



The Pakistan Credit Rating Agency Limited

Rating Report

Fazal Cloth Mills Limited

Report Contents

1. Rating Analysis
2. Financial Information
3. Rating Scale
4. Regulatory and Supplementary Disclosure

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
24-Jan-2019	A-	A2	Stable	Maintain	-
24-Jul-2018	A-	A2	Stable	Maintain	-
22-Jan-2018	A-	A2	Stable	Maintain	-
29-Jun-2017	A-	A2	Stable	Maintain	-
08-Sep-2016	A-	A2	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

Fazal Cloth Mills Limited (Fazal Cloth) enjoys a strong business profile in otherwise volatile textile industry. This primarily emanates from its large size – yielding economies of scale – established relationships with a diverse customer base and diversity of operations – spinning & weaving. This has helped the entity to sustain its position despite suppressed textile dynamics in previous years. Recent withdrawal of custom duty and sale tax on cotton imports, coupled with subsidized gas rates for textile sector will help industry margins despite high cotton prices. With improved industry dynamics and focused marketing efforts, the Company has been able to capitalize on additional capacities thereby generating incremental volumes, mainly in spinning segment, eventually translating into improved margins. Volumes declined in 1QFY19, however these are expected to normalize in near future. The management is contemplating a gradual entry into value-added segment – dyeing and finishing; once implemented, it is likely to further strengthen business risk profile of the entity. Fazal Cloth's financial risk assessment encompasses irrevocable and unconditional inter-corporate debt guarantee provided to Fazal Weaving Mills Limited – a wholly owned subsidiary – with fall back on Fazal Cloth's cash flows. Nevertheless, overall financial profile is considered adequate. Although coverages are low, the company's designed financial strategy keeps sizeable cushion in short-term borrowing lines to meet shortfalls in operational cash flows in servicing debt obligations. Furthermore dividend stream from investment provides comfort to cash flows; this provides flexibility in management of financial affairs.

The ratings are dependent on the company's ability to yield improvement in margins. Meanwhile, management of financial obligations amid rising interest rates, thereby impacting coverages, is considered important. Improvement in business and financial profile along with effective changes in governance framework would be rating positive.

Disclosure

Name of Rated Entity	Fazal Cloth Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology Corporate Ratings(Jun-18),Methodology Criteria Rating Modifier(Jun-18),Methodology Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study Textile(Oct-18)
Rating Analysts	Muhammad Hassan muhammad.hassan@pacra.com +92-42-35869504

Profile

Legal Structure Fazal Cloth Mills Limited (Fazal Cloth) was incorporated in 1966 as public limited company. The Company is listed on PSX.

Background Fazal Cloth is the flagship company of Fazal Group, engaged in the manufacturing and marketing of different varieties of yarn and grieg fabric. The Company's production facilities are located in the vicinity of Multan and Muzaffargarh.

Operations The Company operates with seven spinning units (199,044 spindles, 3,660 rotors, 912 MVS spindles and 119 doubling machines) and a weaving unit (224 air jet looms). The Company has two gas-fired captive power generation plants, with total capacity of 44MW along with a renewable energy generator (1.63MW), which is sufficient to meet energy requirement. Meanwhile, diesel generators and MEPCO connections are used as back-up.

Ownership

Ownership Structure The Company's majority stakes are owned by Fazal Group and Fatima Group (~45% each). The remaining shareholding rests with financial institutions (~6%) and general public (~4.7%).

Stability The considerable positions in the Company are held by Sheikh Naseem's family. The Group has a holding company in place, portraying a structured line of succession. However, the transfer of ownership to the next generation is not documented.

Business Acumen The sponsoring Groups have over seven decades of presence in Pakistan's textile industry, developing expertise to sustain through the volatile textile industry. Mr. Rehman Naseem – a textile veteran primarily manages the company operations, providing business acumen in order to sustain and flourish in competitive textile industry.

Financial Strength The sponsoring Groups have a prominent position in Pakistan's corporate sector, with interests in textile, fertilizer, energy and trading. This portrays strong financial health and room of financial support to Fazal Cloth, if needed.

Governance

Board Structure The Company's board comprises seven members, including the Chief Executive Officer (CEO). The board has equal representation (three each) of Fazal Group and Fatima Group, while one director is independent director – Mr. Babar Ali.

Members' Profile Mr. Sheikh Naseem Ahmad – the Chairman – is a graduate and carries over five decades of experience in textile industry. Moreover, the board members have vast knowledge and extensive experience of the textile value chain, which benefits the board in efficient decision making.

Board Effectiveness Attendance of board members in meetings remains strong and meeting minutes were appropriately recorded. Moreover, the Company's board have two committees, namely (i) Audit and (ii) Human Resource & Remuneration, to assist board on relevant matters.

Financial Transparency M/s. KPMG Taseer Hadi & Co., Chartered Accountants serves as external auditor for Fazal Cloth. They have expressed unqualified opinion and review report for the year ended 30th June, 2018. Moreover, the Company has an internal audit department which reports directly to Mr. Rehman Naseem (CEO).

