The Pakistan Credit Rating Agency Limited

Rating Report

LOTTE Kolson (Pvt.) Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
09-Jun-2021	A-	A2	Stable	Maintain	-
26-Jun-2020	A-	A2	Stable	Maintain	YES
27-Dec-2019	A-	A2	Stable	Maintain	-
27-Jun-2019	A-	A2	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

The ratings reflect Lotte Kolson (Pvt.) Limited’s ('Lotte Kolson' or 'the Company') association with Lotte Corporation, one of the biggest conglomerates of South Korea. Though food industry remained operational since Covid-19 outbreak, however, demand for snacks and confectionery remain low due to closure of schools and malls. The Company's revenue growth remained limited mainly due to government's regulation on unregistered distributors and an overall contraction in demand in snacks segment. Utilization of the Company’s state-of-the-art ‘Choco Pie’ plant remains low, though improving, due to slow market pick up of the product despite aggressive marketing campaigns. Business margins improved despite increase in raw material costs leading to profits at gross and operational level. The Company is focusing on changing its sales mix to higher margin products, such as pasta, and increasing capacity utilization of new plant through product innovation. The financial profile of the Company is characterized by strong working capital management due to its cash based sales and a moderately leveraged capital structure with long term loan at fixed rate. Loan deferment facility introduced by SBP provide during Covid-19 outbreak provided the necessary respite, however, coverages are still weak as the Company's cashlfows are under pressure. The ratings draw comfort from the sponsor's financial strength, guidance on managing interest rate fluctuation and demonstrated ability to provide support, if needed.

The ratings are dependent on the Company’s ability to improve sales, margins and profitability. Increasing capacity utilization of new plant and gaining traction of newly introduced products will be important. Any further deterioration in margins and/or coverages will exert pressure on the ratings. Continued support from Lotte Confectionery, technically and financially, is critical for ratings.

Disclosure

Name of Rated Entity	LOTTE Kolson (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 | Food Products(Dec-20)
Rating Analysts	Faiqa Qamar | faiqa.qamar@pacra.com | +92-42-35869504

Profile

Legal Structure Lotte Kolson (Private) Limited (Lotte Kolson or 'the Company') was incorporated in 1975 as a private limited company.

Background The Company was formerly known as KS Sulemanji Esmailiji & Sons (Private) Limited. It was renamed to Lotte Kolson (Private) Limited after it was acquired by Lotte Corporation, a multinational conglomerate headquartered in South Korea, in 2014.

Operations The Company manufactures and sells five product categories, namely, i) Snacks, ii) Biscuits, iii) Pasta, iv) Cakes, and v) Gum. Lotte Kolson's overall capacity utilization was ~57%. Pasta segment had the highest utilization level at ~69% and the pie segment had the lowest utilization at ~8%. Production facilities are located in Karachi, Islamabad and Lahore, whereas, the head office is in Karachi.

Ownership

Ownership Structure Major shareholding of the Company lies with Lotte Confectionery (96.5%). Remaining stake is held by Mr. Dong Bin Shin (3.5%), son of the founder, Mr. Shin Kyuk-Ho, whereas, Mr. Choi Myeong Rim (Chairman), Mr. Abdul Latif (non-executive director) and Mr. Jeung Hoon Lee (executive director) hold one share each.

Stability The Company went through an ownership change as the Group realigned its businesses under a holding company structure. During the period, ownership share of Lotte Corporation (96.5%) was transferred to Lotte Confectionery, its subsidiary.

Business Acumen Lotte Corporation, is a Korean multinational conglomerate, which has business ventures spread across the globe, in addition to having a strong footprint in South Korea and Japan. The Corporation has business interests in food, retail, chemicals, infrastructure and finance, among other areas. Moreover, the Group has established a strong presence in Pakistan and operates in the confectionery, chemical, beverages and construction industries.

Financial Strength The Company is considered to have strong financial strength owing to support from Lotte Confectionery and Lotte Corporation. Additionally, Lotte Corporation is the fifth largest conglomerate in South Korea.

Governance

Board Structure Board of Directors comprises four members that include the Chairman, two executive directors and a non-executive director. The Company lacks representation of independent members on its Board.

Members' Profile Board represents qualified individuals who specialize in retail and production, in addition to confectionery. Mr. Choi Myeong Rim, Chairman of the Board, has over 28 years of experience in the industry and has been associated with the Company's Board for ~1 year.

Board Effectiveness The Company has no Board committees in place. The Board meets twice a year to discuss matters pertaining to current performance and future strategy, with minutes of meetings being captured in a formal manner.

Financial Transparency EY Ford Rhodes & Co., Chartered Accountants are the external auditors of the Company. The auditor has expressed an unqualified opinion on the financial statements for the year ending 31st December, 2020.

Management

Organizational Structure The organizational structure of the Company is split between twelve departments. Some of the major departments are sales, supply chain, production, quality and finance. Each department head reports to the CEO, who in turn, reports to the Chairman. The CFO has additional reporting to Chairman in Korea as CFO is a Korean national and this is required for communication purpose.

