# Rating Rationale for Hindustan Organic Chemicals Ltd's proposed Issue of Bond XVIII of INR 100 Crore

| Bond Issue Rating: BWR AAA (SO) | Outlook : Stable |
| --- | --- |

Brickwork Ratings (BWR) has assigned BWR AAA (SO) [Pronounced BWR Triple A (Structured obligation)] Rating for **Hindustan Organic Chemicals Ltd's (HOCL)** proposed issue of Bond XVIII of Rs.100 crore. 'BWR AAA (SO)' stands for an instrument that is considered to offer Best credit quality / safety in terms of timely servicing of principal and interest obligations. The rating factors, inter alia, HOCL's performance, unconditional and irrevocable guarantee from Government of India, and the escrow mechanism for servicing the proposed bond issue.

**Background**

HOCL was established in the year 1960, by Govt. of India with the objective of attaining self-reliance in basic organic chemical needs. HOCL manufactures basic organic chemicals and intermediates for dyes, rubber chemicals, pesticides, resins, laminates, paints, drugs and pharmaceuticals, etc.

HOCL has two manufacturing units; at Rasayani in Maharashtra & at Kochi in Kerala. HOCL primarily manufactures Phenol, Acetone and Hydrogen peroxide, Nitrobenzene, Aniline, Nitrotoluenes, Formaldehyde, Sulphuric Acid and Concentrated Nitric Acid.

HOCL's subsidiary Hindustan Fluorocarbons Limited (HFL) manufactures polytetrafluoroethylene (PTFE) and Hydro chlorofluorocarbon – 22. HFL has its manufacturing unit at Rudraram in Andhra Pradesh.

Being a Government of India undertaking, HOCL's Board of Directors are appointed by the GoI and its management has rich industry experience.

**Structured Payment Mechanism**

HOCL will put in place an escrow mechanism to ensure timely repayment of principle and interest on the due date. The proposed bond issue with tenor of up to 2 years is backed by an unconditional and irrevocable guarantee by Government of India for timely repayment of principle and interest. The Ministry of Chemicals and Fertilisers, Department of Chemicals &

Petrochemicals has extended a guarantee for the proposed bond issue and is valid till August 2012 in terms of letter dated February 1, 2010.

Details of the Structured Payment Mechanism are stated below

| Trigger Date | Payment mechanism |
|---|---|
| | HOCL will open a Trust and Retention Account (TRA) with HDFC bank and Trustee being Bank of Maharashtra |
| T-15 | HOCL will fund the TRA with requisite funds. In the event of there being a shortfall, the trustees would serve a notice to HOCL and GoI to bridge the shortfall |
| T-8 | In event of TRA not being funded, Trustees will invoke GoI guarantee |
| T-7 | GoI will pay the shortfall amount in TRA to ensure timely payment on due date |

*Note: T is due date*

BWR has taken cognizance of the declaration provided by the company to adhere to the above structured payment mechanism for repayment of the proposed issue.

**Business**

HOCL has over four decades on experience in the organic chemicals business. The company was set up to meet India's organic chemicals requirements during the licensed era. Over the period HOCL has established a wide distribution network and a strong customer base.

HOCL has two manufacturing units; at Rasayani in Maharashtra & at Kochi in Kerala. The Rasayani unit was commissioned in 1970 and Kochi Unit was commissioned in 1988. The main products manufactured at Kochi are Phenol, Acetone and Hydrogen peroxide while Nitrobenzene, Aniline, Nitrotoluenes, Formaldehyde, Sulphuric Acid and Concentrated Nitric Acid are manufactured at Rasayani.

The Rasayani plant is loss making and its caustic soda unit has been closed down on account of its unviability due to high power costs. However HOCL can start the plant and operate it within 4- 5 days if the market turns favourable. Further HOCL is in the process of setting up a 16MW captive power plant at Rasayani (expected to go on stream in 2 years) to manage its power requirements. The Kochi plant is profitable with phenol, acetone etc earning good margins in a strong market.

**Foray into Trading Business**

Besides manufacturing, HOCL plans to trade in organic chemicals products viz aniline, caustic soda, nitrotoluene, phenol, acetone, other chemicals like MDI (Methylene diphenyl diisocyanate) and TDI (Toluene diisocyanate) and a few select raw materials like benzene.

Consumption levels of organic chemicals in India are higher than the domestic production capacity. Further, continued rise in annual consumptions gives HOCL a good opportunity to improve turnover through trading. HOCL's proposed foray into trading of organic chemicals is expected to grow its topline.

**Fluctuating prices of key raw materials and end products along with threat of low cost imports**

Phenol, Acetone and Aniline prices have been fluctuating over the last 1 – 2 years. In December 2008 with fall in international prices of phenol and acetone due to global recession coupled with dumping of these products in the domestic market by international players, HOCL's realizations took a dip. Prices have started to look up since December 2009. In April 2010, GoI imposed anti dumping duties on Phenol and Acetone to protect the domestic manufacturers.

Key raw materials for HOCL are Benzene, Toluene, LPG, Methanol, Naphtha and Sulphur, majority of which are sourced from petroleum refineries. Benzene accounts for ~60% of total raw material cost. Natural gas and crude oil or their derivatives are used for feedstock requirements. This makes the industry vulnerable to fluctuations in oil and gas prices.

**Financial Performance**

HOCL's financial profile stands weak with accumulated losses of Rs.338 crore as on March 31, 2010. Equity capital and reserves stood at Rs. 67 crore and Rs. 65 crore respectively and preference capital at Rs. 270 crore as at year ended March 31, 2010.

