The Pakistan Credit Rating Agency Limited

Rating Report

Liberty Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
11-Jan-2019	A+	A1	Stable	Maintain	-
09-Apr-2018	A+	A1	Stable	Maintain	-
12-Jun-2017	A+	A1	Stable	Maintain	-
14-Jun-2016	A+	A1	Stable	Initial	-

Rating Rationale and Key Rating Drivers

Liberty Mills ratings reflect diversity in revenue stream emanating from textile business topped up with non-core recurring income from investments. The holding company structure of the entity strengthens its profile; investment book constitutes ~53% of the equity base and related income provides a significant buffer to bottomline (28%). Strategic holding in IPP – Liberty Powertech is reaping strong dividends, though declined in FY18 due to ongoing liquidity problems of the power sector. Liberty Mills, a family-owned textile company, operates in value-added segment - processing of fabric and made-ups. While this insulates it against volatility in cotton prices, the company's resilient business profile from core operations featured by business margins which, though reduced in recent years, remain in comfortable range. With an export market orientation, the company focuses on its established niche of quality-conscious institutional buyers. Although this has led to customer concentrations, longevity of relationship with big-name clients in addition to sustained quality helps manage the risk. Liberty witnessed growth in its revenues primarily due to currency devaluation. Liberty's strong financial risk profile is characterized by limited long-term debt, healthy cash flows, and, in turn, strong debt-servicing ability. Working capital cycle is stretched, mainly due to increased inventory procurement foreseeing currency devaluation. Long association of experienced management team adds comfort. However, governance framework needs improvement.

Going forward, Liberty Group - the sponsors - intends to expand its industrial footing with a diversification philosophy. A number of medium and long term projects are underway at group-level including (i) Pakistan Aluminum Beverage Cans Limited (PABC) (ii) Liberty Wind Power One (Pvt.) Limited (iii) Engro PowerGen Thar (Pvt.) Limited (iv) Steel Plant (v) Hydro Power projects.

The ratings are dependent on the management's ability to sustain its margins while improving growth in revenue. Meanwhile, utilization of beefed-up capacities is considered important. Going forward, increase in business size, continuation of dividend/other income stream vis-à-vis solidification of governance framework will have positive implications on ratings.

Disclosure	
Name of Rated Entity	Liberty 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 Liberty Mills Limited (Liberty) is a public limited concern incorporated in 1964. The company is not listed on the Pakistan Stock Exchange.
Background Liberty commenced operations in 1964 as a private limited company. Later in 1969, its legal status was changed to a public limited company. In Dec'13, the company was delisted.
Operations Liberty is in the business of manufacturing and processing of textile fabrics and made ups. It operates in two main segments: processing (dyeing and printing) and home textile. The company generates electricity for its in-house use though captive power generation. Its manufacturing facility is located at Sindh Industrial and Trading Estate in Karachi.

Ownership

Ownership Structure Liberty Mills is the flagship company of Liberty Group. It is owned wholly by the Mukaty Family mainly through family members.
Stability In the absence of a group holding company and the personal relationship that exists between the sponsors, there is no formal succession plan, which poses a threat to the stability of the company.
Business Acumen With almost four decades of experience, Liberty Group has expertise in textile and energy sectors of Pakistan. The sponsors carry extensive diversified industrial experience.
Financial Strength Apart from presence in textile and energy, the Group also has interests in the aluminium sector. Furthermore, it has planned investments in power and steel sectors. The sponsors have shown willingness and ability to support the company if the need arises.

Governance

Board Structure The Board of Directors comprises eight members of the Mukaty family, chaired by Mr. Muhammad Salim Mukaty who also holds the office of CEO. During the year, Mr. Luqman F. Poonawala (Non-executive Director) resigned and Mr. Muhammad Ali Sadiq joined the board as an Executive Director. Absence of independent oversight indicates need for improvement in the governance structure of the company.
Members' Profile Chairman, Mr. Salim Mukaty, brings with him over 50 years of experience in the local textile industry while all Board members have significant industry related as well as diversified experience and have a long association with Liberty.
Board Effectiveness BoD meetings are conducted at regular intervals. However, documentation of discussion in meetings needs improvement. To ensure proper oversight, the company has also formed two committees – Audit, and Human Resource & Remuneration – to assist the board on relevant matters.
Financial Transparency M/s, Kreston Hyder Bhimji & Co. Chartered Accountants is the external auditor of the company. They are classified by the State Bank of Pakistan in "Category A" on its panel of auditors. The auditor gave an unqualified opinion on the company's financial statements for the year ended June 30, 2017 while audit process for FY18 financial statements is in process.

