The Pakistan Credit Rating Agency Limited

Rating Report

Ellcot Spinning Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
25-Sep-2020	A-	A2	Stable	Maintain	-
28-Sep-2019	A-	A2	Stable	Maintain	-
30-Mar-2019	A-	A2	Stable	Maintain	-
28-Dec-2018	A-	A2	Stable	Maintain	-
30-Jun-2018	A-	A2	Stable	Maintain	-
28-Dec-2017	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

Ellcot Spinning Mills Limited, incorporated in 1991 as public limited company, is a part of one of the oldest medium-sized textile group in Pakistan - Nagina Group. The ratings reflect Ellcot Spinning's improving business profile; as evidenced by slight increase in revenue and better margins. The Company largely caters to the needs of local market and it has developed a reputable clientele over the years. The Company has also planned significant BMR over the next couple of years to increase operational efficiencies. Ellcot Spinning's operations came to a halt for an entire week during the last quarter of FY20, as a result of the COVID-19 outbreak and nationwide lockdown imposed. The entire textile chain suffered due to lockdowns in Pakistan and internationally. Production resumed on 7th April, 2020; since the Government allowed export-oriented sector to recommence operations. The Company's financial risk profile is relatively strong, as displayed by healthy coverages and shortening of working capital cycle. Although reduced in 9MFY20; the significantly high leverage remains the only disconcerting factor in otherwise favorable financial risk profile. Furthermore, in order to relieve pressure on cashflows caused by the pandemic and economic slowdown, the Company availed SBP's moratorium relief and deferred principal repayments for one year. Reduction of 625bps in interest rates by SBP also provided respite in this regard. Ellcot Spinning's investment portfolio exposes the Company to market risk as exhibited by the portfolio's lackluster performance during 9MFY20; due to pandemic induced volatility in stock market. A decline in investments leading to losses, and eventually equity erosion, will have an impact on the financial profile of the Company. Going forward, the Company plans on carrying out a major BMR in the next financial year; replacing ~25,000 spindles with new ones. Moreover, the demand is beginning to improve prompting price correction by market forces, which is allowing the yarn prices to gradually recuperate; both locally and internationally. Nonetheless, the likelihood of a second wave of pandemic is also lurking around; which is a cause of concern for a few countries around the world, while some other economies have reopened. The assigned ratings derive comfort from Ellcot Spinning’s association with Nagina Group.

The ratings are dependent on the Company’s ability to increase business margins through operational efficiencies and product quality. Meanwhile, any significant deterioration of cashflows culminating in notable impact on the coverages may affect the ratings. Prudent management of investment portfolio is also critical.

Disclosure

Name of Rated Entity	Ellcot Spinning Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-20),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria | Rating Modifier(Jun-20)
Related Research	Sector Study | Spinning(Sep-19)
Rating Analysts	Adil Kaleem | adil.kaleem@pacra.com | +92-42-35869504

Profile

Legal Structure Ellcot Spinning Mills Limited (Ellcot) was incorporated in 1991 as a public limited company.

Background Ellcot is associated with Nagina Group since its inception. The group has presence in local spinning and weaving sector through Nagina Cotton and Prosperity Weaving. The Company's manufacturing facility is located in District Kasur, Punjab.

Operations The Company's current operational capacity comprises 61,698 Spindles. The total energy requirement of the Company is ~6MW which is wholly met through captive plant. Furthermore, the Company has LESCO connection as alternative source.

Ownership

Ownership Structure Ellcot is majorly (~58%) owned by Nagina Group, through group companies and sponsoring individuals. The remaining stake rests with financial institutions and general public.

Stability The considerable positions in Nagina Group are held by Ellahi Family. The Group has a structured line of succession, reflected from equal distribution of shareholding among Ellahi brothers and their family members. Meanwhile, third generation has already been in business, serving at various capacities.

Business Acumen Nagina Group is one of the oldest medium-sized textile houses in Pakistan. Operating under Ellahi's for five decades, developing credential expertise in spinning and weaving over the period of time. The Group has adequately expanded its operations despite competitive textile industry.

