



The Pakistan Credit Rating Agency Limited

## Rating Report

### Mekotex (Pvt.) Limited

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#### Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
06-Aug-2019	A-	A2	Stable	Maintain	-
04-Feb-2019	A-	A2	Stable	Initial	-

#### Rating Rationale and Key Rating Drivers

The ratings highlight the Company's strong business prospects reflected by growing revenues and profitability. The ratings incorporate strong business acumen of the sponsors, making Mekotex group a vertically integrated textile unit. The Company is a composite unit of textile with diversified products like denim & greige fabric. Margins remain in-line with good players in the market. The Company has adequately invested in BMR and expansion projects to remain competitive and ensuring technological upgrades. This has helped in capturing growing demand in the local market, while export markets are pitched through group businesses – Kam International and Kam Apparel. The financial risk profile is relatively stretched, reflected by good coverages since cash flows from recent expansion are yet to fully materialize. Comfort is drawn from sponsors commitment and support, demonstrated in the form of interest-free loans and subscription of right issue. The financial matrix is expected to remain well managed.

Ratings are dependent upon sustenance of top line growth, capitalizing on ongoing BMR and expansion initiatives, and conversion in profitability. This, in turn, should benefit in better debt service coverage ratios. Improvement in reporting mechanism and governance framework would be critical for the ratings.

#### Disclosure

<b>Name of Rated Entity</b>	Mekotex (Pvt.) Limited
<b>Type of Relationship</b>	Solicited
<b>Purpose of the Rating</b>	Entity Rating
<b>Applicable Criteria</b>	PACRA_Methodology_Corporate_FY19(Jun-19),PACRA_Criteria_LT ST Relationship_FY19(Jun-19),PACRA_Criteria_Rating Modifiers_FY19(Jun-19)
<b>Related Research</b>	Sector Study   Textile(Oct-18)
<b>Rating Analysts</b>	Ateeb Riaz   ateeb.riaz@pacra.com   +92-42-35869504

## Profile

**Legal Structure** Mekotex (Pvt.) Limited is a private limited concern incorporated in 1991.

**Background** The foundation of the Mekotex group was laid by Mr. Abdul Majid Qasim (late) in 1979 and has since evolved to become one of the leading denim manufacturer and exporter of the country. Mekotex, the flagship company of the group, was pioneered by Mr. Abdul Majid's sons: Mr. Ebrahim Qasim and his elder brother, Mr. Abdul Majeed. Mr. Ebrahim Qasim exited the company in 2001 after the family decided to split the family wealth among different family members.

**Operations** Mekotex is a fully integrated textile unit involved in ginning, spinning, weaving and printing of denim and greige fabric. The company operates with 4 ginners, ~111,000 spindles, 450 looms, and 5 digital printing machines with production facilities located at Lodhran (ginning), Kotri (spinning) and Karachi (weaving), while its head office resides in Karachi. It is also self-sufficient in power production and water supply.

## Ownership

**Ownership Structure** The Company is fully owned by the families of 3 brothers: Mr. Khalid Majeed, Mr. Ashraf Majeed, and Mr. Shoaib Majeed. Mr. Khalid Majeed and Mr. Ashraf Majeed owns 36% shares each, while 28% shares are held by Mr. Shoaib Majeed.

**Stability** There is absence of a shareholding agreement and formal succession plan among the brothers which poses a risk to the stability of the business.

**Business Acumen** With over three decades of experience, the group carries expertise in textile, energy and power. Its sponsors also have diversified industrial experience.

**Financial Strength** While textile operations of the group are segregated into three businesses – Mekotex, KAM International (Home Textile), Kam International (Apparel), the group has diversified itself into energy and water supply projects, generating a stable stream of income. Annual turnover of the group exceeds ~USD 160mln per annum. The sponsors have demonstrated willingness and ability to support the business in the past, through substantial interest free director loans and new equity injections.

## Governance

**Board Structure** The overall control of the board vests in a 5-member Board of Directors, three sponsors and two non-executive independent directors. However, the Board is still dominated by the sponsors. Induction of independent directors is a step towards strengthening of governance framework of the Company.

**Members' Profile** The Board members have diversified experience and knowledge of the textile industry at local and international levels which helps in providing useful insight in developing strategy.

**Board Effectiveness** At Mekotex, there are no formal Board meetings or a system to record the Board meeting minutes; financial information financial decisions are communicated to management after board meetings. There are no board committees and there is great degree of centralized control of the CEO over the operations.

**Financial Transparency** The Company's external auditors are M. Saleem Associates, Chartered Accountants. The auditors are QCR rated by ICAP; however, they are not inducted on the State bank of Pakistan's panel of auditors. The auditors expressed an unqualified opinion on the financial statements for the period ended 30th June, 2018. However, as part of improving financial transparency, the Company has appointed Horwath Hussain Chaudhury & Co Chartered Accountants, listed in category A of SBP, as external auditor for FY19.

