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HEG/SECTT/2016

7th June, 2016

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: Clarification on revised credit Rating of HEG Limited by India Ratings & Research (Ind-Ra).

Dear Sir/Madam,

This is further to our earlier letter dated 23rd May, 2016 regarding intimation of revised Credit Rating of HEG Limited by India Ratings & Research (Ind-Ra).

As desired, please find enclosed the press release by India Ratings & Research mentioning the reasons of such revision in ratings. The same is also appearing on the website of India Ratings & Research.

Kindly take the same on record.

Thanking you,

Yours faithfully,
For HEG Limited

(Ashish Sabharwal)
Company Secretary



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HEG LIMITED



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Corporate Identification No.: L23109MP1972PLC008290

India Ratings Downgrades HEG to 'IND A'/ Stable and its CP to 'IND A1'

Home · Press Releases · India Ratings Downgrades HEG to 'IND A'/ Stable and its CP to 'IND A1'

India Ratings & Research

A Fitch Group Company

India Ratings Downgrades HEG to 'IND A'/ Stable and its CP to 'IND A1'

23 May 2016

By Vivek Jain

India Ratings and Research (Ind-Ra) has downgraded HEG Limited's Long-Term Issuer Rating to 'IND A' from 'IND A+'. The Outlook is Stable. The agency has also downgraded HEG's INR2,300m commercial paper (CP) to 'IND A1' from 'IND A1+'. A full list of rating actions is at the end of this commentary.

KEY RATING DRIVERS

Leverage Remains High: The rating downgrade reflects Ind-Ra's expectation that HEG's net leverage would have remained above 5x in FY16 (FY15: 5.2x). Though the net leverage may decline marginally in FY17 due to scheduled debt repayments of INR1.06bn, it would still be higher than the category medians because the company has tied up additional funds of INR700m to augment its long-term working capital requirements. The improvement in leverage would also be aided by an improvement in EBITDA because of the cost saving initiatives being taken up by the company.

Capacity Utilisation Declines: HEG's capacity utilisation declined continuously to reach 58% during 9MFY16 from the highs of 81% in FY11. This has been a result of a decline in the industry share of steel manufactured through the electric-arc-furnace (EAF) route with EAF's global share in steel making falling to 25% in 2015 from 30% in 2011. Ind-Ra expects the EAF share to remain at 24%-25% in 2016 and HEG's capacity utilisation to remain muted in FY17 at 50%-55%. The price differential between iron ore and scrap, the key raw materials used in manufacturing through blast furnace and EAF route respectively, has increased with iron ore having fallen higher than scrap thus making blast furnace more economical than the EAF route. Given HEG's low capacity utilisation, HEG does not plan to increase further capacity in the medium term.

Revenue Decline: HEG's revenue declined to INR12.4bn in FY15 (FY14: INR14.67bn) from INR16.2bn in FY13. Ind-Ra expects the revenue to have fallen further to INR8.5bn in FY16. The fall in revenue has been because of a fall in sales volumes on muted demand and thus the fall in realisations. However, the fall in realisations has also been accompanied by a fall in key input raw material prices namely needle coke, impregnation pitch and binder pitch which has moderated the impact of the fall in revenue at the gross margin level. During FY17, the prices of key input raw materials are likely to decline further, given the muted demand for electrodes, thus providing cushion to EBITDA.

Global Capacity Shut-Downs to Aid Industry: Given the high capital intensity of the graphite electrode business, a drop in utilisation levels leads to negative operating leverage for most of the international players.

Globally, big players such as GrafTech International Limited and SGL Carbon SE have shut down capacities and/or looking at it which should lower the global demand-supply imbalance and improve the utilisation levels in the ultra-high power graphite electrodes (capacity: 800,000tpa) from the current 60% levels.

Cost Saving to Lower Costs: HEG plans to stop one of its two 33MW thermal power plants, due to its low capacity utilisation levels, thus reducing the associated maintenance and other costs. Also, power from its 13MW hydro power plant could be used for captive consumption instead of external sales. Moreover, if rainfall turns out to be sufficient, hydro power generation could be higher and since its variable cost of generation is nearly one-third of the thermal variable cost, it could result in power savings for the company. The company is also looking at internal efficiency improvements to lower cost incidence. Overall, the management expects to save INR150-INR200m in FY17 due to the said initiatives.

Forex Risk: HEG derives 60%-65% of its revenue from export markets, which exposes it to both euro and the dollar currency exchange risks. So far, the bulk of the short-term borrowings was export packing credit. However beginning FY16, HEG has started using the interest equalisation scheme (IES) extended by the government towards graphite electrodes to reduce cost, where in an interest subvention to the extent of 3% is allowed on export funding. Also, the company would continue to take plain forward covers to hedge sales in dollar and euro terms on a net basis, lowering the foreign exchange variation risk.

Long Working Capital Cycle: HEG has a long working capital cycle with debtor days of 119 in FY15 (FY14: 130). Ind-Ra expects the debtor days to have been higher at 130-150 in FY16 due to the muted demand and prevailing market conditions. Given the long manufacturing cycle and the lead time associated with procurement of imported raw materials, the inventory days remain high. During FY15, the inventory days reduced to 165 (FY14: 185). However, they are likely to have been higher in FY16 with customers deferring deliveries to suit year-end planning.

RATING SENSITIVITIES

Positive: A significant improvement in the capacity utilisation levels, EBITDA and working capital cycle leading to lowering of net financial leverage below 3.5x would be positive for the ratings.

Negative: Deterioration in the capacity utilisation levels, a further decline in EBITDA, and a stretch in the working capital cycle resulting in net leverage sustaining below 5x would be negative for the ratings.

COMPANY PROFILE

HEG, set up in 1977, is a flagship company of the LNJ Bhilwara Group. It manufactures graphite electrodes at its 80,000tpa facility in Madhya Pradesh. HEG reported revenue net income of INR364m in FY15 (FY14: INR807m) and gross debt of INR9.2bn (INR10.3bn).

HEG's ratings are as follows:

- Long-Term Issuer Rating: downgraded to 'IND A' from 'IND A+'; Outlook Stable
- INR6,550m fund-based working capital facilities (reduced from INR8,250m): downgraded to 'IND A'/Stable/'IND A1' from 'IND A+'/'Stable'/'IND A1+'
- INR2,600m non-fund-based working facilities (reduced from INR3,100m): downgraded to 'IND A'/Stable/'IND A1' from 'IND A+'/'Stable'/'IND A1+'
- INR2,371.2m long-term loans (increased from INR1,896.5m): downgraded to 'IND A'/Stable from 'IND A+'/'Stable'
- INR2,300m CP programme*: downgraded to 'IND A1' from 'IND A1+'

*CP has been carved out of the fund based facilities of the company.

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.

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