Financial Strength Nagina Group comprises three listed public limited companies, namely; Ellcot Spinning Mills, Prosperity Weaving Mills and Nagina Cotton Mills Limited and has six private limited companies. This portrays adequate financial strength of the Group to support the Company, if needed.

Governance

Board Structure Ellcot's board composition was increased to ten members during the period under review; out of which five members are non-executive and two member occupy executive roles, while three directors are independent. During 9MFY20, Mr. Imran Motiwala and Mrs. Faaria Rehman Salahuddin joined the board as independent director, whereas Mr. Haroon Shahzada Ellahi Shaikh was appointed as an executive director.

Members' Profile Mr. Shahzada Ellahi Shaikh – the Chairman – holds a bachelor's degree in Economics and International Relations. The board members carry vast knowledge and extensive experience on textile industry, though diversity in experiences also exists which benefits the board in efficient decision making.

Board Effectiveness Three committees: Audit, Executive and Human Resource & Remuneration, are in place to assist the board in relevant matters and ensure proper oversight. Attendance of board members remains strong and meeting minutes were formally documented. Out of total, seven directors are Nagina Group nominees (including six sponsoring family individuals). Their dominance on board along with control over key management positions poses limited challenge to the management, thus, hampers effective governance.

Financial Transparency M/s. Rahman Sarfaraz Rahim Iqbal Rafiq, Chartered Accountants are the external auditors of the Company.

Management

Organizational Structure The management team is headed by the CEO, with defined reporting line. The Company has seven functional departments and all HOD's reports directly to the CEO.

Management Team In January, 2020, Mr. Haroon Shahzada Ellahi Shaikh replaced his uncle; Mr. Shafqat Ellahi Shaikh as the CEO of Ellcot Spinning Mills Limited. Mr. Haroon Ellahi has eleven years of experience in textile sector, working in non-executive roles on the boards of other group companies.

Effectiveness The management meetings are held on daily basis with follow-up points to resolve or pro-actively address operational issues, if any, eventually ensuring smooth flow of operations. In addition to this, daily and weekly reports are generated for top management with main focus on production and liquidity position of the Company. Whereas, on monthly basis the Company's P&L is presented and discussed in the meetings.

MIS The Company has in place Oracle based Enterprise Resource Planning (ERP) system with comprehensive MIS reporting.

Control Environment The Company is compliant with multiple safety and quality assurance standard, majorly including; ISO 9001:2008, Standard 100 by OEKO-TEX, Global Organic Textile Standards (GOTS), Organic Content Standard, Organic Content Standard 100, and Organic Content Standard Blended.

Business Risk

Industry Dynamics Textile exports of the country increased by ~14% for 1MFY21 to stand at ~USD 1.3bln as compared to ~USD 1.1bln in 1MFY20. Although the demand for textile products internationally deteriorated on account of lock downs in major export destinations, the export market had under-performed in 1MFY20. Furthermore, economies around the world have been gradually reopening as businesses recommenced in the past month. Hence, the exports in 1MFY21, experienced an upward trend despite prior lockdowns. Going forward, uncertainty still prevails with regards to full resumption of businesses around the globe and a return to normality. Locally, textile sector has found comfort in relief measures introduced by State Bank of Pakistan such as, deferment of loan payments for one year, low interest rates and salary refinance scheme.

Relative Position Nagina Group has a long operating history in Pakistan and has developed prominent position in local spinning industry. Currently, the Group's spinning capacity stands at 115,446 spindles which strengthens Ellcot's market position. However, on standalone basis, Ellcot's share in local spinning industry is minimal.

Revenues Revenue grew by ~2% (9MFY20: PKR 4,863mln; 9MFY19: PKR 4,756mln) on the back of improved prices when compared with same period last year. The Company followed a sales mix dominated by local revenue, whereas exports constituted only ~17% in 9MFY20 (9MFY19: 21%). Furthermore, the Company has a diversified customer base in the local market and enjoys little concentration risk.

