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HEG/SECTT/2020 14th July, 2020

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 downgraded HEG Limited's (HEG) **Long-Term Issuer Rating to 'IND AA-' from '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 Downgrades HEG to 'IND AA-'/Stable

14
JUL 2020

By Akash Krishnatry

India Ratings and Research (Ind-Ra) has downgraded HEG Limited's (HEG) Long-Term Issuer Rating to 'IND AA-' from '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*	-	-	30-365 days	INR1	IND A1+	Affirmed
Fund-based working capital limits	-	-	-	INR9 (reduced from INR12)	IND AA-/Stable/IND A1+	Long-term rating downgraded and short-term rating affirmed
Non-fund-based limits	-	-	-	INR4.7 (reduced from INR9.2)	IND AA-/Stable/IND A1+	Long-term rating downgraded and short-term rating affirmed

*carved out of working capital limits.

The downgrade reflects a significant fall in the price of graphite electrode (GE) over 2HFY20 resulting in a sharp compression in the spreads between GE prices and its raw material needle coke (NC) prices, coupled with a significant inventory valuation hit, which resulted in a significantly lower-than-Ind-Ra-expected EBITDA. The rating downgrade also factors in the limited diversification achieved by the company to mitigate EBITDA volatility risks. The strong cash flows generated over FY18-FY20 have been used towards shareholder dividends and equity share buyback in line with HEG's historical dividend payout ratio of 30%-35%. Moreover, the company has embarked on a significantly large capex to increase the capacity that has the potential to lower the liquidity available on the balance sheet and the management expects the same to come on-stream by FY23.

The Stable Outlook reflects the favourable industry structure, healthy on balance sheet liquidity, and the low production cost advantages enjoyed by HEG on account of its single-location plant, labour cost advantages and moderate electricity tariffs.

KEY RATING DRIVERS

Sharp Correction in Spreads: The market price of GE has plunged to around USD4,500/tonne as of March 2020 (March 2019: USD14,000/tonne) and this sharp fall has resulted in spreads compression to about USD3,000/tonne (USD10,000 USD/tonne) partially offset by decline in market needle coke (NC) prices to USD1,500/tonne(USD4,000/tonne). Owing to this 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 INR4.6 billion on raw material, work in progress and finished goods in FY20.

Ind-Ra believes any further fall in the prices of GE can have an adverse impact on the company's gross margins, resulting in additional inventory losses. The agency believes the situation of plummeting prices has been exacerbated by the ongoing COVID-19 pandemic as the global steel production, excluding China, is likely to be reduced by 10%-15% yoy. Given this backdrop of lower demand, the agency does not expect a significant jump in the GE prices in the medium term. Moreover, Ind-Ra believes an overcapacity with Chinese GE players could also result in further pressure on GE prices especially in the non-ultrahigh power (UHP) electrodes segment. The management expects the UHP category to remain protected from the threat of Chinese supply glut.

Favourable Supply-Side Dynamics Continue; Demand Recovery Gradual: Despite the ongoing headwinds, Ind-Ra expects the global supply of UHP GE to remain favourable as UHP capacity is likely to decline to 700,000 tonne per annum (tpa) in 2020 (2018: 750,000tpa; 2014: 810,000tpa) due to capacity closures in Europe. The agency expects no new capacity to come on-stream in the next three years except HEG's 20,000 tpa expansion by 2HFY23.

The capacity closures have been a function of unviable plant sizes, operations in high-labour cost geographies, unfavourable location of the plants within city premises and the sharp fall in GE prices, which render the plants uncompetitive. Ind-Ra believes HEG and other producers with no backward integration for NC could face transient loss of market share amidst low GE demand as US-based producer Graftech International's (GI) volumes are protected by long-term take-or-pay contracts while the total GE demand has reduced in the market. Given, the present dip in demand, Ind-Ra expects capacity utilisation of GE producers, except Graftech International, to moderate to 45% in FY21 (FY20: 65%), thus making smaller capacities unviable. The agency believes global UHP GE market is not severely impacted by any supply glut of the Chinese GE, but non-UHP GE market could remain impacted over FY21-FY22.

Moreover, the agency expects GE demand to keep growing in the medium-to-long term, as the environmentally-safe electric arc furnace route steel production's share would gradually improve, along with the overall steel demand growth.

Fall in Revenue and Profitability: HEG's revenue reduced significantly to INR21.5 billion in FY20 (FY19: INR65.9 billion) and absolute EBITDA to negative INR0.06 billion (INR46.6 billion) and EBITDA margins to negative 0.3% (71%), driven by the sharp fall in GE prices leading to inventory losses amid weak demand dynamics. Ind-Ra believes HEG's profitability during FY21 would remain contingent on the prices of GE and needle coke. Ind-Ra's expects subdued GE prices in FY21-FY22 owing to the demand-supply scenario.

