The Pakistan Credit Rating Agency Limited

Rating Report

Fazal Rehman Fabrics Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
29-Aug-2019	A-	A2	Stable	Maintain	-
28-Feb-2019	A-	A2	Stable	Maintain	-
29-Aug-2018	A-	A2	Stable	Upgrade	-
28-Feb-2018	BBB+	A2	Stable	Maintain	-
26-Jan-2017	BBB+	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflect Fazal Rehman Fabrics Limited’s (Fazal Rehman Ltd.) improved business profile characterized by sizable revenue base and strong profitability. The top line grew by ~41% in FY19 due to partial impact of last year’s expansion and attractive prices in the local market. The Company sales mix tilted toward local sales due to better pricing but it reaped the benefit of PKR depreciation in exports. Significant rupee devaluation and subsidized utilities have made the local textile industry cost competitive. The Company's financial profile strengthened from efficient working capital management and healthy liquidity position. Improved profitability, eventually translating into better cash flows, led to strong debt coverages. The Company’s leveraging remains relatively high and is expected to further increase due to capacity expansion in near future. The Company has a sizable investment portfolio. Despite the conservative investment approach, the Company is exposed to the stock market volatility. The assigned ratings derive comfort from the Company's association with Fazal Group.

The ratings are dependent on the management’s ability to uphold the entity’s strong business performance. Meanwhile, prudent management of cash flows and maintaining strong coverage to fulfill financial obligations arising from increased leveraging will be critical, going forward.

Disclosure	
Name of Rated Entity	Fazal Rehman Fabrics Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	PACRA_Methodology_Corporate_FY19(Jun-19),PACRA_Crtieria_LT ST Relationship_FY19(Jun-19),PACRA_Criteria_Rating Modifiers_FY19(Jun-19)
Related Research	Sector Study | Textile(Oct-18)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Fazal Rehman Fabrics Limited (Fazal Rehman Ltd.), a public unlisted company, was incorporated in 2004 and started commercial operations in 2007.
Background Fazal Rehman Ltd. is associated with Fazal Group and is a wholly owned subsidiary of Ahmed Fine Textile Mills Limited. The Company's Mills are located in the vicinity of Multan, Punjab.
Operations The Company operates with one weaving unit having 358 air-jet looms. The Company caters its power needs via in house production ~6MW, as well as MEPCO's connection.

Ownership

Ownership Structure Fazal Rehman Ltd. is a wholly owned subsidiary of Ahmed Fine Textile, which is jointly owned by Fazal Group and Hussain Group (~50% each). Both groups belong to the same family descending from Mr. Fazal-ur-Rehman.
Stability The considerable positions in the Company are held by Sheikh Naseem's family, where third generation is gradually being inducted into the business. Distribution of responsibilities are clearly defined among family members, portraying structured line of succession. However, the transfer of ownership to the next generation is not documented yet.
Business Acumen The Sponsoring groups have a long presence in local textile industry. Over the period of time, they have developed strong credentials and expertise in textile value chain. This has helped the Company in expanding its operation's despite challenging market.
Financial Strength Fazal and Hussain Groups maintain dominant position in Multan's textile industry. Furthermore, Fazal Group's interest in fertilizers and textile provide ample room of financial support to Fazal Rehman Ltd., if needed.

Governance

Board Structure The Company's seven members Board consists of four Fazal Group's representatives, including the Chairman. The remaining three directors are representatives of Hussain Group including the CEO.
Members' Profile Board members have diversified experience and have long association with the Company, while Mr. Sheikh Naseem is the Chairman of board.
Board Effectiveness The Board has Audit Committee in place to assist the board on relevant matters. Additionally, attendance of board members in meetings remained strong and meeting minutes are appropriately documented.
Financial Transparency M/s Shinewing Hameed Chaudhri & Co., Chartered Accountants is the external auditor of the Company. The auditors have expressed unqualified opinion on the financial reports for FY18. Meanwhile, Audit of financial statements for the period FY19 is still under process.

Management

Organizational Structure Mr. Hussain Fazal is the Company's CEO, while Management control vests with Fazal Group with Mr. Rehman Naseem (representative of Fazal Group) primarily managing the Company's operations.
Management Team Management team comprises individuals that have extensive expertise in textile value chain. Mr. Naveed Amir is serving in capacity of CFO. He has been associated with the Fazal Group since 1993.
Effectiveness The management meetings are held on periodic basis, with formal recording of meeting minutes, followed by need based meetings to resolve bottlenecks and to ensure smooth flow of operations. Additionally, detailed reporting on cash position and inventory is done on regular basis and presented to senior management for performance review; eventually ensuring efficiency.
MIS Fazal Rehman Ltd. deploys Oracle based Enterprise Resource Planning (ERP) system with comprehensive MIS reporting.
Control Environment The Company's plant is connected with head office through VPN, thereby reporting on real time basis. Furthermore, Fazal Rehman Ltd. is compliant with multiple safety and quality assurance standards; majorly including ISO 9001, Lycra assured, Fair Trade and Organic exchange.

