HEG/SECTT/2022 12th July, 2022

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**

Vivek

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Encl: As above

IndiaRatings
& Research
A Fitch Group Company

India Ratings Affirms HEG at 'IND AA-'/Stable; Limits Enhanced

Jul 12, 2022 | Infrastructure

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	-	-	-	INR9.5 (increased from INR6.5)	IND AA-/Stable/A1+	Affirmed
Non-fund-based limits	-	-	-	INR5.35 (increased from INR3.25)	IND AA-/Stable/A1+	Affirmed

*Carved out of working capital limits

The affirmation reflects HEG's strong operating and financial performance over FY22, resulting in a bolstered finance profile, led by strong on-balance sheet liquidity and the consequent net-cash status of the entity. The company's business profile is strengthened by the oligopolistic nature of the industry, the low production cost advantages it enjoys due to its single-location plant, labour cost advantages and so on. The ratings, however, are constrained by the company's limited product diversification, the volatility in its raw material prices and the continuance of limited bargaining power within the value chain.

Key Rating Drivers

Revenue and Profitability Likely to Remain Strong over FY23: HEG's revenue improved significantly to INR22 billion in FY22 (FY21: INR12.56 billion; FY20: INR21.5 billion; FY19: INR65.9 billion) due to strong price realisations as well as demand. Consequently, its absolute EBITDA turned positive at INR5.3 billion (FY21: negative INR0.59 billion; FY20: negative INR0.06 billion; FY19: INR46.6 billion) and EBITDA margins at 23.9% in FY22 (negative 4.7%; negative 0.3%; positive 71%). The capacity utilisation, which improved to 90% in FY22 after being subdued at around 65% over FY21 and FY20 led to better fixed-cost absorption.

Ind-Ra believes HEG's profitability during FY23 could largely sustain, driven by the high graphite electrode (GE) and needle coke (NC) prices, while the demand remains fairly sustainable with temporary blips. This will support its gross margins and help improve its profitability during the year.

Strong Demand Fundamentals over FY23: With electric arc furnace (EAF) production being used for around 47% of the total ex-China steel production, Ind-Ra expects the GE demand to remain strong over 2023. 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 236MnT inefficient capacities with EAF capacities by 2025 and 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. Thus, 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. Furthermore, there is no new entrant in the GE segment nor any capacity enhancement announced in the western markets over the last 25 years.

Spreads Likely to Sustain in FY23: HEG's profitability is susceptible to a fall in the GE prices, which can have an adverse impact on the company's gross margins. However, Ind-Ra believes that while demand could face intermediary headwinds; it is likely to still remain relatively strong in FY23 and support GE prices. Accordingly, the spreads are likely to sustaining at near-similar levels over FY23.

The global steel output has started to moderate in FY23 due to the escalation of the Russia Ukraine crisis. This, coupled with supply chain interruptions and the rising input costs, has impacted steel producers' margins despite near-record levels of steel prices. World Steel Association (WSA) expects FY23 crude steel output to increase 2.2% yoy and by 3.6% yoy ex-China. However, HEG's management has articulated that the capex announcements by some of the large steel companies in the US and Europe to increase capacities by around 20 million tonnes (MnT) and 15MnT, respectively, by establishing new electric arc furnace-based steel capacities will support demand over the medium term. The management expects 15-to-20MnT of these to be on the ground between FY23 and 2025, while the balance will be on the ground between 2025 and 2030.

While the overcapacity with Chinese GE players will 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 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 INR12.4 billion at FYE22 (FYE21: INR14.11 billion; FYE20: INR11.1 billion). Given HEG's large cash balance and low debt of INR6.63 billion at FYE22 (FYE21: INR2.96 billion; FYE20: INR5.93 billion), the company earns a net interest income. Additionally, HEG's diversified financial investments provided other income gains of INR0.79 billion in FY22 (FY21: INR1.13 billion; FY20: INR1.44 billion), aiding its liquidity. The average utilisation of the fund-based working capital limits (based on lower of sanctioned limit and drawing power) was around 60% in over the 12 months ended June

2022. 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. To align with the increasing working capital requirements due to higher capacity utilisation, HEG has further shored up its liquidity, by increasing its fund-based limits to INR9.5 billion in June 2022 (previously INR6.5 billion) and non-fund-based limits to INR5.35 billion (previously INR3.25 billion). Ind-Ra expects HEG to maintain a liquid balance sheet and have 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 negative at INR1.4 billion in FY22 from INR7.2 billion in FY21, due to its increased investment in working capital. The cash flow from operations is likely to improve due to some release of working capital over the near term. However, Ind-Ra expects HEG to have negative free cash flow in FY23 due to the its large capex outflows of around INR4 billion. At FYE22, HEG had an inventory of INR9.78 billion (FY21: INR5.81 billion; FYE20: INR10 billion; FYE19: INR13.1 billion) and receivables of INR5.89 billion (INR2.89 billion; INR4 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 FYE22, HEG incurred a cash outflow of INR8 billion towards the capex project with INR4 billion planned over 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 demand scenario is bullish now. A weak 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 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 and 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 the prerequisite for any positive rating action.

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.

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 graphite electrodes at its 80,000tpa facility in Madhya Pradesh.

FINANCIAL SUMMARY

Particulars	FY22	FY21
Revenue (INR million)	22,016	12,562
Operating EBITDA (INR million)	5,272	-593
EBITDA margin (%)	23.95	-4.71
Source: Ind-Ra, HEG		

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.

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Rating History

Instrument Type	Current Rating/Outlook			Historical Rating/Outlook		
	Rating Type	Rated Limits (billion)	Rating	13 July 2021	14 July 2020	24 June 2019
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	INR9.5	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	INR5.35	IND AA-/Stable/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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