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HEG/SECTT/2021

13th July, 2021

1	**BSE Limited** P J Towers Dalal Street MUMBAI - 400 001. **Scrip Code : 509631**	2	**National Stock Exchange of India Limited** Exchange Plaza, 5th Floor Plot No.C/1, G Block, Bandra - Kurla Complex Bandra (E), MUMBAI - 400 051. **Scrip Code : HEG**

Sub: Update - Credit Rating

Dear Sirs,

This is to inform you that India Ratings and Research (Ind-Ra) has affirmed HEG Limited's (HEG) **Long-Term Issuer Rating at 'IND AA-'**. The Outlook is Stable. A detailed rationale is attached herewith for your reference.

Kindly take the same on record.

Thanking you,

Yours faithfully,
For **HEG Limited**

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Encl : as above.

India Ratings & Research
A Fitch Group Company

India Ratings Affirms HEG at 'IND AA-'/Stable

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JUL 2021

By Siddharth Rego

India Ratings and Research (Ind-Ra) has affirmed HEG Limited's Long-Term Issuer Rating at 'IND AA-'. The Outlook is Stable. The instrument-wise rating actions are as follows:

Instrument Type	Date of Issuance	Coupon Rate (%)	Maturity Date	Size of Issue (billion)	Rating/Outlook	Rating Action
Commercial paper (CP)*	-	-	30-365 days	INR1	IND A1+	Affirmed
Fund-based limits	-	-	-	INR6.5 (reduced from INR9)	IND AA-/Stable/A1+	Affirmed
Non-fund-based limits	-	-	-	INR3.25 (reduced from INR4.7)	IND AA-/Stable/A1+	Affirmed

*Carved out of working capital limits

The affirmation reflects HEG's strong finance profile, led by strong on-balance sheet liquidity resulting in it being a net cash entity. The company's business profile is strengthened by the oligopolistic nature of the industry, low-production cost advantages enjoyed by HEG on account of its single-location plant, labour cost advantages, etc. The ratings, however, are constrained by the company's limited product diversification.

The Stable Outlook reflects Ind-Ra's expectation of an improvement in demand and the resultant pick up in the prices of graphite electrode (GE) in FY22, causing a reversal in the sharp compression in the spreads between GE prices and its raw material needle coke (NC) prices as witnessed over FY20 and FY21. Further, with most of the high-cost NC being consumed and with its prices on the rise, Ind-Ra believes the inventory-valuation losses are unlikely in FY22 and would help bolster operational EBITDA and cash flows over FY22. The company is still carrying out a large capacity-increasing capex, which has the potential to lower the liquidity available on the balance sheet and the management expects the same to come onstream by FYE23. The management also expects the reduction in liquidity, on account of the capex, to get offset by higher operational EBITDA and resultant operational cash flows in FY22.

KEY RATING DRIVERS

Spreads Likely to Improve In FY22: HEG's profitability is susceptible to a fall in the GE prices, which can have an adverse impact on the company's gross margins, and result in inventory losses. However, Ind-Ra believes the strong demand-supply fundamentals and the improving price of GE will lead to improved spreads over FY22.

For FY21, the agency estimates the average market price of GE to have been around USD3,000/tonne (t; FY20: around USD6,000/t). The already-low prices were exacerbated by the COVID-19 pandemic with global steel consumption, excluding China, reducing by around 10% yoy in 2020. This contributed to a sharp fall in the spreads, which compressed to around USD1,000/t in FY21 (FY20: around USD1,400/t). The company was further impacted by its high-cost NC inventory when prices were falling. Owing to the sharp correction in prices of both GE and NC, and the long manufacturing process of four-to-five months, which entails HEG to carry higher inventory, the company took an inventory loss of INR0.15 billion on raw material, work-in-progress and finished goods in FY21 (FY20: loss of INR4.6 billion).

However, Ind-Ra expects the spreads to improve to USD2,000-2,500/t in FY22 aided by the strong demand recovery and the low base of FY21. While the overcapacity with Chinese GE players would continue to be a risk, especially for non-ultrahigh power (UHP) electrodes segment, the agency believes the risk is partially contained by various government measures and announcements. The management also expects the UHP category to remain protected from the threat of Chinese supply glut.