## Management

**Organizational Structure** The Company is segregated into seven key departments, with the heads of all departments qualifying as "strategic managers" and reporting directly to the Board of Directors.

**Management Team** Overall management control is in the hands of eldest brother - Mr. Khalid Majeed – who acts as the CEO of the Company, while the rest of the brothers oversee specified functions. Mekotex places high importance on experience and no member of the strategic management group has experience of less than two decades.

**Effectiveness** There are no formal management committees at Mekotex. However, all department heads generate reports relevant to their department through MIS or manually which are kept updated in a timely and accurate manner.

**MIS** The Company has deployed Oracle-based ERP. The IT system is fully integrated in the all major departments and ensures proper financial and operational control.

**Control Environment** The Company has adequate quality control procedures in place to ensure efficiency and minimize wastage. These controls are implemented manually, unlike industrial peers. There is also an internal audit function operating in the Company. The Company has obtained certification from various international accreditation organizations including Global Organic Textile Standards, Organic Exchange, Worldwide Responsible Accredited Production, etc.

## Business Risk

**Industry Dynamics** The global denim market is estimated to grow from ~USD 57bln to ~USD 75bln in 2021, driven by westernization in developing countries, especially India and China. Pakistan's denim sector market size hovers around 10-15% of total textile exports of Pakistan, with major markets for fabric exports including Bangladesh, Turkey and Egypt while prime markets for denim garments comprise US and Europe.

**Relative Position** The Company has an adequate position on standalone basis and is considered a middle-tier playing in Pakistan's denim industry.

**Revenues** The Company's top line clocked in at ~PKR 10,274mln during the 9MFY19 (FY18: 10,478), showing strong growth on YoY basis. The Company's top line is mainly driven by local sales with a share of ~80%, while rest comes from exports. The growth in revenue during the period mainly came from increased yarn sales volume at better prices after the capacity expansion, as the new spinning unit is capable of producing finer quality yarn which attracts premium prices.

**Margins** The Company's gross margins stood at ~12% during 9MFY19 (FY18: ~12.4%). Better control at administrative and selling costs allowed the Company to improve its operating margins, which stood at ~10% during 9MFY19 (FY18: ~9%). The increased finance cost, due to both higher benchmark rate and greater outstanding borrowings during the period, led to decrease in net profit margin, which clocked in at ~4.6% during 9MFY19 (FY18: 6%). The net profit of the Company stood at ~PKR 474mln during 9MFY19 (FY18: ~PKR 634mln).

**Sustainability** The Company has continued to expand its operations during the period and has started a new spinning unit at Kotri with a capacity of ~64,000 spindles, allowing it to produce finer quality yarn. In the near future, it is planning to induct the latest technology digital printing machines, which will allow the Company to provide printing services to the premium local and international brands. The continued Capex enable the Company to remain competitive in the industry and sustain growth in its top line.

## Financial Risk

**Working Capital** The working capital requirements are a function of inventory and receivables. This is partially catered by availing adequate terms from creditors, while rest has to be financed via short term borrowings. The considerable increase in inventories due to stocking in peak season and increase in operational capacity during the period, lead to increase in working capital days (gross – 9MFY19: 150days, FY18, 123days, net – 9MFY19: 128days, FY18: 110days). The Company's short-term borrowings increased (9MFY19: PKR 6,151mln, FY18: PKR 3,532mln) to finance the increased stock levels.

**Coverages** The Company's FCFO during 9MFY19 increased on the back of higher revenues and, in turn, profitability. The Company's interest coverage ratio increased to 3.4x during 9MFY19 (FY18: 2.0x) despite higher finance costs. The Company's debt coverage ratio also improved during 9MFY19 and clocked in at 3.4x, due to repayment of current maturity of long-term debt. The coverages are expected to remain at adequate level, going forward.

**Capitalization** The Company's capital structure is highly leveraged at ~59% during 9MFY19 (FY18: ~52%). The borrowings of the Company has increased significantly during the year and stood at ~PKR 9,522mln (FY18: ~PKR 6,228mln). However, the Company has also increased its share capital by PKR 1bln during the period, which has helped to maintain the leveraging. Continuous injection by sponsors in the form of subordinated interest free loan has supported the Company. However, the leveraging of the Company is expected to increase as the Company is embarking on new Capex, partially financed by bank borrowings, going forward.



