



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
05-Aug-2020	A-	A2	Negative	Maintain	YES
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 profile reflected by growing revenues and profitability in recent years. The ratings incorporate strong business acumen of sponsors, making Mekotex group a vertically integrated textile unit. The Company is a composite unit of textile with diversified products mainly denim & greige fabric. Margins remain in-line with industry averages. The Company has adequately invested in BMR and expansion projects to remain competitive through 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. Overall export volumes of textile industry declined during FY20 owing to COVID-19 outbreak in early 2020 and subsequent lockdowns in major export destinations (Europe & USA). Domestic players had to shut down production or remained partially operational during lockdown in 4QFY20 as per Government directives. Resultantly, the industry is facing challenges including low demand, build-up of inventory and receivables and lower capacity utilization. The situation has improved to an extent as orders are now being delivered and gradual improvement is seen in international markets. However, this could be disrupted by second wave of COVID or prolonged slowdown. Mekotex is no exception to this scenario. The Company exhibited strong results till 3QFY20 but its operations, particularly denim segment, was hit hard in 4QFY20. The revenues of the Company are expected to remain low in 4QFY20, impacting margins and profitability in the short-term. The Company's financial risk profile is characterized by high leveraging and adequate coverages. The Company availed SBP's moratorium relief and deferred principal repayments for one year. This, coupled with reduction of 625bps in interest rates, will provide relief in cashflows.

The 'Rating Watch' signifies the COVID-19 outbreak and a challenging economic environment. The entire textile chain has been impacted due to the lockdowns across the globe. Although demand is recovering gradually, it remains fragile and the relative timeline and extent of full recovery remains uncertain. The Government and SBP has announced several initiatives to provide support. PACRA will monitor the situation closely and accordingly take action.

The ratings are dependent on the Company's ability to maintain strong business profile and optimal capacity utilization amidst current circumstances. Meanwhile, careful management of financial obligations during and after the pandemic is imperative. Improvement in reporting mechanism and governance framework would be critical for the ratings.

Disclosure

Name of Rated Entity	Mekotex (Pvt.) Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology Corporate Ratings(Jun-20),Methodology Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria Rating Modifier(Jun-20)
Related Research	Sector Study Garments(Dec-19)
Rating Analysts	Ateeb Riaz ateeb.riaz@pacra.com +92-42-35869504

Profile

Legal Structure Mekotex (Pvt.) Limited (Mekotex or 'the Company') is a private limited concern incorporated in 1991. The registered office of the Company is situated in Karachi, Sindh.

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. 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, ~110,000 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 majority shares are owned by three brothers; Ashraf Majeed (~30%), Khalid Majeed (23%) and Shoaib Majeed (~14%), while rest of the shareholding lies with other family members.

Stability There is absence of a shareholding agreement and formal succession plan among the family members 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. 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 board has not formed any committee and there is great degree of centralized control of the CEO over the operations.

Financial Transparency Horwath Hussain Chaudhury & Co., Chartered Accountants, are the external auditors of the Company. They gave an unqualified opinion on financial statements for the year end June 30, 2019. The firm is QCR rated by ICAP and is classified in Category 'A' in the panel of auditors maintained by SBP.

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 The Company has no management committees in place. Management meetings are convened on "as and when required basis". The management effectiveness can be improved by formalizing the management committee.

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 During FY20, ready-made garment exports declined by ~4% YoY and clocked in at ~USD 2,552mln (FY19: ~USD 2,653mln), owing to COVID-19 outbreak in early 2020 and subsequent global lockdowns which has impacted the entire textile industry's exports. Export orders had been postponed or cancelled as the major denim export destinations (USA & Europe) were in lockdown to contain the virus. Several domestic players were either closed or partially operational during countrywide lock-down in 4QFY20 due to supply chain disruption and labor issues despite exemption from restrictions. This resulted in liquidity pressure on the sector. However, post June, demand for denim is rebounding slowly as buyers/stores replenish their inventories. The recent partial reopening of export markets is a positive sign but recovery remains fragile due to threat of second COVID-19 wave.

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

Revenues Mekotex derives its revenue mainly from manufacturing and sale of denim and other fabrics. The Company's top-line is mainly driven by local sales with a share of ~84%, while rest comes from exports. The Company's top-line clocked in at ~PKR 12,255mln during 9MFY20 (9MFY19: ~PKR 10,274), showing a growth of ~19%. The growth emanated from increased yarn sales volume at better prices after recent capacity enhancement, as the new spinning unit is capable of producing finer quality yarn which attracts premium prices.

Margins During 9MFY20, gross margins of the Company remained stable at ~12% (9MFY19: ~12%), despite cost push inflation due to efficient cotton procurement and other cost efficiencies. Although, operating cost increased to ~PKR 263mln in 9MFY20 (9MFY19: ~PKR 215mln), operating margin remained intact at ~10% (9MFY19: ~10%). However, higher finance cost narrowed net profit margin to ~4% (9MFY19: ~5%), with bottom-line standing at ~PKR 485mln (9MFY19: ~PKR 474mln).

Sustainability Due to COVID-19 outbreak and subsequent lockdown, the Company's operations remained shut for few days but resumed partial operations afterwards. Since, the government has eased the lockdown, demand has improved, however, complete recovery in sales remains unclear. However, SBP measures in shape of interest rate cuts and deferment of loan repayments will provide some respite.

