party risk, locational advantage, established brand name & market position and average financial profile. These rating strengths, however, are constrained by NEEK's existence in a competitive industry as reflected in low capacity utilization. Further, the ratings also note NEEK's exposure to customer and supplier concentration risk, volatility in prices of raw materials, foreign exchange risks, product warranty risks, interest rate volatility risk, and working capital intensive nature of business. Going forward, sustained growth in revenue with improvement in overall margins and prudent working capital management aiding financial risk profile will remain key a rating sensitivities.

Detailed Description of Key Rating Drivers

Key Rating Strengths

Long track record of operations with experienced promoters and management team

NEEK has an operational track record of more than three decades in manufacturing of distribution transformers under the brand name "NEEK". The major operations of the company are overseen by the Chairman, Mr. Kush Kumar Joshi, who has over three decades of experience in managing the company. Similarly, other directors of the company also have a relevant experience in transformer manufacturing business. The promoters are further supported by a team of technically qualified and experienced professionals, leading to a better understanding of the market dynamics.

Moderate order book position with short term visibility

As of January end 2023, the company's unexecuted orders in hand stood at ~NPR 1,567 Mn (including NEEK's share in JVs). The order book of NEEK is considerable vis-à-vis the operating income of FY22. NEEK's order book position remains moderate as of January end 2023, with an unexecuted order in hand of ~1.08 times the operating income in FY22. Nevertheless, the order book reflects short-term revenue visibility as the orders are due within a year.

Moderate counter party risk and locational advantage

NEEK generates majority of its revenue from the sales of distribution transformers to various governmental entities and domestic parties. As on January end 2023, ~68% of the outstanding unexecuted order was attributable to Nepal Electricity Authority (NEA) resulting in moderate counter party risk as it is fully owned by government of Nepal and has been regular in making payments to concerned parties. Furthermore, the counterparty risk associated with other parties are moderated to some extent, given its adequate credit policies and long standing relationship with its clients. Additionally, NEEK's factory located in Hetauda provides locational advantage to the company in terms of logistic operation and management.

Average financial profile

The financial profile of NEEK reflects average performance as reflected by its improving total operating income (TOI), moderately leveraged capital structure and debt coverage indicators. The TOI of NEEK has significantly improved to NPR 1,447 Mn in FY22 vis-à-vis NPR 559 Mn in FY21 and NPR 501 Mn in FY20, owing to resumption of NEA's contract after a decade. Despite, the fall in EBITDA margins in FY22 vis-à-vis FY21 and FY20, the absolute values have considerably improved to NPR 131 Mn in FY22, NPR 77 Mn in FY21 and NPR 88 Mn in FY20. The interest coverage ratio remains moderate at 2.62x in FY22 which however has deteriorated from 6.84x in FY21 on account of increased dependence on bank borrowings and higher interest rate charged on borrowings in recent years. Furthermore, the tangible net-worth base of the company has slightly declined in FY22 due to planned profit extraction in the form of dividend, resulting in more leveraged capital structure marked by higher overall gearing ratio of 2.24x in FY22 vis-à-vis 0.52x in FY21. Going forward, sustained growth in revenue with improvement in overall margins, coverage & capitalization indicator remains crucial.

Key Rating Weaknesses

Low Capacity Utilization

The capacity utilization of NEEK has been on the lower side with an average of ~19% in the past three financial years ended FY22. The decline in capacity utilization in past years was mainly attributed to COVID-19 & its subsequent after effect. Furthermore, the improvement in capacity utilization of NEEK has been impeded by technical criteria specified in the bid document from parties like NEA. However, with the normalization of the economy the capacity utilization has been improved in recent years and is expected to improve further. NEEK has an installed capacity of 18,000 units per annum.

Client and supplier concentration risk

NEEK's revenue concentration remained on the higher side with ~73% of total sales from top-ten clients in FY22, as the major buyer is NEA. Also, with the supply agreement with its JV partner especially for the NEA project, for supplying the requisite copper wires, the company's exposure in its top-ten suppliers has increased to ~82% in FY22 vis-à-vis 67% in FY21, thereby resulting in higher client and supplier concentration risk.

Exposure to raw material prices volatility and foreign exchange rates

NEEK imports cold rolled grain oriented (CRGO) silicon steel, transformer oils, transformer tanks from India while copper wires are typically sourced from the domestic market. These raw materials correspond to ~80-90% of the total production costs and prices of these raw materials are highly volatile in nature as prices are guided by international demand-supply scenario due to their global linkages. This exposes NEEK to any major adverse raw material price fluctuations. Nevertheless, the presence of supplier agreement for copper wires for significant portion of the outstanding order in hand provides comfort to an extent. Further, NEEK is exposed to foreign exchange fluctuation risk due to the mismatch in currency, as majority of its key raw materials are imported (in USD) while significant portion of the revenue is realization in local currency.

Competitive transformer industry with significant working capital intensive nature of operations

The company remains exposed to competitive pressure by ways of import from countries such as India along with presence of few domestic manufacturers. The competitive nature of the industry coupled with tender or quotation based procurement by majority of the customers has resulted in pressure on pricing and margins for players like NEEK. Furthermore, the operations of the company are working capital intensive especially due to NEEK's practice of maintaining adequate inventories for key raw materials and distribution transformers to ensure availability during periods of demand. Nevertheless, the operating cycle of the company improved to 144 days in FY22 vis-à-vis 236 days in FY21.

Product warranty and interest rate risk

NEEK is susceptible to financial losses arising out of defects identified during the product warranty period which typically lasts up to two years from the date of sale. Furthermore, the interest rates on deposits and borrowing remains a significant factor in the Nepalese economy. In line with NRB's directives, the BFI's typically charge interest rate on loans by adding a premium to the base rate which are revised on a quarterly basis. The interest rates charged by BFIs have been historically volatile over the past 2-3 years and thus borrowing from banks and financial institutions exposes NEEK to risk of interest rate volatility.

Analytical Approach: Standalone

Applicable Criteria:

[Corporate Credit Rating Methodology](#)

About the Company:

Incorporated on January 1991, NEEK is a private company having its plant located at Thana Bharyang, Hetauda for manufacturing distribution transformer with total installed capacity of 18,000 units per annum. The company manufactures distribution transformers in a range between 1kVA² and 10 MVA³ and voltage up to 132kV.

Financial Indicators (Standalone)

For the year ended* As on	FY20	FY21	FY22
	Audited	Audited	Audited
Total Operating Income (in NPR Mn.)	501	559	1,447
EBITDA Margin (%)	17.63	13.80	9.07
Interest Coverage Ratio (x)	4.98	6.84	2.62
Current Ratio (x)	2.05	2.88	1.13
Overall Gearing Ratio (x)	0.30	0.52	2.24

* Classification as per Infomerics Nepal standards

Annexure:1 Detail of Facilities:

Name of Instruments/ Facilities	Type of Facilities	Amount (NPR Mn.)	Ratings
Fund Based Bank Facilities- Term Loan (TL)	Long Term	136.98	IRN BB
Fund Based Bank Facilities-Working Capital (WCL)	Short Term	220.00	IRN A4
Non Fund based Bank Facilities- LC/BG ⁴	Long Term/ Short Term	3,139.00	IRN BB/A4
Non Fund based Bank Facilities- LC/BG (Proposed)	Long Term/ Short Term	504.02	IRN BB/A4

¹ Bank and Financial Institutions

² Kilovolt-ampere

³ Megavolt-ampere

⁴ Letter of Credit (LC), Bank Guarantee (BG)

Total Facilities		4,000.00	
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About Infomerics Credit Rating Nepal Limited:

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