Business Risk

Industry Dynamics The export performance of Pakistan's textile industry remained stagnated during FY19, despite ~34% currency devaluation and incentives introduced by the government to promote in exports. While the current deficit has shown improvement, overall exports showed lackluster performance with the textile sector displaying negative YoY growth of ~1% in dollar terms. Even though leading textile categories including ready-made garments, knitwear and cotton cloth displayed double-digit volumetric growth, the hit to unit prices on account of exporters having to share the benefit of the currency depreciation with buyers in the extremely competitive international market, curbed overall growth. Meanwhile, cotton yarn exports fell by ~18% YoY. This decline was driven by falling yarn prices due to decreasing trend in international cotton prices during the year, as well as volumetric decline owing to the US-China trade war. The withdrawal of zero rating status may cause liquidity crunch for the companies with majority exports. This, along with restriction on sales to unregistered person has resulted in a slowdown in textile's operations, in local market.
Relative Position Fazal Rehman Ltd. is associated with Fazal Group. The Group is one of the largest yarn exporters of Pakistan; though it has limited share in fabric sale on both local and export front, as non-mill sector continues to dominate the fabric market with almost 90% market share. However, on standalone basis Fazal Rehman Ltd.'s share in local weaving industry is minimal.
Revenues Fazal Rehman Ltd.'s revenues are on growing trajectory since last two years. This was largely achieved on account of volumetric growth due to expansion. During FY19, the Company's revenues posted significant YoY growth (~40%) and stood at PKR 11,026mln. It is mainly attributable to partial impact of last year's expansion, resulting in volumetric growth and improved product pricing in local market. Export comprised 34% of revenues (FY18: 54%).
Margins In FY19, the Company's gross margin has slightly improved (FY19: 12.7%, FY18: 12.3%), on account of cost efficiency through subsidized utilities. However, operating margin improved in relatively higher proportion (FY19: 9.6%, FY18: 8.6%) due to lower then proportionate increase in distribution expense when compared to revenues, a factor of declined exports. The Company received dividend income of ~PKR 55mln (FY18: PKR 39mln). Despite the increase in finance cost by 40%, the Company's net margin has improved (FY19: 6%, FY18: 4.9%). The Company reported a net profit of PKR 656mln in FY19, reporting 72% YoY growth.
Sustainability The dividend inflow from investments in equity market (constituting PKR 908mln) along with capital gains is considered important. However in FY19, the Company booked an unrealized loss on investment of PKR 84mln. Moreover, Fazal Rehman Ltd. has recently completed expansion project and plans to further expand its operational capacity by adding 110 looms.

Financial Risk

Working Capital Working capital requirements, a function of inventory and receivables, are historically met through a mix of internal cash generation and short-term borrowing. In FY19, the Company's inventory days have increased modestly (FY19: 51days, FY18: 48days), owing to increased raw material prices and higher inventory requirement due to expansion. Meanwhile, the Company's receivables and payables have remained intact. These factors have slightly widened the net working capital cycle (FY19: 78days, FY18: 74days). Meanwhile, the Company's STB remained well covered against net trade assets, portraying significant room for further short term borrowing.
Coverages During FY19, the Company's operating cash flows (FCFO) have considerably improved (FY19: PKR 1,289mln, FY18: PKR 802mln), because of revenue growth and better margins. Moreover, lower than proportionate increase in finance cost led to improved interest coverages (FY19: 5.4x, FY18: 4.7x). Meanwhile, debt coverage has declined (FY19: 2.4x, FY18: 3.0x), owing to maturity of debt repayment. The accumulation of further debt for expansion is largely LTFF based, posing lesser pressure on the Company's coverages in rising interest rate scenario.
Capitalization The Company has significantly leveraged capital structure ~59.4% (FY18: 69.7%); though declined YoY due to lower STB and repayment of LTB. The Company's total debt stands at PKR 3.7bln, out of which LTB constitutes 57.3%. Since, ~39% of the Company's long term borrowings are availed at the SBP's concessionary rates, the Company's exposure in the current rising interest rate environment is limited.