Margins During 9MFY20, gross margin experienced a significant improvement (9MFY20: 12.4%; 9MFY19: 9.4%) on the back higher prices. This translated in to improved operating margin (9MFY20: 8.9%; 9MFY19: 6.3%. Net margin also registered a significant improvement (9MFY20: 5.0%; 9MFY19: 1.6%) as the finance cost reduced (9MFY20: PKR 143mln; 9MFY19: PKR 219mln); resulting in increased net income (9MFY20: 242mln; 9MFY19: 76mln). The Company also has a small investment portfolio worth PKR 373mln, which includes equity investments as well as investment in mutual funds.

Sustainability The Company remained shut for a week during the lockdown, enforced by the Government on account of COVID-19. In order to combat the adversities posed by COVID19 led lockdowns; the Company availed SBP's moratorium relief and deferred principal repayments for one year. Reduction in policy rates by the State Bank will also provide crucial support to the cashflows. Furthermore, the Company forecasts the revenue to be at PKR 6,163mln at the end of FY20; which is expected to face a drop of 9%, ending up at PKR 5.746mln in FY21. The reduction is projected as an aftermath of the pandemic. The reduction is projected as an aftermath of the pandemic. Moreover, the Company is going through BMR/Expansion phase for Unit # 1, the capital expenditure is projected to be ~PKR 1.8bln. Against the BMR, Ellcot has ~PKR 894mln off-balance sheet commitments in relation to LCs and other non-funded lines open.

Financial Risk

Working Capital In 9MFY20, net working capital cycle favorably reduced to 118 days (9MFY19: 143 days) on the back of lower inventory level (9MFY20: 1,685mln; 9MFY19: PKR 2,026mln) as compared to same period last year. Furthermore, room-to-borrow at the trade level increased (9MFY20: PKR 1,224mln; 9MFY19: PKR 781mln) due to a contraction in short-term borrowing (9MFY20: PKR 1,552mln; 9MFY19: PKR 1,932mln); culminating in higher ST trade leverage adequacy (9MFY20: ~43%; 9MFY19: ~28%). Moreover, aging of receivables is normal; whereby only an insignificant amount i.e. ~PKR 3mln is due past 365 days.

Coverages The Company recorded higher free cash flows (9MFY20: PKR 588mln; 9MFY19: 463mln) on account of improved profitability; coupled with reduced finance cost (9MFY20: PKR 143mln; 9MFY19: PKR 219mln). This strengthened interest coverage (9MFY20: 4.2x; 9MFY19: 2.2x) and debt coverage (9MFY20: 1.8x; 9MFY19: 1.4x).

Capitalization Ellcot Spinning fulfills its working capital needs through a mix of internal cashflows and short term borrowing. During 9MFY20, Company's leverage decreased to 67% (9MFY19: ~72%), but remained high. The total debt stood at PKR 3,509mln (9MFY19: PKR 3,862mln); out of which, short term borrowing constituted ~44% (9MFY19: ~50%). Whereas, ~42% (9MFY19: ~8%) of the total debt was borrowed at SBP's concessionary rates.

