The Pakistan Credit Rating Agency Limited

# FAZAL REHMAN FABRICS LIMITED

| | INITIAL [JAN-17] |
|---|---|
| **Entity** | |
| Long Term | BBB+ |
| Short Term | A2 |
| **Outlook** | Stable |

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JANUARY 2017

## Profile

- Fazal Rehman Fabrics Limited (Fazal Rehman) incorporated in 2004 as public unlisted company, started operations in 2007. It is engaged in manufacturing and sale of greige fabric
- Production facility is located in Multan; operates with 240 air-jet looms
- Total power requirement of 4.5MW; met through captive sources

## Ownership

- Fazal Rehman is a wholly-owned subsidiary of Ahmed Fine Textile Mills Limited. Ahmed Fine is jointly owned by Fazal Group and Hussain Group (50% each). The company is involved in the manufacturing and marketing of yarn.
- Fazal Group (flagship entity: Fazal Cloth – equity at end-Sep16: PKR 15bln), has interests in Textile, Fertilizer, Energy, and Real Estate sectors
- Hussain Group, through its flagship entity (Hussain Mills Limited), is primarily engaged in spinning and weaving business. The group has interest in ginning as well; Hussain Mills: equity at end-Jun15: PKR 4,137mln

## Governance & Management

- Seven members BoD: fFour directors represent Fazal Group (including Chairman) while three represent Hussain Group (including CEO); presence of three housewives on board weakens governance profile; lacks challenge to management decisions
- Mr. Hussain Ahmed Fazal is the CEO; however, operational control vests with Mr. Rehman Naseem (Director). He carries with him over two decades of experience in textile sector; supported by seasoned management team

## Systems & Controls

- Deployed European technology sizing and warping machines, while Japanese technology implemented for air-jet looms
- Oracle based ERP system implemented since 2008. Comprehensive MIS reports generated on daily and monthly basis
- Operational consolidation with subsidiary in near-term; operational synergies expected to flow gradually

## Business Risk

- Consistent revenue growth in past years; however, in FY16, revenues dropped by ~5% YoY on account of lower fabric prices in local and export markets
- Local and export revenues declined by 4% and 6% YoY despite surge in volumes; relatively balanced export: local sales mix. European region mainly contributed to revenues (45%); customers' concentration relatively high
- Margins improved YoY (gross: FY16: 8.4%, FY15: 7.7%, operating: FY16: 5%, FY15: 4%) due to lower input costs
- In 1QFY17, the company generated revenue amounting to PKR 1,489mln, with slightly increased margins; gross margin: 9%, operating margin: 6%. Net profitability (PKR 50mln) was further supported by falling finance costs (PKR ~20mln)
- Profitability significantly improved from same period last year (FY16: PKR 108mln, FY15: PKR 46mln) on account of lower finance cost
- Capitalizing on potential industry demand in home textile, the management is adding 96 new wider-width looms; 66 looms to be installed in first phase at an estimated cost of PKR 1.1bln with 70:30 debt-to-equity ratio (expected CoD: Jul17)
- Going forward, prudent management of expansion and related debt remains important

## Financial Risk

- Company's working capital requirements are a function of inventory and receivables, for which the company relies on mix of internal generation and short term borrowings; room for borrowing exists, while being covered by trade and net current assets
- Adequate coverages in recent periods (end-Jun16: 1.1x, end-Jun15: 1.3x). Though witnessed an improvement at end-Sep16 (1.6x), coverages are expected to remain squeezed in the near term with addition of expansion-related debt (~PKR 800mln), in light of projected cash flows
- Moderately leveraged capital structure (end-Sep16: 43%, end-Jun16: ~46%); expected to reach ~56% at end-Jun17
- Ahmed Fine has issued a cross-corporate guarantee on a short/medium-term financing facility of Fazal Rehman, enabling the former to directly provide financial support in time of need
- Overall standalone financial risk profile considered adequate, despite strong liquidity. Incremental cashflows from expansion, and parent company support remain important to keep the financial profile afloat

## RATING RATIONALE

Fazal Rehman Fabrics – a wholly owned subsidiary of Ahmed Fine Textile Mills – which, in turn, is equally owned by Fazal and Hussain Group – has been in weaving business since 2007. The company's business risk profile is characterized by sizeable revenue base, adequate profitability, and healthy return on equity. However, business concentrations are relatively high. The strength of financial profile emanates from efficient working capital management and healthy liquidity position. On standalone basis, debt service coverages are adequate. Going forward, Fazal Rehman Fabrics is eyeing to strengthen its weaving capacities; 96 air jet looms are planned to be added in two phases. First phase of expansion of 66 looms, with an estimated cost of PRK 1.1bln (debt: equity - 70:30), is expected to start commercial operations by end-Jul17. Therefore, further accumulation of debt is expected this year, adding to standalone financial risk. Nevertheless, financial support and corporate guarantee against financial obligations from parent company provides comfort.

## KEY RATING DRIVERS

The ratings are dependent on the management's ability to uphold the entity's risk profile. Meanwhile, prudent management of expansion-related debt, post-expansion cashflows, and parent company's support will be important to support the financial profile of the company.