Management Team The management team comprises experienced individuals in the retail industry with diversified skills. Mr. Khayyam Rajput, the Chief Executive Officer, holds an MBA and specializes in sales, marketing and general management. He joined the Company in 2018 and has previously worked for multi-nationals. The Company also receives support from Lotte regional plateform in terms of strategy and best practices.

Effectiveness In order to ensure efficient operations, the Company has in place a management committee, which meets twice a month. Meetings are chaired by the CEO and are attended by all functional heads. Purpose of the Committee is to improve coordination in operations while ensuring compliance.

MIS The Company has deployed Oracle 12-C as its Enterprise Resource Planning (ERP) system and operates five modules.

Control Environment The Company has a strong control environment represented by strict quality control measures, with an increased emphasis on hygiene, and an efficient internal audit department. Findings are reported to the CEO, in addition to headquarters in Korea.

Business Risk

Industry Dynamics The confectionery, biscuits and snacks industry in Pakistan is largely dominated by domestic players and is highly price elastic. Distinction among products lies in mass marketing. Pakistan has a large retail base though it is highly fragmented and dominated by small retailers. Post Covid-19, the food industry remain exempted from lockdown implemented by the Government. However, there was a detrimental impact on demand of non-essential food products due to the lockdown as schools and malls remained closed. The measures announced by SBP, including rate cut of 625bps, eased some pressure.

Relative Position The Company has robust brand recognition in the snacks industry with its flagship product 'Slanty'. However, 'Lays' remains clear market leader in the segment. The Company holds a strong position in the pasta segment, it is yet to establish a notable presence in other product categories.

Revenues The Company's revenue emanates from five product segments which include snacks, biscuits, pasta, cakes and gum, with Slanty contributing over 40% of the total revenue. Utilization of the Company's Choco Pie plant remains low due to slow pick up of the product despite aggressive marketing campaigns. During CY20, the revenue of the Company remained stagnant and stood at ~PKR 11.9bln (CY19: ~PKR 11.8bln). Growth of the Company suffered owing to contraction of consumer demand during the outgoing year due to closure of schools and malls to counter Covid-19. In 1QCY21, the top-line of the Company increased to ~PKR 2.8bln (1QCY20: ~PKR 2.6bln). The Company expects better demand with the easing of lockdown.

Margins During CY20, the gross margin of the Company improved to ~18% (CY19: ~15%) on the back of efficient cost management. This resulted in profit at operating level and operating margin stood at 1% (CY19: -1.3%). Finance cost declined slightly to ~PKR 408mln in CY20 (CY19: ~PKR 423mln). However, the Company reported net loss of ~PKR 421mln (CY19: ~PKR 355mln) with a net margin of -3.5% (CY19: -3%). In 1QCY21, the Company continued to incur losses and reported net loss of ~PKR 64mln with a net margin of -2.3% (1QCY20: -12%).

Sustainability Going forward, the Company has plans to introduce innovative products in the biscuits and pasta segments. Moreover, the Company is also going to add new production lines for those products that have increasing demand which cannot be met due to capacity constraints. These additions are expected to help the Company in sustaining growth in revenues.

Financial Risk

Working Capital Due to its cash based nature, the Company maintained average trade receivable days of 7 days. Inventory days observed a minor improvement to 36 days in CY20 (CY19: 38 days). Moreover, the payable days witnessed no change and stood at 15 days. In accumulation, the net working capital days stood at 28 days (CY19: 28 days). The Company holds sufficient room to borrow against trade assets. In 1QCY21, the net working capital remained stagnant at 28 days owing to efficient working capital management.

Coverages In CY20, the FCFO of the Company improved significantly to ~PKR 1,062mln (CY19: ~PKR 583mln) owing to lower loss before tax compared to the corresponding period. Moreover, the finance cost declined slightly to ~PKR 408mln in CY20 (CY19: ~PKR 423mln). As a result, the interest coverage ratio increased to 2.7x in CY20 (CY19: 1.4x). On the other hand, the core and total coverage observed a minor jump to 0.7x (CY19: 0.4x) and 0.7x (CY19: 0.4x), respectively, due to higher debt repayments. In 1QCY21, the coverages remained at the same level.

Capitalization The Company has a moderately leveraged capital structure with a leveraging ratio of ~32% in CY20 (CY19: ~31%). Leveraging decreased compared to the previous years due to equity injection of ~PKR 1.5bln in CY19 as well as gradual repayment of the Company's long-term loan. The leveraging of the Company is expected to remain stable in near future. In 1QCY21, the leveraging stood at ~31%.