PKR mln

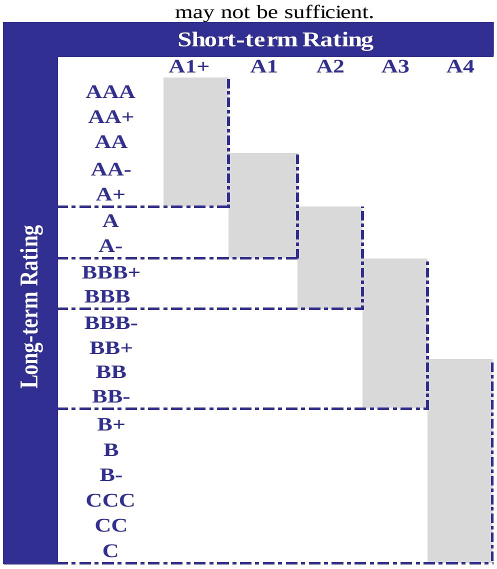
Ellcot Spinning Mills Limited	Mar-20	Jun-19	Jun-18	Jun-17
Textile	9M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	2,523	2,460	2,652	1,180
2 Investments	373	558	451	546
3 Related Party Exposure	-	-	-	-
4 Current Assets	3,101	2,575	3,140	1,628
a Inventories	*1,685*	*1,510*	*1,821*	*850*
b Trade Receivables	*574*	*548*	*741*	*390*
5 Total Assets	5,998	5,593	6,243	3,354
6 Current Liabilities	642	504	431	293
a Trade Payables	*77*	*47*	*46*	*31*
7 Borrowings	3,509	3,357	4,129	1,490
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	120	98	134	122
10 Net Assets	1,727	1,634	1,549	1,449
11 Shareholders' Equity	1,727	1,634	1,549	1,449
B INCOME STATEMENT				
1 Sales	4,863	6,347	5,563	4,869
a Cost of Good Sold	*(4,259)*	*(5,706)*	*(5,156)*	*(4,552)*
2 Gross Profit	604	641	407	317
a Operating Expenses	(171)	(207)	(175)	(144)
3 Operating Profit	433	433	231	173
a Non Operating Income	*27*	*19*	*16*	*6*
4 Profit or (Loss) before Interest and Tax	460	452	247	179
a Total Finance Cost	*(143)*	*(285)*	*(115)*	*(58)*
b Taxation	*(75)*	*37*	*(1)*	*(43)*
6 Net Income Or (Loss)	242	205	131	78
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*588*	*657*	*341*	*267*
b Net Cash from Operating Activities before Working Capital Changes	*438*	*398*	*290*	*233*
c Changes in Working Capital	*(515)*	*720*	*(1,352)*	*(234)*
1 Net Cash provided by Operating Activities	(77)	1,118	(1,062)	(1)
2 Net Cash (Used in) or Available From Investing Activities	(106)	(170)	(1,530)	(528)
3 Net Cash (Used in) or Available From Financing Activities	86	(836)	2,593	369
4 Net Cash generated or (Used) during the period	(97)	112	1	(160)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	2.2%	14.1%	14.3%	--
b Gross Profit Margin	12.4%	10.1%	7.3%	6.5%
c Net Profit Margin	5.0%	3.2%	2.3%	1.6%
d Cash Conversion Efficiency (EBITDA/Sales)	13.0%	11.4%	7.0%	6.5%
e Return on Equity (ROE)	19.2%	12.9%	8.7%	5.4%
2 Working Capital Management				
a Gross Working Capital (Average Days)	122	133	125	89
b Net Working Capital (Average Days)	118	130	122	87
c Current Ratio (Total Current Assets/Total Current Liabilities)	4.8	5.1	7.3	5.5
3 Coverages				
a EBITDA / Finance Cost	4.5	2.6	3.5	5.7
b FCFO / Finance Cost+CMLTB+Excess STB	1.8	1.3	1.6	2.1
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	3.3	5.0	8.2	2.7
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	67.0%	67.3%	72.7%	50.7%
b Short-Term Borrowings / Total Borrowings	0.4	0.4	0.5	0.6
c Average Borrowing Rate	5.4%	7.4%	3.9%	3.7%

Credit Rating

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating	
Scale	**Definition**
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating	
Scale	**Definition**
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

Entities

a) Broker Entity Rating
b) Corporate Rating
c) Financial Institution Rating
d) Holding Company Rating
e) Independent Power Producer Rating
f) Microfinance Institution Rating
g) Non-Banking Finance Companies (NBFCs) Rating

Instruments

a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating

Regulatory and Supplementary Disclosure

(Credit Rating Companies Regulations,2016)

Rating Team Statements

(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**

i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)

ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)

iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions

(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)

(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)

(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business

(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)

(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.

(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)

(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)

(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)

(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest

(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity

(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)

(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)

(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)

(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)

(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review

(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)

(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)

(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)

(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)

Probability of Default

(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)

Proprietary Information