Management

Organizational Structure The management control of the company vests with Fazal family. There is a well-defined organizational structure with clear segregation of responsibilities. The structure is divided into six functional departments: i) Production, ii) Finance & Accounts, iii) Marketing, iv) Admin, v) HR, and vi) Internal audit.

Management Team Mr. Rehman Naseem – the CEO, is a Columbia University graduate and carries over two decades of experience in the textile sector. Moreover, Fazal Cloth employs a long associated and experienced professionals, which bodes well for the Company's sustainable growth.

Effectiveness The Company has formed three-member management committee – Executive Committee headed by the CFO. Routine management issues are discussed in the Executive meeting to avoid financial and legal bottlenecks. Moreover, the top management, in addition to standard reports on pre-determined key indicators, gets reports for ad hoc reviews as well.

MIS The Company has deployed an Oracle based Enterprise resource planning (ERP) solution since 2004, with comprehensive reporting.

Control Environment Fazal Cloth is accredited with various International certifications for compliance. The Company is following latest Quality Assurance Standards for yarn, and fabric production. Few of the prominent certification includes ISO 9001, Lycra assured, Fair Trade and Organic exchange, etc.

Business Risk

Industry Dynamics During FY18, total textile exports of Pakistan stood at USD ~13.53bln, a 9% YoY growth. The withdrawal of custom duty and sales tax on cotton imports (effective from January 15, 2019), coupled with subsidized gas rates for textile industry has made the local textile industry cost competitive. Moreover, rupee devaluation in recent times has further improved the textile industry dynamics, particularly for the entities with net exports.

Relative Position Fazal Cloth is one of the largest composite textile unit in Pakistan, with significant spinning capacity when compared to peers, along with representation in weaving segment. Moreover, the Company is one of the leading yarn exports with ~6% (FY18) share in country's yarn exports.

Revenues Fazal Cloth's top-line is dominated by spinning sales (FY18: ~80%, FY17: 76%), followed by weaving segment share. During FY18, the Company's revenues clocked in at PKR 31,288mln, posting a growth of ~18.7%. The growth was largely lead by better industry dynamics and volumetric growth in spinning segment. Moreover, the Company has a reputable local clientele, mitigating the sales concentration risk. The Company's sales have remained tilted towards local market (FY18: 61%, FY17: ~69%). Revenues are moderately diversified in different geographical regions, with top three exporting countries are China ~51.4%, followed by USA ~8% and Portugal ~5.6%. Whereas during 1QFY19, the Company's revenues declined by ~1.7% on QoQ basis and landed at ~PKR 7,444mln.

Margins The Company's gross margins increased during the year (FY18: 9.7%, FY17: 6.7%). This is attributable to prudent inventory procurement and operational efficiency; a factor of continuous BMR. This was followed by higher operating margins (FY18: 6.9%, FY17: 4.0%). Meanwhile, the Company received a dividend income of PKR 156mln from Fatima Fertilizer Limited. Finance costs increased by ~29%, largely led by increased long term borrowing. Despite that increase, the Company posted a profit of ~PKR 1,214mln (FY17: ~PKR 388mln). The Company's margins further improved in 1QFY19 (gross: 11.6%, net: 9.3%), owing to prudent inventory procurement. Despite the significant increase in finance cost, the Company's net profit increased ~PKR 377mln (1QFY18: PKR 150mln) on QoQ basis.

Sustainability Balancing, Modernization, and Replacement (BMR) is a regular feature at the Company. In FY18, Fazal Cloth has incurred a BMR of PKR 1.56 bln, for the purpose of mechanical up-gradation and advancement. Fazal Cloth maintains a sizable investment portfolio, constituting ~31% of its equity base at end-Sep18, mainly comprising strategic holdings.

Financial Risk

Working Capital The Company meets its working capital requirements through a mix of internal cash generation and short term borrowings. During FY18, Company's reliance on STB has significantly increased (FY18: PKR 7,953mln, FY17: PKR 7,516mln), owing to higher inventory procurement. At the same time, STB remains well covered when compared to net trade assets (FY18: 43%, FY17: 34%). Meanwhile, increase in inventory days (FY18: 85days, FY17, 79days), lead to higher working capital cycle (gross - FY18: 138days, FY17, 122days, net - FY18: 134days, FY17 117days); though remain in line with industry. The working capital cycle further increased in 1QFY19, reflected from higher working capital days (gross – 1QFY19: 152days, net – 1QFY19: 148days), on the back of seasonal inventory procurement.

Coverages Fazal Cloth's operating cash flows (FCFO) almost doubled in FY18, on account of higher profitability. The finance cost increased in lower then proportionate of FCFO, resultantly interest and debt coverages improved (FY18: 2.8x, FY17: 1.8x) and (FY18: 1.1x, FY17: 0.6) respectively. In 1QFY19, the Company's coverages further strengthened (interest - 1QFY19: 3.1x, debt - 1QFY19: 1.2x). Fazal Cloth has provided unconditional and irrevocable corporate guarantee on all financial obligations of its subsidiary – Fazal Weaving. Taking into account the financial obligations of Fazal Weaving, coverages slightly decline, though remain at sustainable level. Going forward, despite the increase in interest rate, the Company's coverages are expected to improve on the back of regular long term debt repayment and improved operational performance.