Strong Demand Fundamentals over FY22-FY23: The World Steel Association forecasts the global steel demand (excluding-China) to grow 9.4% and 4.8% yoy in 2021 and 2022 respectively, after the overall economic slowdown and COVID-19 related disruptions over 2019-2020. With electric arc furnace (EAF) production being used for around 47% of the total ex-China steel production, the agency expects the GE demand to be stronger over 2021-2022. The agency believes China's GE overcapacity will continue to be a risk for the company's non-UHP GE. This risk, however, the agency believes will be lower than the previous years with the Chinese government announcing the replacement of 236 million tonne inefficient capacities with EAF capacities by 2025; the removal of import duty on pig iron, crude steel and ferrous scrap to nil to promote EAF production within China. All these measures, the agency believes, could lead to a higher domestic consumption of GE within China.

For every tonne of steel produced, the EAF production emits one fourth of the total carbon emitted while using a blast furnace. Resultantly, the Chinese government has looked to limit blast furnace output by removing export rebates on steel exports and is even considering the imposition of export duties. This, the agency believes, should reduce China's disruption, with its consumption likely to grow further by 3% and 1% yoy in 2021 and 2022 as per the World Steel Association. Domestically, after witnessing weak demand over FY20 and 1HFY21, the demand for steel has significantly improved from 2HFY21. Further, there is no new entrant in the GE segment nor any capacity enhancement announced in the western markets over the last 25 years

Post Decline in FY21, Revenue and Profitability May Recover in FY22: HEG's revenue reduced significantly to INR12.56 billion in FY21 (FY20: INR21.5 billion; FY19: INR65.9 billion) due to the pandemic, weaker demand fundamentals and inventory losses. This resulted in the compression of spreads ultimately resulting in a negative absolute EBITDA of INR0.59 billion (FY20: negative INR0.06 billion; FY19: INR46.6 billion) and EBITDA margins of negative 4.7% (negative 0.3%; positive71%).

The capacity utilisations have remained subdued over FY20 and FY21 at around 65% (FY19: 80%) leading to lower fixed-cost absorption. However, the management stated that the capacity utilisation improved to 85% in 4QFY21 due to improving demand. While the company incurred an EBITDA loss of INR47 million in 4QFY21, an expenditure of INR348.5 million was incurred towards corporate social responsibility expense; adjusting for this, the company would have reported a positive EBITDA in 4QFY21.

Ind-Ra believes HEG's profitability during FY22 could improve driven by the rise in GE and NC prices, while demand is likely to recover. This would support gross margins and help in improving profitability.

Liquidity Indicator- Adequate: HEG had healthy unrestricted cash and bank balances, investments and unencumbered fixed deposits of INR14.11 billion at FYE21 (FYE20: INR11.1 billion). Given HEG's large cash balance and lower debt of INR2.96 billion at FYE21 (FYE20: INR5.93 billion), the company had low net interest expense (gross interest expenses- interest income from investments) of negative INR0.18 billion (negative INR0.01 billion). Additionally, HEG's diversified financial investments provided other income gains of INR1.13 billion in FY21 (FY20: INR1.44 billion) aiding its liquidity. The average utilisation of the fund-based working capital limits was also low around 40% during the 12 months ended March 2021. The company takes on working capital debt in the form of export packing credit limits given the interest subvention available to the company, thus reducing its cost of borrowings. Ind-Ra expects HEG to maintain a liquid balance sheet and have a low reliance on external debt, thus maintaining a negative net debt figure going forward. Any change in the balance sheet structure, which results in the net debt turning positive without a positive change in the GE cycle, could result in a negative rating action.

Ind-Ra expects HEG's cash flow from operations to remain positive in FY22, after having improved in FY21 to INR7.4 billion (FY20: INR5.3 billion) despite a negative EBITDA, due to the release of working capital. However, Ind-Ra expects HEG to have negative free cash flow in FY22 due to the its large capex outflows of around INR6 billion. At end-FY21, HEG had inventory of INR5.81 billion (FYE20: INR10 billion; FYE19: INR13.1 billion) and receivables of INR2.89 billion (INR4 billion; INR11.9 billion).