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Fazal Rehman Fabric Limited	Jun-19	Jun-18	Jun-17
Weaving	12M	12M	12M
A BALANCE SHEET			
1 Non-Current Assets	3,050	3,265	2,515
2 Investments	908	617	645
3 Related Party Exposure	-	-	-
4 Current Assets	3,480	3,034	1,984
a Inventories	*1,722*	*1,370*	*685*
b Trade Receivables	*1,088*	*1,136*	*494*
5 Total Assets	7,438	6,916	5,145
6 Current Liabilities	1,067	732	726
a Trade Payables	*392*	*194*	*324*
7 Borrowings	3,664	3,947	2,423
8 Related Party Exposure	-	107	291
9 Non-Current Liabilities	204	199	167
10 Net Assets	2,503	1,930	1,538
11 Shareholders' Equity	2,503	1,930	1,538
B INCOME STATEMENT			
1 Sales	11,026	7,821	5,459
a Cost of Good Sold	*(9,626)*	*(6,856)*	*(5,005)*
2 Gross Profit	1,401	965	454
a Operating Expenses	(347)	(295)	(171)
3 Operating Profit	1,054	669	282
a Non Operating Income	*(9)*	*(54)*	*36*
4 Profit or (Loss) before Interest and Tax	1,045	615	318
a Total Finance Cost	*(261)*	*(199)*	*(130)*
b Taxation	*(127)*	*(35)*	*(36)*
6 Net Income Or (Loss)	656	381	152
C CASH FLOW STATEMENT			
a Free Cash Flows from Operations (FCFO)	*1,289*	*802*	*459*
b Net Cash from Operating Activities before Working Capital Changes	*1,049*	*597*	*362*
c Changes in Working Capital	*(235)*	*(1,144)*	*(52)*
1 Net Cash provided by Operating Activities	814	(546)	310
2 Net Cash (Used in) or Available From Investing Activities	(465)	(972)	(612)
3 Net Cash (Used in) or Available From Financing Activities	(313)	1,525	286
4 Net Cash generated or (Used) during the period	35	6	(16)
D RATIO ANALYSIS			
1 Performance			
a Sales Growth (for the period)	41.0%	43.3%	-2.6%
b Gross Profit Margin	12.7%	12.3%	8.3%
c Net Profit Margin	6.0%	4.9%	2.8%
d Cash Conversion Efficiency (EBITDA/Sales)	12.4%	11.4%	9.1%
e Return on Equity (ROE)	29.6%	21.9%	10.4%
2 Working Capital Management			
a Gross Working Capital (Average Days)	88	86	70
b Net Working Capital (Average Days)	78	74	54
c Current Ratio (Total Current Assets/Total Current Liabilities)	3.3	4.1	2.7
3 Coverages			
a FCFO / Finance Cost	5.4	4.7	7.1
b FCFO / Finance Cost+CMLTB+Excess STB	2.4	3.0	1.6
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	2.0	3.4	4.5
4 Capital Structure (Total Debt/Total Debt+Equity)			
a Total Borrowings / Total Borrowings+Equity	59.4%	67.2%	61.2%
b Short-Term Borrowings / Total Borrowings	0.4	0.5	0.3
c Average Borrowing Rate	6.3%	5.3%	3.6%

Rating Scale | Corporate

2019

Credit Rating Scale & Definitions

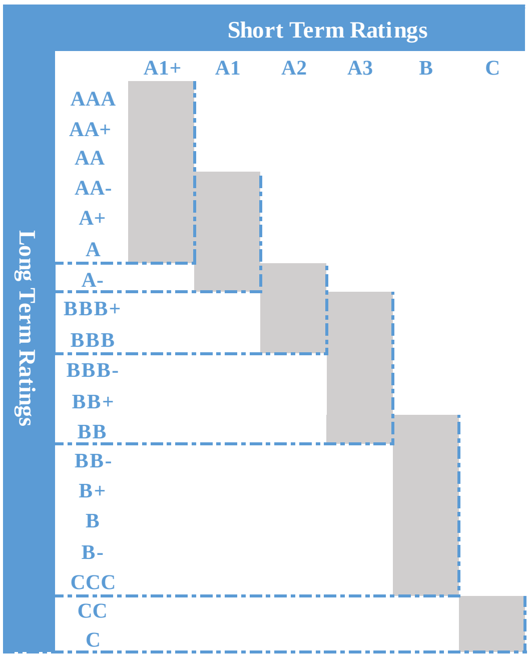
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

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