Capitalization Fazal Cloth has intermediately leveraged capital structure, with current debt constituting ~54% of total debt. Whereas at end-Sep 18, the company's leveraging slightly declined.



The Pakistan Credit Rating Agency Limited

Composite

Financial Summary

PKR mln

Fazal Cloth Mills Limited

BALANCE SHEET	30-Sep-18	30-Jun-18	30-Jun-17	30-Jun-16
	1Q	FY18	FY17	FY16
Non-Current Assets	23,541	22,356	17,988	16,814
Investments (Incl. associates)	6,524	5,577	5,012	5,890
Equity	4,287	3,940	4,044	4,075
Debt	2,237	1,637	969	1,815
Current Assets	14,650	15,191	13,219	8,319
Inventory	8,361	8,124	6,420	5,113
Trade Receivables	3,541	4,848	4,243	1,903
Others	2,748	2,219	2,556	1,303
Total Assets	44,715	43,124	36,200	31,024
Debt	17,996	17,884	16,213	11,335
Short-term	7,225	7,953	7,516	3,886
Long-term (Incl. Current Maturity of long-term debt)	10,772	9,931	8,697	7,449
Other shortterm liabilities	3,444	2,703	2,098	2,193
Other Longterm Liabilities	2,566	2,521	2,379	2,279
Shareholder's Equity	20,708	20,015	15,509	15,217
Total Liabilities & Equity	44,715	43,124	36,200	31,024
INCOME STATEMENT				
Turnover	7,444	31,288	26,361	20,616
Gross Profit	862	3,025	1,755	1,754
Financial Charges	(308)	(1,134)	(879)	(917)
Net Income	377	1,214	388	150
Cashflow Statement				
Free Cashflow from Operations (FCFO)	953	3,226	1,563	1,700
Net Cash changes in Working Capital	1,525	(1,464)	(3,681)	367
Net Cash from Operating Activities	2,161	716	(2,755)	1,442
Net Cash from Investing Activities	(2,017)	(2,280)	(2,021)	200
Net Cash from Financing Activities	112	1,515	4,808	(1,726)
Ratio Analysis				
Performance				
Turnover Growth	-1.7%	18.7%	27.9%	-18.9%
Gross Margin	11.6%	9.7%	6.7%	8.5%
Net Margin	5.1%	3.9%	1.5%	0.7%
ROE	7.3%	6.0%	2.7%	1.0%
Coverages				
Debt Service Coverage (x) (FCFO/Gross Interest+CMLTD+Uncovered STB)	1.2	1.1	0.6	0.6
Interest Coverage (x) (FCFO/Gross Interest)	3.1	2.8	1.8	1.9
Debt Payback (Years) (Total Lt.Debt (excluding Covered Short Term Borrowings) /FCFO - Gross Interest)	4.2	4.7	12.7	9.5
Liquidity				
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	148	134	118	130
Capital Structure (Total Debt/Total Debt+Equity)				
	46%	48%	51%	43%

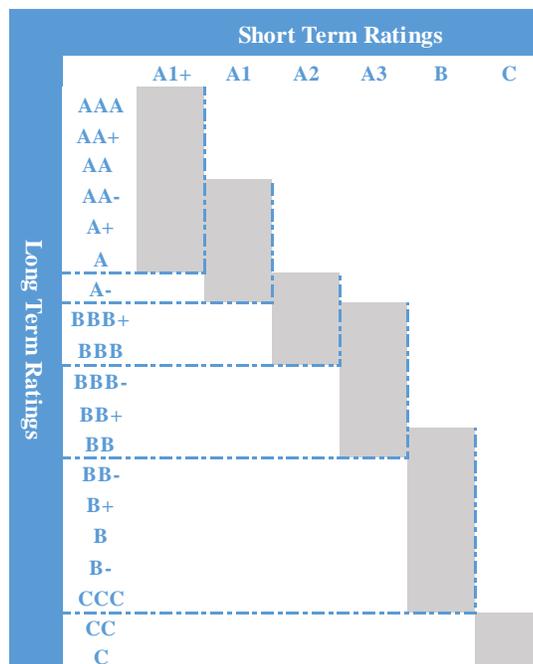
Fazal Cloth Mills Limited

January 2019

Credit 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		Short Term Ratings	
AAA	Highest credit quality. Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments	A1+	The highest capacity for timely repayment.
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.	A1	A strong capacity for timely repayment.
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.	A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial 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.	A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
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	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
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.	C	An inadequate capacity to ensure timely repayment.
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.		



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, a) some material identifiable event and/or b) deviation from expected trend. 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 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) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults, or/and f) PACRA finds it impractical to surveil the opinion due to lack of requisite information.

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

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(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

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- (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

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- (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.
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- (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)
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- (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)
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- (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)

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- (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)

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