In 2006, the GoI approved a financial restructuring scheme for HOCL. GoI infused Rs. 270 crore through 8% preference share capital (redeemable in 4 equal installments from FY2010).

Considering the present economic conditions and its financial position, the company has approached GoI with a proposal for postponement of the redemption by 5 years or conversion into equity. Further, HOCL is presently not servicing outstanding GoI debt as on March 31, 2010 (inclusive of overdue interest) aggregating to Rs. 80 crore and has proposed to GoI to convert the debt into equity.

Decline in revenues is primarily on account of fall in volumes and poor price realizations further accentuated by global recession adding pressure on HOCL's margins.

**Key Financials:**

**Rs. Crore**

| Year ending March 31, | 2010 | 2009 | 2008 |
|---|---|---|---|
| Net Sales | 479 | 547 | 571 |
| EBITDA | (52) | (32) | 40 |
| PAT | (83) | (25) | 14 |
| Tangible Networth | (206) | (123) | (98) |
| Tangible Networth (inclusive of preference share capital)* | 64 | 147 | 172 |
| Total Debt# | 524 | 501 | 452 |
| Total Debt (excluding preference share capital)* | 254 | 231 | 182 |
| Equity Capital | 67 | 67 | 67 |
| Total Debt/Tangible Networth (x) | (2.60) | (4.18) | (4.73) |
| Interest Coverage (x) | (2.24) | (1.44) | 2.13 |
| Debt-Service coverage ratio (x) | (0.19) | 0.13 | 0.82 |
| Operating Margins (EBITDA/ Op Income) (%) | (10.86) | (5.83) | 7.00 |
| Profitability Margins (PAT/Op Income) (%) | (17.35) | (4.62) | 2.38 |
| Return on capital employed (%) | (18.07) | (0.71) | 9.01 |
| Net cash accruals to total debt (x) | (0.11) | 0.00 | 0.09 |
| Current ratio (x) | 0.78 | 0.92 | 0.94 |

*Note:*

*# includes 8% preference share capital of Rs. 270 crore.*

** 8% preference share capital of Rs. 270 crore issued to GoI was redeemable in 4 equal installments from FY2010 onwards. HOCL has approached GoI with a proposal for postponement of the redemption by five years or conversion to equity.*

With introduction of anti-dumping duties in April 2010 by GoI and improvement in realizations, HOCL has registered improvement in performance in its first quarter results of FY 11 as compared to Q1 FY 10. (Refer Table below)

| | **Q1 FY2011** | | **Q1 FY2010** | |
|---|---|---|---|---|
| | **Rs. Crs** | **%** | **Rs. Crs** | **%** |
| Net Sales | 148.5 | 100 | 81.3 | 100 |
| OPBDIT | 11.4 | 7.7 | (19.8) | (24.3) |
| PAT | 1.6 | 1.1 | (30.0) | (36.9) |
| NCA | 8.2 | | (23.3) | |
| Interest Coverage | 2.5 | | (2.9) | |

**Industry**

The chemical industry is fairly unorganized, diverse and heterogeneous comprising several sectors that are largely unrelated to one another. The key segments that make up the industry are Petrochemicals, Chlor- Alkali & Inorganic chemicals, Organic chemicals, Paints and dyes, Fine and specialties, Pesticides and Agrochemicals. Chemical Industry contributes ~ 3% of India's GDP. Chemical compounds that contain carbon atoms are called organic chemicals. Organic chemicals segment constitutes ~ 15% of the chemical industry and thereby forming the second largest segment in the industry. The segment covers the largest number of products classified under it viz. Acetic acid, phenol, methanol, formaldehyde, nitrobenzene, citric acid, etc which are mostly used in drugs, pesticides, etc. Primary export markets for Indian organic chemicals include Germany, Indonesia, China, USA.

The organic chemical industry is prone to risks of high prices of the basic feed stock, volatility in the prices of raw materials as well as the outputs of the industry, high overhead cost and dumping of chemical products by competitors abroad at a price lower than the domestic prices. In order to safeguard the Indian industry from dumping and as part of reforms to enable the sector to meet global competition, Government is making active follow ups and has levied import duties and anti dumping duties on various chemical imports over a period of time.

**Outlook**

Chemical industry being one of the oldest industries in India has a good growth potential. The key success factors for the Indian chemical industry would depend on improvement of research capabilities, use of advanced technology, development of domestic capacity and conformation to international quality standards. The imposition of anti dumping duty on import of chemical products is expected to support domestic demand.

Hindustan Organic Chemicals Ltd has four decades of experience in the industry and a strong network of established marketing and distribution facilities. The improvement in the HOCL's profit margin is dependent on its ability to cope with the vast fluctuating prices of raw materials and end products. HOCL's initiatives such as foray into trading business of chemical products and turning around of its Rasayani is expected to help the company to improve its financial position.


| Analysts | Media |
|---|---|
| **Anusha Subramaniam**<br>anusha.s@brickworkratings.com<br><br>**Ashwini T R**<br>ashwini.t@brickworkratings.com | **Anitha G**<br>media@brickworkratings.com<br>**Relationship Contact**<br>**K N Suvarna**<br>**Senior VP – Business Development**<br>kn.suvarna@brickworkratings.com |
| **Phone: 1-860-425-2742** | |




Brickwork Ratings (BWR) has adopted SEBI's standardized Rating Symbols and their definition advised vide SEBI circular CIR/MIRSD/4/2011 dated June 15,2011, with effect from June 21, 2011. While there is no change in the Rating symbol as a consequence to the above, for the amended definition of the Rating, please refer to http://www.brickworkratings.com/scale.html. It is clarified that the said change in the definition should not be construed as a change in the Rating.