Management

Organizational Structure The structure of the company is currently divided into ten functional departments, with the Head of each department reporting directly to Executive Director – Mr. Ashraf, who oversees daily operations.
Management Team Mr. Muhammad Ashraf – son of Mr. Mukaty, manages day to day operations and will succeed Mr. Salim Mukaty as CEO. Mr. Ashraf is supported by a team of experienced professionals. Most of the senior management has been associated with the company for a reasonably long period of time.
Effectiveness Liberty maintains adequate IT infrastructure and related controls. The company maintains a comprehensive reporting system for the management to keep track of activities with regular upgrades to its technology framework.
MIS Oracle based Enterprise Resource Planning (ERP) system has been deployed which provides an integrated view of business processes, facilitating comprehensive MIS reporting.
Control Environment Liberty has a well-trained quality control department. The company is ISO 9001 certified. It also has an internal audit department which reports directly to the CEO, while it should report to the Audit Committee, to ensure effectiveness of the function.

Business Risk

Industry Dynamics Textile exports of the country grew by ~9% for FY18 backed by devaluation of the rupee, bailout package from the government and GSP Plus Scheme of the EU. This growth was led mainly by the value added segment, including knitwear, home textile and ready-made garments. Recent re-imposition of custom duty and sales tax on cotton imports in FY19 budget may put pressure on industry margins. Going forward, exports are expected to remain strong on account of devalued currency.
Relative Position The country's processed and home textile exports for FY18 amounted to ~PKR540 bln, of which Liberty contributed ~2.6%. Liberty faces competition from major textile players such as Yunus Textile Mills, Kohinoor Textile Mills, Gul Ahmed and Nishat Mills.
Revenues During FY18, revenues increased by ~5% on YoY basis to ~PKR 16bln (FY17: ~PKR 15bln), mainly attributable to currency devaluation. The company's sales have remained tilted towards exports (FY18: ~90%) which are moderately diversified in different geographical regions. The company's sales mix is currently dominated by the processing segment; however, the mix is shifting towards home textile (FY18: Processing: 60% Home Textile: 40%, FY17: Processing: 70%, Home Textile: 30%). Concentration of revenue from top ten customers' (~80%), is significantly high, portraying concentration risk.
Margins Cost of production for the year increased by ~5% led mainly by higher raw material costs, leading gross margins to remain at ~14%. Operating margins improved on account of reduced administrative and distribution expenses (FY18: 7.1%, FY17: 6.7%). Net profitability was negatively impacted YoY (FY18: 10.2%, FY17: 24.6%) due to ~26% increase in finance cost and smaller dividend received from subsidiary. Net profit thus amounted to PKR 1,654mln as against PKR 3,783mln in the comparative period.
Sustainability Regular BMR activities and continued dividend income is expected to support the company's bottomline and improve margins. Going forward, the company is planning to set up a 1.3MW solar power plant for captive power generation which is expected to bring significant cost efficiencies. Furthermore, acquisition of the land of adjacent Al-Abid Silk Mills for an estimated cost of ~PKR700 mln is also planned.

Financial Risk

Working Capital In FY18, inventory and receivables as a percentage of sales increased to 61% (FY17: 43%) as the company purchased a significant amount of inventory of yarn and dyeing chemical, foreseeing the rupee devaluation, increasing inventory days (FY18: 161 days, FY17: 112 days). Additionally, trade receivables grew significantly (FY18: ~PKR3,376 mln, ~FY17: PKR2,267 mln). Resultantly, net cash cycle also increased significantly (FY18: 200 days, FY17: 142 days).
Coverages During FY18, surge in operating cashflows resulted in significantly improved interest coverages (FY18: 9.2x, FY17: 6.3x) and debt coverages (FY18: 5.5x, FY17: 4.0x) despite increased finance cost. Dividend received during FY18 amounted to ~PKR463 mln, of which ~PKR 289mln was received from Liberty Power- subsidiary, while the remaining emanated from the trading portfolio.
Capitalization Liberty maintains a moderately leveraged capital structure. Debt increased YoY (FY18: ~PKR7.7 bln, FY17: ~PKR5.6 bln) resulting in increased leveraging of ~35% against 31% in FY17. Major portion of debt continues to be dominated by short-term borrowing (end-Jun18: 85%, end-Jun17: 81%) primarily to finance higher inventory needs. Going forward, leveraging is expected to increase to finance BMR activities and setting up of the captive solar power plant.