Ind-Ra expects HEG's EBITDA margins to recover 2HFY21 onwards as the softer raw material prices could effectively support the gross margins with a lag of three-to-six months. Further, the agency believes the company's capacity utilisation may remain subdued at 50% in FY21 (FY20: 65%), resulting in higher fixed costs per tonne. In a declining price scenario, customers tend to enter into short-term contracts than the six-12 months contracts they had entered into FY18 and FY19, thereby providing lower revenue visibility. Thus Ind-Ra believes, low production volume leading to higher fixed costs/tonne and inventory price risks would remain the key risks in FY21. HEG is looking to reduce fixed costs and other overheads.

Liquidity Indicator- Adequate: HEG had healthy unrestricted cash and bank balances and liquid investments of INR11.1 billion at FYE20 (FYE19: INR11.1 billion, FYE18: INR0.05 billion). Given the large cash balances and debt of INR5.93 billion at FYE20 (FYE19: INR6.66 billion), HEG has low net interest expense (gross interest expenses- interest income from investments) of INR0.01 billion (negative INR0.32 billion). Additionally, HEG's diversified financial investments have provided income gains of INR0.73 billion in FY20 (FY19: INR0.52 billion) aiding its liquidity. The average utilisation of the fund-based working capital limits was also low around 50% during the 12 months ended May 2020. The company takes on working capital debt in the form of export packing credit limits given the interest subvention available to the company, thus lowering the 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 to have positive free cash flow in FY21 despite the capex outflows on the likely reduction in inventory and receivables. A similar trend was also seen in FY20, wherein despite an EBITDA loss, HEG reported cash flow from operations of INR8.3 billion owing to significant release in receivables and inventory of INR8.2 billion and INR3 billion, respectively. As of March 2020, HEG had inventory of INR10 billion (FY19:INR13.1 billion) and receivables of INR4 billion (INR11.9billion).

Limited Diversification and Capex risks: The management had earlier indicated 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 and plant HEG is undertaking an equity-funded capex project of INR12 billion towards brownfield capacity expansion of 20,000 tpa over FY20-FY23. As of March 2020, HEG had cash outflow of INR2.4 billion on the capex project while the balance is planned over FY21-FY23.

The company is creating a separate complex for nipple manufacturing, which would free up the existing capacity by nearly 10,000 tonne and HEG will also be adding GE capacity of nearly 10,000 tonne, thus increasing the total capacity by 20,000 tonne. 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 expects the capex stabilisation risks to increase in case of prolonged demand sluggishness in the GE market. Given the weak demand environment and low utilisations of GE industry, the ability of the company to tie up 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-expected business risk profile for HEG and could lead to a negative rating action. Moreover, HEG's net debt position turning positive, led by 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	FY20	FY19
Revenue (INR billion)	21.5	65.9
Operating EBITDA (INR billion)	-0.06	46.6
Operating EBITDA less exceptional inventory Loss (INR billion)	4.5	46.6
EBITDA margin (%)	-0.3	70.7

Net cash* (INR billion)	5.2	4.4
Gross interest coverage (x)	-NA	259.0
Source: Ind-Ra, HEG *Company is net cash positive		

RATING HISTORY

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook		
	Rating Type	Rated Limits (billion)	Rating	24 June 2019	20 April 2018	11 December 2017
Issuer rating	Long-term	-	IND AA-/Stable	IND AA/Stable	IND AA/Stable	IND A+/Positive
Fund-based limits	Long-term/Short-term	INR9.0	IND AA-/Stable/IND A1+	IND AA/Stable/IND A1+	IND AA/Stable/IND A1+	IND A+/Positive/IND A1+
Non-fund-based limits	Long-term/Short-term	INR4.7	IND AA-/Stable/IND A1+	IND AA/Stable/IND A1+	IND AA/Stable/IND A1+	IND A+/Positive/IND A1+
Commercial paper	Short-term	INR1	IND A1+	IND A1+	IND A1+	IND A1+

COMPLEXITY LEVEL OF INSTRUMENTS

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

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Ind-Ra currently maintains coverage of corporate issuers, financial institutions (including banks and insurance companies), finance and leasing companies, managed funds, urban local bodies and project finance companies.

Headquartered in Mumbai, Ind-Ra has seven branch offices located in Ahmedabad, Bengaluru, Chennai, Delhi, Hyderabad, Kolkata and Pune. Ind-Ra is recognised by the Securities and Exchange Board of India, the Reserve Bank of India and National Housing Bank.

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For more information, visit www.indiaratings.co.in.

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Applicable Criteria

Corporate Rating Methodology

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