The Pakistan Credit Rating Agency Limited

Financial Summary

PKR mln

Mekotex (Private) Limited Denim	Mar-19 9M	Jun-18 12M	Jun-17 12M	Jun-16 12M
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#### A BALANCE SHEET

1 Non-Current Assets	8,201	6,805	5,040	4,018
2 Investments	-	-	-	-
3 Related Party Exposure	51	51	51	51
4 Current Assets	9,134	5,817	4,096	3,454
a Inventories	4,900	2,046	1,669	1,582
b Trade Receivables	2,314	1,989	1,384	957
5 Total Assets	17,386	12,673	9,187	7,523
6 Current Liabilities	1,205	770	544	610
a Trade Payables	1,205	467	320	412
7 Borrowings	9,413	6,228	4,059	3,391
8 Related Party Exposure	109	-	-	-
9 Non-Current Liabilities	24	23	37	69
10 Net Assets	6,635	5,652	4,547	3,453
11 Shareholders' Equity	6,635	5,652	4,547	3,452

#### B INCOME STATEMENT

1 Sales	10,274	10,478	8,219	6,939
a Cost of Good Sold	(9,037)	(9,180)	(7,109)	(5,857)
2 Gross Profit	1,237	1,297	1,110	1,082
a Operating Expenses	(215)	(369)	(301)	(267)
3 Operating Profit	1,022	928	809	814
a Non Operating Income	(23)	78	90	(39)
4 Profit or (Loss) before Interest and Tax	998	1,006	899	775
a Total Finance Cost	(396)	(424)	(441)	(462)
b Taxation	(128)	52	29	(9)
6 Net Income Or (Loss)	474	634	488	305

#### C CASH FLOW STATEMENT

a Free Cash Flows from Operations (FCFO)	1,348	796	591	508
b Net Cash from Operating Activities before Working Capital Changes	952	946	711	508
c Changes in Working Capital	(2,921)	(1,193)	(614)	(352)
1 Net Cash provided by Operating Activities	(1,969)	(246)	97	156
2 Net Cash (Used in) or Available From Investing Activities	(1,746)	(2,272)	(1,401)	(1,470)
3 Net Cash (Used in) or Available From Financing Activities	3,687	2,639	1,275	1,319
4 Net Cash generated or (Used) during the period	(28)	121	(28)	6

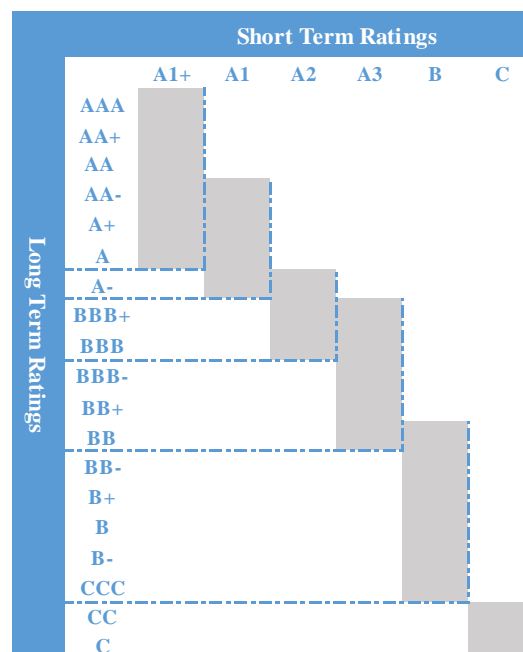
#### D RATIO ANALYSIS

1 Performance				
a Sales Growth (for the period)	30.7%	27.5%	18.4%	--
b Gross Profit Margin	12.0%	12.4%	13.5%	15.6%
c Net Profit Margin	4.6%	6.0%	5.9%	4.4%
d Cash Conversion Efficiency (EBITDA/Sales)	13.1%	9.6%	9.0%	9.5%
e Return on Equity (ROE)	10.3%	12.4%	12.2%	8.8%
2 Working Capital Management				
a Gross Working Capital (Average Days)	150	123	124	94
b Net Working Capital (Average Days)	128	110	108	72
c Current Ratio (Total Current Assets/Total Current Liabilities)	7.6	7.6	7.5	5.7
3 Coverages				
a EBITDA / Finance Cost	3.4	2.5	1.9	1.5
b FCFO / Finance Cost+CMLTB+Excess STB	3.4	0.8	0.7	0.7
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	2.7	6.9	8.3	14.4
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	58.9%	52.4%	47.2%	49.5%
b Short-Term Borrowings / Total Borrowings	65%	57%	58%	70%
c Average Borrowing Rate	6.7%	7.9%	10.4%	12.9%

## 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	<b>Highest credit quality.</b> Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments	A1+	The highest capacity for timely repayment.
AA+	<b>Very high credit quality.</b> 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.
AA		A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
AA-		A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
A+	<b>High credit quality.</b> 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.	B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
A		C	An inadequate capacity to ensure timely repayment.
A-			
BBB+	<b>Good credit quality.</b> 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.		
BBB			
BBB-			
BB+	<b>Moderate risk.</b> 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.		
BB			
BB-			
B+	<b>High credit risk.</b> 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.		
B			
B-			
CCC	<b>Very high credit risk.</b> 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.		
CC			
C			
D	Obligations are currently in default.		



<b>Outlook (Stable, Positive, Negative, Developing)</b> 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'.	<b>Rating Watch</b> 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.	<b>Suspension</b> 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.	<b>Withdrawn</b> 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.	<b>Harmonization</b> A change in rating due to revision in applicable methodology or underlying scale.
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**Disclaimer:** PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.

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