Liberty Mills Limited

BALANCE SHEET	30-Jun-18	30-Jun-17	30-Jun-16
	FY18	FY17	FY16
Non-Current Assets	**4,258**	**4,232**	**4,106**
Investments (Incl. Associates & Subsidiaries)	**7,527**	**6,624**	**3,646**
Equity	7,527	6,624	3,146
Debt Securities	-	-	500
Current Assets	**12,552**	**8,797**	**7,589**
Inventory	6,139	4,055	3,579
Trade Receivables	3,377	2,267	2,097
Others	3,036	2,474	1,913
Total Assets	**24,337**	**19,653**	**15,341**
Debt	**7,702**	**5,635**	**5,317**
Short-Term	6,434	4,477	4,365
Long-Term (Incl. Current Maturity of Long-Term Debt)	1,268	1,158	953
Other Short-Term Liabilities	2,417	1,446	1,240
Other Long-Term Liabilities	-	-	-
Shareholder's Equity	**14,219**	**12,572**	**8,784**
Total Liabilities & Equity	**24,337**	**19,653**	**15,341**
INCOME STATEMENT			
Turnover	**16,137**	**15,358**	**15,055**
Gross Profit	2,219	2,129	2,662
Net Other Income	918	3,424	519
Financial Charges	(179)	(142)	(161)
Net Income	**1,654**	**3,783**	**1,890**
Cash Flow Statement			
Free Cash Flow from Operations (FCFO)	1,654	893	1,789
Net Cash changes in Working Capital	(2,161)	(864)	(530)
Net Cash from Operating Activities	(229)	2,970	1,602
Net Cash from Investing Activities	(1,150)	(3,128)	(2,629)
Net Cash from Financing Activities	2,066	318	934
Ratio Analysis			
Performance			
Turnover Growth	5.1%	2.0%	0.8%
Gross Margin	13.8%	13.9%	17.7%
Operating Margin	7.1%	6.7%	11.4%
Net Margin	10.2%	24.6%	12.6%
ROE	12.9%	33.7%	23.4%
Coverages			
Interest Coverage (FCFO/Gross Interest)	9.2	6.3	11.1
Core: (FCFO/Gross Interest+CMLTD+Uncovered Total STB)	5.5	4.0	11.1
Total: (TCF) / (Gross Interest+CMLTD+Uncovered Total STB)	7.1	17.8	14.4
Liquidity			
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	200	142	129
Capital Structure (Total Debt/Total Debt+Equity)	35.1%	31.0%	37.7%

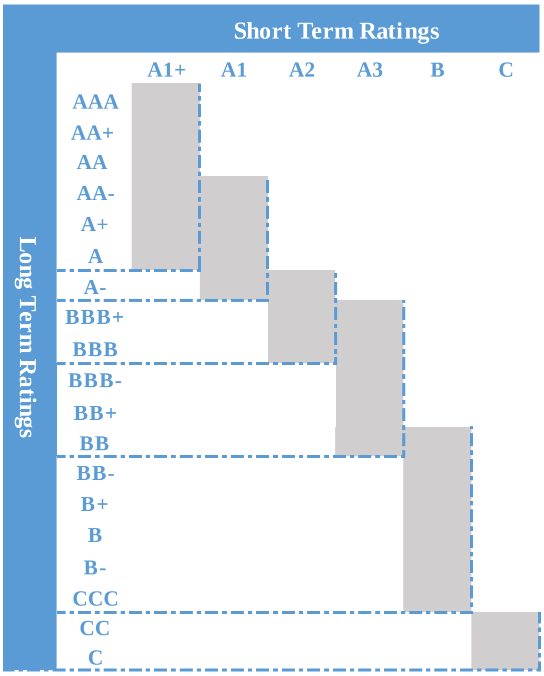
Rating Scale

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	
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 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.



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 surveill the opinion due to lack of requisite information.

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

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