HEG/SECTT/2023 11th July, 2023

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: India Ratings Revises HEG's Outlook to Positive; Affirms 'IND AA-'

Dear Sirs,

This is to inform you that India Ratings and Research (Ind-Ra) has revised HEG Limited's (HEG) outlook to Positive from Stable while affirming the **Long-Term Issuer Rating at 'IND AA-'**. A detailed rationale is attached herewith for your reference.

Kindly take the same on record.

Thanking you,

Yours faithfully,
For **HEG Limited**

VIVEK CHAUDHARY Digitally signed by VIVEK CHAUDHARY Date: 2023.07.11 18:48:29 +05'30'

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India Ratings Revises HEG's Outlook to Positive; Affirms 'IND AA-'

Jul 11, 2023 | Electrodes & Refractories

India Ratings and Research (Ind-Ra) has revised HEG Limited's Outlook to Positive from Stable while affirming the Long-Term Issuer Rating at 'IND AA-'. 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	-	-	-	INR9.5	IND AA-/Positive/IND A1+	Affirmed; Outlook revised to Positive from Stable
Non-fund-based limits	-	-	-	INR5.35	IND AA-/Positive/IND A1+	Affirmed; to Positive from Stable

*Carved out of working capital limits

The Positive Outlook reflects HEG's strong operating and financial performance in FY23 and expanding scale of operations, with near-term commercialisation of an additional 20,000t graphite electrodes (GE) capacity, taking the total capacity to 100,000t. HEG sustained its net cash status in FY23, despite the large capex of around INR10 billion.

Moreover, Ind-Ra expects HEG to maintain strong financial flexibility in FY24 in view of the absence of any long-term capex amid large free cash balances and a net cash position. While there only could be a marginal improvement in volumes along with some moderation in the revenue and margins due to a slight correction in GE prices and a weak global steel production outlook in FY24, HEG is likely to have an edge over peers. This is in view of its expanded capacity, along with lower operating costs than that for its peers in developed markets, with which it can cater to expanding electric arc furnace (EAF) steel capacities over the medium term.

Key Rating Drivers

Revenue and Profitability Growth Likely to Remain Healthy with Slight Correction: HEG's revenue improved around 12% yoy to INR24.67 billion in FY23 (FY22: INR22.02 billion; FY21: INR12.56 billion), due to strong price realisations. Consequently, its absolute EBITDA increased to INR6.20 billion in FY23 (FY22: INR5.3 billion; FY21: negative INR0.59 billion) and EBITDA margins to 25.12% (23.9%; negative 4.7%). The capacity utilisation remained at 89% in FY23 (FY22: 90%) after being subdued at around 65% over FY20-FY21, led to better fixed-cost absorption.

Ind-Ra believes HEG's profitability could decline during FY24 while remaining at a healthy level, driven by the sustenance of high GE and needle coke prices with some correction, while GE demand would be slightly impacted due to a lower steel demand because of the weak global economic outlook, elevated inflation pressures and high input costs. However, the evident focus on substantial decarbonisation measures in the developed world indicates that the growth of EAF will surpass that of blast furnace/basic oxygen furnace.

Strong Medium to Long-term Demand Fundamentals: With EAF production being used for around 49% of the total ex-China steel production, Ind-Ra expects GE demand to become stable over FY25. China's steel production through EAF is around 11% and is likely to increase to 15% by 2025 and 20% by 2030 for decarbonisation. Also, America and Europe's focus on decarbonisation would accelerate GE demand. Hence, global steel industry's efforts to decarbonise will drive a continuous shift to EAF steelmaking which supports the long-term GE demand growth.

Ind-Ra believes China's GE overcapacity will continue to be a risk for the company's non-ultrahigh power (UHP) GE. This risk, however, will be alleviated with the Chinese government announcing the replacement of 236MnT inefficient capacities with EAF capacities by 2025 which could lead to a higher domestic consumption of GE. For every tonne of steel produced, EAF production emits one fourth of the total carbon emitted while using a blast furnace. China's GE consumption is likely to grow 3%-4% yoy by 2025, as per the World Steel Association. Domestically, steel demand has been healthy in 2022 and is expected to remain healthy for 2023. Furthermore, there is neither any new entrant in the GE segment nor any capacity enhancement announced in the western markets over the past 25 years.

Spreads Likely to Remain Healthy in FY24: HEG's profitability is susceptible to price volatility in GE. Ind-Ra believes that while demand could face intermediary headwinds; it is likely to remain strong with some correction in FY24 and support GE prices. Accordingly, the spreads are likely to sustain at near-similar levels over FY24. The gross margin in FY23 stood at 63% (FY22: 62%; FY21: 36%). Ind-Ra believes that any sharp correction in GE prices would be a key monitorable which can lead to significant inventory losses.

The global steel output started to moderate in FY23 due to the escalation of the Russia-Ukraine crisis and would remain so in FY24 due to the prevailing war, weak global economic outlook, elevated inflation pressures and high input costs. World Steel Association expects the global crude steel output to increase 2.3% yoy and by 2.6% yoy ex-China in 2023 and 1.7% and 3.6% ex-China in 2024.