PKR mln

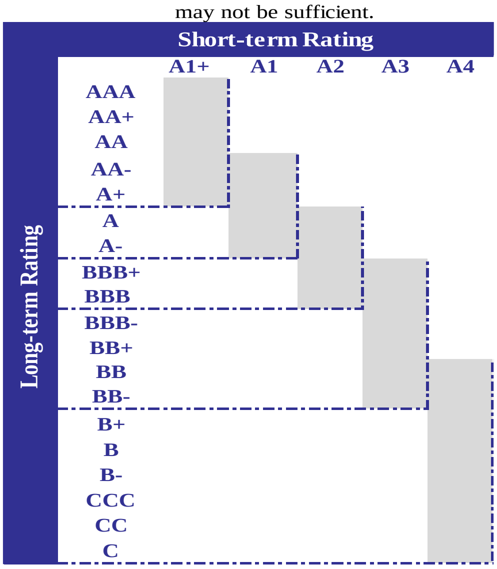
Lotte Kolson (Pvt.) Limited Food Products	Mar-21 3M	Dec-20 12M	Mar-20 3M	Dec-19 12M	Dec-18 12M
A BALANCE SHEET					
1 Non-Current Assets	12,135	12,391	13,009	13,381	10,517
2 Investments	140	140	140	140	140
3 Related Party Exposure	-	-	-	-	-
4 Current Assets	3,071	2,746	3,240	2,983	2,454
a Inventories	*1,282*	*1,021*	*1,545*	*1,339*	*1,149*
b Trade Receivables	*277*	*224*	*238*	*211*	*127*
5 Total Assets	15,346	15,277	16,389	16,504	13,112
6 Current Liabilities	1,495	1,030	1,469	1,280	1,571
a Trade Payables	*579*	*525*	*547*	*461*	*566*
7 Borrowings	4,029	4,298	4,410	4,367	5,396
8 Related Party Exposure	276	250	401	338	415
9 Non-Current Liabilities	459	527	735	733	86
10 Net Assets	9,086	9,172	9,374	9,787	5,643
11 Shareholders' Equity	9,086	9,172	9,374	9,787	5,643
B INCOME STATEMENT					
1 Sales	2,804	11,891	2,614	11,826	11,434
a Cost of Good Sold	*(2,343)*	*(9,749)*	*(2,282)*	*(10,012)*	*(9,368)*
2 Gross Profit	461	2,142	333	1,814	2,065
a Operating Expenses	(508)	(2,023)	(480)	(1,973)	(2,216)
3 Operating Profit	(46)	119	(148)	(160)	(151)
a Non Operating Income or (Expense)	*19*	*(11)*	*(23)*	*(17)*	*(119)*
4 Profit or (Loss) before Interest and Tax	(28)	108	(170)	(177)	(270)
a Total Finance Cost	*(85)*	*(408)*	*(96)*	*(423)*	*(350)*
b Taxation	*49*	*(122)*	*(47)*	*245*	*598*
6 Net Income Or (Loss)	(64)	(421)	(314)	(355)	(22)
C CASH FLOW STATEMENT					
a Free Cash Flows from Operations (FCFO)	*228*	*1,062*	*27*	*583*	*497*
b Net Cash from Operating Activities before Working Capital Changes	*132*	*653*	*(91)*	*146*	*177*
c Changes in Working Capital	*(116)*	*(25)*	*64*	*(668)*	*72*
1 Net Cash provided by Operating Activities	16	629	(27)	(521)	249
2 Net Cash (Used in) or Available From Investing Activities	(19)	(154)	(24)	(42)	(1,046)
3 Net Cash (Used in) or Available From Financing Activities	(269)	(285)	43	479	731
4 Net Cash generated or (Used) during the period	(273)	190	(7)	(85)	(66)
D RATIO ANALYSIS					
1 Performance					
a Sales Growth (for the period)	-5.7%	0.6%	-11.6%	3.4%	9.4%
b Gross Profit Margin	16.4%	18.0%	12.7%	15.3%	18.1%
c Net Profit Margin	-2.3%	-3.5%	-12.0%	-3.0%	-0.2%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	4.0%	8.7%	3.5%	-0.7%	5.0%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Sh*	-2.8%	-4.4%	-13.3%	-4.0%	-0.4%
2 Working Capital Management					
a Gross Working Capital (Average Days)	46	43	58	44	35
b Net Working Capital (Average Days)	28	28	41	28	8
c Current Ratio (Current Assets / Current Liabilities)	2.1	2.7	2.2	2.3	1.6
3 Coverages					
a EBITDA / Finance Cost	3.2	3.1	1.3	2.2	2.3
b FCFO / Finance Cost+CMLTB+Excess STB	0.6	0.7	0.1	0.4	0.4
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	6.9	6.4	-14.9	23.0	31.6
4 Capital Structure					
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	30.7%	31.9%	32.0%	30.9%	48.9%
b Interest or Markup Payable (Days)	3.8	3.0	15.0	12.5	18.6
c Entity Average Borrowing Rate	7.8%	9.1%	8.2%	8.6%	6.5%

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.

Long-term Rating	
Scale	**Definition**
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 Rating	
Scale	**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
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 surveill 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):

Entities
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

Instruments
a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating

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