Limited Diversification and Capex Risks: The management had previously indicated that its surplus cash flows could be potentially used to lower the inherent business volatility in the GE industry through diversification; however, the agency believes the company's ongoing capex would further increase its dependence on a single product. HEG's ongoing capex is equity-funded with a project cost of INR12 billion towards brownfield capacity expansion of 20,000 tonnes per annum over FY20-FY23. At end-FY21, HEG incurred cash outflow of INR4.46 billion towards the capex project with INR6 billion planned over FY22 and the remaining in FY23.

The company is creating a separate complex for nipple manufacturing, which will increase its overall plant capacity to 100,000t (from 80,000t). Ind-Ra believes the project execution risks to be limited because of the debt-free capex funding and five-decade-long experience of the company's management in the existing business. However, there could be temporary delays with every COVID-19 wave. The agency expects the capex stabilisation risks to increase in case of any prolonged demand sluggishness in the GE market, although the current demand scenario is currently bullish. A weak demand environment and low utilisations of the GE industry upon the completion of capex and the ability of the company to tie up raw material and achieve healthy utilisation levels would remain a key monitorable.

Industry Risks: HEG is exposed to cyclicality in the steel business, as well as to risks arising from the volatility in the costs of raw materials, mostly crude/coal derivatives. HEG has a single-manufacturing unit and its cash flows are dependent on single product revenue. However, it is well diversified in terms of markets and customers across geographies, which mitigates this risk to some extent.

RATING SENSITIVITIES

Positive: Business diversification leading to stable operational cash flows, safeguarding high volatility in GE business could be positive for ratings. The sustenance of a healthy balance sheet supported by timely recovery of healthy EBITDA margins would remain prerequisite for any positive rating actions.

Negative: Concerns on weak profitability turning severe or remaining prolonged would reflect weaker-than-Ind-Ra-expected business risk profile for HEG and could lead to a negative rating action. Moreover, HEG's net debt position turning positive, led by another debt-funded capex; acquisition; exceptional operating losses, or otherwise would result in a negative rating action.

COMPANY PROFILE

Formed in 1977, HEG is a promoted by LNJ Bhilwara Group. It manufactures graphite electrodes at its 80,000tpa facility in Madhya Pradesh.

FINANCIAL SUMMARY

Particulars (INR billion)	FY21	FY20
Revenue	12.56	21.49
EBITDA	-0.59	-0.06
EBITDA margin (%)	-4.71	-0.27
Net cash	11.14	5.09
Gross interest coverage (x)	-NA	-NA
Source: HEG, Ind-Ra		

RATING HISTORY

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook		
	Rating Type	Rated Limits (billion)	Rating	14 July 2020	24 June 2019	20 April 2018
Issuer rating	Long-term	-	IND AA-/Stable	IND AA-/Stable	IND AA/Stable	IND AA/Stable
CP	Short-term	INR1	IND A1+	IND A1+	IND A1+	IND A1+
Fund-based limits	Long-term /Short-term	INR6.5	IND AA-/Stable/ IND A1+	IND AA-/Stable/ IND A1+	IND AA/Stable/ IND A1+	IND AA/Stable/ IND A1+
Non-fund-based limits	Long-term /Short-term	INR3.25	IND AA-/Stable/ IND A1+	IND AA-/Stable/ IND A1+	IND AA/Stable/ IND A1+	IND AA/Stable/ IND A1+

COMPLEXITY LEVEL OF INSTRUMENTS

Instrument type	Complexity Indicator
CP	Low
Fund-based working capital limits	Low
Non-fund-based working capital limits	Low

For details on the complexity level of the instrument, please visit https://www.indiaratings.co.in/complexity-indicators.

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Applicable Criteria

Corporate Rating Methodology
Short-Term Ratings Criteria for Non-Financial Corporates

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