However, HEG's management has articulated that the capex announcements by some large steel companies in the US and Europe to increase capacities by around 20MnT and 26MnT, respectively, by establishing new EAF-based steel capacities will support the medium-term demand. The management expects 24MnT of these to be on the ground between FY23 and FY26, while the balance will come up FY27-FY31. While the overcapacity with Chinese GE players will continue to be a risk, especially for non-ultrahigh power (non-UHP) electrodes segment as the country manufactures UHP electrodes in low quantities, the agency believes the risk is partially contained by various government measures and announcements. The management also expects the ultra-high power category to remain protected from the threat of the Chinese supply glut.

Liquidity Indicator - Adequate: HEG had healthy unrestricted cash and bank balances, investments and unencumbered fixed deposits of INR7.58 billion at FYE23 (FYE22: INR12.46 billion; FYE21: INR14.11 billion). Given HEG's large cash balance and low debt of INR7.41 billion at FYE23 (FYE22: INR6.63 billion; FYE21: INR2.96 billion), the company earns a net interest income. Additionally, HEG's diversified financial investments provided other income gains of INR1.09 billion in FY23 (FY22: INR0.79 billion; FY21: INR1.13 billion). The average utilisation of the fund-based working capital limits (based on lower of sanctioned limit and drawing power) was around 75% in over the 12 months ended May 2023. 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 low reliance on external debt, thus maintaining a negative net debt figure over the near-to-medium term. 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.

HEG's cash flow from operations turned positive at INR1.37 billion in FY23 (FY22: negative INR1.22 billion; FY21: INR7.4 billion), due to the higher operating profits. Ind-Ra expects HEG's free cash flow to remain negative in FY24 due to the its large capex outflows of around INR2 billion. At FYE23, HEG had an inventory of INR14.4 billion (FY22: INR9.78 billion; FY21: INR5.81 billion) and receivables of INR4.89 billion (INR5.89 billion; INR2.89 billion).

Limited Diversification and Capex Risks: The management had previously indicated that its surplus cash flows could be used to lower the inherent business volatility in the GE industry through diversification; however, the agency believes the company's ongoing capex of INR12 billion towards a brownfield capacity expansion of 20,000 tonnes per annum and a separate complex for nipple manufacturing would further increase its dependence on a single product. The capex is spread over FY20-FY24. The company has already incurred around INR10 billion till FY23 and expects to incur the balance in FY24. The additional new capacity is likely to be operational in 2QFY24 and 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. The agency however expects the capex stabilisation risks to increase in case of any prolonged demand sluggishness in the GE market, although the demand scenario seems bullish for the medium term-long term. A weak global demand environment and low utilisation 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 remain key monitorables.

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. Moreover, the company 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: Successful ramp-up of new capacities resulting in better fixed cost absorption, strong sector fundamentals leading to a reduction in the margin volatility, and sustenance of a strong liquidity position and net cash position would lead to a positive rating action.

Negative: All or any of the factors below may result in a negative rating action :-
- a delay in the ramping-up of new capacities and weak sector fundamental leading to a sustained fall in the operating profitability;
- debt-funded capex, acquisition and exceptional operating losses, substantially depleting the balance sheet liquidity; and
- net cash position turning into a net debt position.

ESG Issues

ESG Factors Minimally Relevant to Rating: Unless otherwise disclosed in this section, the ESG issues are credit neutral or have only a minimal credit impact on HEG, due to either their nature or the way in which they are being managed by the entity. For more information on Ind-Ra's ESG Relevance Disclosures, please click here. For answers to frequently asked questions regarding ESG Relevance Disclosures and their impact on ratings, please click here.

Company Profile

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

FINANCIAL SUMMARY

Particulars	FY23	FY22
Revenue (INR million)	24,672	22,016
Operating EBITDA (INR million)	6,197	5,272
EBITDA margin (%)	25.12	23.95
Source: Ind-Ra, HEG		

Non-Cooperation with previous rating agency

Not applicable

Solicitation Disclosures

Additional information is available at www.indiaratings.co.in. The ratings above were solicited by, or on behalf of, the issuer, and therefore, India Ratings has been compensated for the provision of the ratings.

Ratings are not a recommendation or suggestion, directly or indirectly, to you or any other person, to buy, sell, make or hold any investment, loan or security or to undertake any investment strategy with respect to any investment, loan or security or any issuer.

Rating History

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook		
	Rating Type	Rated Limits (billion)	Rating	12 July 2022	13 July 2021	14 July 2020
Issuer rating	Long-term	-	IND AA-/Positive	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	INR9.5	IND AA-/Positive/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	INR5.35	IND AA-/Positive/IND A1+	IND AA-/Stable/IND A1+	IND AA-/Stable/IND A1+	IND AA-/Stable/IND A1+

Bank wise Facilities Details

Click here to see the details

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

Evaluating Corporate Governance

The Rating Process

Short-Term Ratings Criteria for Non-Financial Corporates

Corporate Rating Methodology

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