## Fazal Rehman Fabrics Limited

| BALANCE SHEET | 30-Sep-16 | 30-Jun-16 | 30-Jun-15 | 30-Jun-14 |
|---|---|---|---|---|
| | Annual | Annual | Annual | Annual |
| **Non-Current Assets** | **1,799** | **1,772** | **1,865** | **1,728** |
| **Investments (Incl. associates)** | - | - | - | - |
| Equity | - | - | - | - |
| Mutual funds | - | - | - | |
| **Current Assets** | **1,548** | **1,468** | **1,718** | **1,818** |
| Inventory | 639 | 660 | 869 | 780 |
| Trade Receivables | 493 | 258 | 512 | 544 |
| Others | 416 | 550 | 337 | 494 |
| **Total Assets** | **3,348** | **3,240** | **3,583** | **3,546** |
| **Debt** | **1,086** | **1,168** | **1,749** | **1,785** |
| Short-term | 141 | 140 | 541 | 779 |
| Long-term (Inlc. Current Maturity of long-term debt) | 945 | 1,028 | 1,208 | 1,006 |
| Other shortterm liabilities | 693 | 554 | 425 | 447 |
| Other Longterm Liabilities | 141 | 140 | 114 | 66 |
| **Shareholder's Equity** | **1,428** | **1,378** | **1,295** | **1,249** |
| **Total Liabilities & Equity** | **3,348** | **3,240** | **3,583** | **3,546** |
| **INCOME STATEMENT** | | | | |
| **Turnover** | **1,489** | **5,604** | **5,921** | **4,513** |
| Gross Profit | 134 | 472 | 458 | 455 |
| Other Income | (5) | (11) | (7) | (15) |
| Financial Charges | (20) | (126) | (157) | (95) |
| **Net Income** | **50** | **83** | **46** | **194** |
| **Cashflow Statement** | | | | |
| Free Cashflow from Operations (FCFO) | 121 | 430 | 428 | 349 |
| Net Cash changes in Working Capital | 52 | 383 | 16 | (645) |
| Net Cash from Operating Activities | 154 | 691 | 269 | (362) |
| Net Cash from InvestingActivities | (70) | (88) | (321) | (1,207) |
| Net Cash from Financing Activities | (82) | (581) | (36) | 1,495 |
| Net Cash generated during the period | 2 | 22 | (88) | (74) |
| **Ratio Analysis** | | | | |
| **Performance** | | | | |
| Turnover Growth | N/A | -5.3% | 31.2% | 23.8% |
| Gross Margin | 9.0% | 8.4% | 7.7% | 10.1% |
| Net Margin | 3.3% | 1.5% | 0.8% | 4.3% |
| ROE | 14.1% | 5.7% | 3.6% | 20.8% |
| **Coverages** | | | | |
| Debt Service Coverage (x) (FCFO/Gross Interest+CMLTD+Uncovered STB) | 1.6 | 1.3 | 1.3 | 2.2 |
| Interest Coverage (x) (FCFO/Gross Interest) | 6.0 | 3.4 | 2.7 | 3.7 |
| Debt Payback (Total LT Debt Including UnCovered Total STBs) / (FCFO- Gross Interest) | 2.3 | 3.4 | 4.5 | 3.9 |
| **Liquidity** | | | | |
| Net Cash Cycle (Inventory Days + Receivable Days - Payable Days) | 48 | 65 | 72 | 67 |
| **Capital Structure** (Total Debt/Total Debt+Equity) | 43.2% | 45.9% | 57.5% | 58.8% |

# STANDARD RATING SCALE & DEFINITIONS

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 Ratings

| Rating | Definition |
|---|---|
| AAA | **Highest credit quality.** Lowest expectation of credit risk.<br>Indicate exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events. |
| AA+<br>AA<br>AA- | **Very high credit quality.** Very low expectation of credit risk.<br>Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events. |
| A+<br>A<br>A- | **High credit quality.** Low expectation of credit risk.<br>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+<br>BBB<br>BBB- | **Good credit quality.** Currently a low expectation of credit risk.<br>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+<br>BB<br>BB- | **Speculative.** Possibility of credit risk developing.<br>There is a possibility of credit risk developing, particularly as a result of adverse economic change over time; however, business or financial alternatives may be available to allow financial commitments to be met. |
| B+<br>B<br>B- | **Highly speculative.** Significant credit risk.<br>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<br>CC<br>C | **High default risk**. Substantial credit risk<br>"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 Ratings

**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 conditions.

**B:** The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.

**C:** An inadequate capacity to ensure timely repayment.

**Rating Watch**
Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. Rating Watch may carry designation – Positive (rating may be raised, negative (lowered), or developing (direction is unclear). A watch should be resolved with in foreseeable future, but may continue if underlying circumstances are not settled.

**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'.

**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) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, or e) the entity/issuer defaults.

## Regulatory and Supplementary Disclosure

**Name of Issuer** Fazal Rehman Fabrics Limited
**Sector** Textile
**Type of Relationship** Solicited

**Purpose of the Rating** Independent Risk Assessment

**Rating History**

| Notification Date | Long Term | Short Term | Outlook | Action |
|---|---|---|---|---|
| 26-Jan-17 | BBB+ | A2 | Stable | Initial |

**Related Criteria and Research**

Rating Methodology: Corporate Rating Methodology
Sector Research: Textile Sector Overview - 2016

**Rating Analysts**


Haider Imran
haider.imran@pacra.com
(92-42-35869504)

Rai Umar Zafar
rai.umar@pacra.com
(92-42-35869504)


Rating Team Statement

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**Prohibition**


Probability of Default (PD)

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