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. During 9MFY20, gross working capital days of the Company remained intact and stood at 152 days (9MFY19: 150 days) on the back of efficient working capital management. However, net working capital days deteriorated to 137 days (9MFY19: 128 days) due to lower payable days (9MFY20: 15 days, 9MFY19: 22 days). Nevertheless, working capital days of the Company are in-line with the industry average. The Company's short term trade leverage (9MFY20: ~4%, 9MFY19: ~4%) remains thin, showing little room to borrow against working capital.

Coverages The Company's free cashflows (FCFO) increased to ~PKR 1,537mln in 9MFY20 (9MFY19: ~PKR 1,348mln) on the back of higher profitability. Meanwhile, finance cost increased substantially to ~PKR 591mln (9MFY19: ~PKR 396mln) due to increase in borrowings and higher benchmark rates. Consequently, interest coverage ratio and debt coverage ratio declined to 2.6x (9MFY19: 3.4x) and 2.6x (9MFY19: 3.4x), respectively. However, the coverages of the Company are considered strong. Reduced interest rates and SBP's moratorium relief availed by the Company will provide comfort to the cashflows and coverages, going forward.

Capitalization Mekotex maintains a highly leveraged capital structure. During 9MFY20, the leveraging stood at ~59% (9MFY19: ~59%). Short term borrowings made up ~67% (9MFY19: ~65%) of the total borrowings. Sponsors have injected the money in the past in order to maintain the leveraging. Going forward, taking on additional debt to finance expansion projects may increase leveraging further.



Mekotex (Pvt.) Limited Denim	Mar-20 9M	Jun-19 12M	Jun-18 12M	Jun-17 12M
A BALANCE SHEET				
1 Non-Current Assets	9,621	8,301	6,805	5,040
2 Investments	-	0	-	-
3 Related Party Exposure	51	51	51	51
4 Current Assets	9,909	7,969	5,817	4,096
a Inventories	4,855	3,367	2,046	1,669
b Trade Receivables	2,772	2,652	1,989	1,384
5 Total Assets	19,581	16,321	12,673	9,187
6 Current Liabilities	1,273	1,133	770	544
a Trade Payables	723	643	467	320
7 Borrowings	10,690	8,316	6,228	4,059
8 Related Party Exposure	50	-	-	-
9 Non-Current Liabilities	33	33	23	37
10 Net Assets	7,535	6,839	5,652	4,547
11 Shareholders' Equity	7,535	6,839	5,652	4,547
B INCOME STATEMENT				
1 Sales	12,255	13,020	10,478	8,219
a Cost of Good Sold	(10,730)	(11,401)	(9,180)	(7,109)
2 Gross Profit	1,525	1,619	1,297	1,110
a Operating Expenses	(263)	(405)	(369)	(301)
3 Operating Profit	1,262	1,214	928	809
a Non Operating Income	11	95	78	90
4 Profit or (Loss) before Interest and Tax	1,273	1,309	1,006	899
a Total Finance Cost	(622)	(759)	(424)	(441)
b Taxation	(166)	60	52	29
6 Net Income Or (Loss)	485	610	634	488
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	1,537	1,676	1,220	1,032
b Net Cash from Operating Activities before Working Capital Changes	1,025	1,044	946	711
c Changes in Working Capital	(2,413)	(1,727)	(1,193)	(614)
1 Net Cash provided by Operating Activities	(1,388)	(683)	(246)	97
2 Net Cash (Used in) or Available From Investing Activities	(1,320)	(2,056)	(2,272)	(1,401)
3 Net Cash (Used in) or Available From Financing Activities	2,128	2,665	2,639	1,275
4 Net Cash generated or (Used) during the period	(579)	(73)	121	(28)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	25.5%	24.3%	27.5%	18.4%
b Gross Profit Margin	12.4%	12.4%	12.4%	13.5%
c Net Profit Margin	4.0%	4.7%	6.0%	5.9%
d Cash Conversion Efficiency (EBITDA/Sales)	13.9%	14.2%	13.6%	14.4%
e Return on Equity (ROE)	9.0%	9.8%	12.4%	12.2%
2 Working Capital Management				
a Gross Working Capital (Average Days)	152	141	123	162
b Net Working Capital (Average Days)	137	125	110	146
c Current Ratio (Total Current Assets/Total Current Liabilities)	7.8	7.0	7.6	7.5
3 Coverages				
a EBITDA / Finance Cost	2.9	2.6	3.5	3.0
b FCFO / Finance Cost+CMLTB+Excess STB	2.6	1.1	1.2	1.3
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	2.8	3.3	3.3	2.6
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	58.8%	54.9%	52.4%	47.2%
b Short-Term Borrowings / Total Borrowings	0.7	0.6	0.6	0.6
c Average Borrowing Rate	8.3%	9.9%	7.9%	10.4%

Credit Rating

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.

Scale	Long-term Rating Definition
AAA	Highest credit quality. Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
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.
AA-	
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.
A-	
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.
BBB-	
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.
BB	
BB-	
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.
B-	
CCC	
CC	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.
C	
D	Obligations are currently in default.

Scale	Short-term Rating Definition
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.
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

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 some material identifiable event with indeterminable rating implications. 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 rating 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) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) 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.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

<p>Entities</p> <ul style="list-style-type: none"> a) Broker Entity Rating b) Corporate Rating c) Financial Institution Rating d) Holding Company Rating e) Independent Power Producer Rating f) Microfinance Institution Rating g) Non-Banking Finance Companies (NBFCs) Rating 	<p>Instruments</p> <ul style="list-style-type: none"> a) Basel III Compliant Debt Instrument Rating b) Debt Instrument Rating c) Sukuk Rating
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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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- (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)

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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)
- (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)

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