The Pakistan Credit Rating Agency Limited

Rating Report

Nagina Cotton Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
23-Nov-2018	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflects Nagina Cototn Mills Limited's improving business profile in harmonization with textile industry dynamics. The company's revenues are on growing trajectory over the years, a factor of continuous BMR translating into operational efficiencies, eventually higher production volumes. Textile industry in general and spinning industry in particular suffer from low international commodity prices and high cost of doing business in Pakistan. Moreover, re-imposition of custom duties and sales tax on cotton & yarn imports, coupled with increasing interest rates has stretched the textile industry. On standalone basis, the rupee devaluation has provided a requisite breather to the company to sustain its business margins, despite declining exports share. Leveraging of the company has increased owing to debt-driven BMR; though remaines modest. Working capital cycle is stretched on the back of higher inventory procurement. Meanwhile, Nagina Cotton intends to gradually build a sizable investment portfolio. This exposes the company to market risk as exhibited by recent volatility in stock exchange. However, the company was able to limit its losses, as a result of conservative approach in stock allocation. Any significant decline in investments leading to losses, and eventually equity erosion, will impact the financial profile of the company. The management's ability to manage this risk is critical. The assigned ratings derive comfort from Nagina Cotton's association with Nagina Group.

The ratings are dependent on the company's ability to sustain its business profile. The sufficient cash generation to fulfill the increasing financial obligations remain critical for the ratings. At the same time, prudent management of investment portfolio is important.

Disclosure

Name of Rated Entity	Nagina Cotton Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-18),Methodology | Criteria | Rating Modifier(Jun-18),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study | Textile(Oct-18)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Nagina Cotton Mills Limited (Nagina Cotton) was incorporated in 1967 as a public limited company. Nagina Cotton has a spinning unit engaged in the production and sale of yarn.

Background Nagina Cotton is the pioneer of Nagina Group, the Group has emerged overtime in textile and real estate business.

Operations Nagina Cotton's current operational capacity comprises 53,748 Spindles. The total energy requirement of the company clocks in at ~6.4MW which can be 100% met through captive plant. Furthermore, the company has a HESCO connection as backup.

Ownership

Ownership Structure Nagina Cotton is majorly (~87%) owned by Nagina Group, through group companies and sponsoring individuals, followed by financial institutions (~2%) and the remaining stake rest with general public.

Stability The considerable positions in Nagina Group are held by Ellahi Family. The Group has a structured line of succession, however the transfer of ownership is yet to be seen. Third genration has already been in business, serving at various capacities.

Business Acumen Nagina Group – one of the oldest medium-sized textile houses in Pakistan. Operating under Ellahi's for over five decades, developing credential expertise in spinning and weaving. However, the growth was limited but the Group sustained through the volatility of textile industry.

Financial Strength Nagina Group has interest in textile and real estate through its group companies, comprising three listed public limited companies – Ellcot Spinning Mills, Prosperity Weaving Mills, and Nagina Cotton Mills Limited and six private limited companies. The sponsors have enough financial strength to support business, if required.

Governance

Board Structure Nagina Cotton's board constitutes nine members out of which five are non-executive, three occupy executive roles – including the CEO and CFO, while there is one independent director. Dominance of sponsors on board along with control over key management positions increases the board efficiency.

Members' Profile Mr. Shahzada Ellahi Shaikh – the Chairman, holds a bachelor's degree in Economics and International Relations. The board member carries vast knowledge and extensive experience of textile industry, though diversity in experiences also exists. The directors' expertise in textile sector benefits the board in efficient decision making.

Board Effectiveness Three committees: Audit, Executive and Human Resource & Remuneration, are in place to assist the board in relevant matters and ensure proper oversight. Attendance of board members in meetings remained strong and meeting minutes were appropriately documented.

Financial Transparency M/s. Deloitte Yousaf Adil, Chartered Accountants is the external auditor of the company. The auditors have expressed unqualified opinion on the financial reports for the year ended 30th June, 2018.

Management

Organizational Structure Management control vests with Ellahi Family, with well-defined reporting line to ensure smooth operations and excellence. Also, daily morning meetings are held to make opinion on cotton prices, eventually ensuring prudent inventory procurement.

Management Team The management team is headed by the CEO Mr. Shaukat Ellahi who holds a graduate degree from Colombia University, in Economics and Political Science. Mr. Shaukat Ellahi is associated with Nagina Cotton since its inception, he is well verse with the textile business and has strong business acumen. He is supported by a team of seasoned professionals, supplementing his expertise.

Effectiveness The management meetings are held on daily basis with follow-up points to resolve or pro-actively address operational issues, if any, eventually ensuring smooth flow of operations. Moreover, the daily and weekly reporting for top management majorly includes reports on production and liquidity position. Whereas, on monthly basis company's P&L is presented and discussed in the meeting.

MIS Nagina Cotton has in place Oracle based Enterprise Resource Planning (ERP) system that provides comprehensive MIS reporting.

Control Environment The company is compliant with multiple safety and quality assurance standards; majorly including ISO 9001:2008, Standard 100 by OEKO-TEX, Global Organic Textile Standards (GOTS), Organic Content Standard, Organic Content Standard 100 certifications.

Business Risk

Industry Dynamics During FY18, total textile exports of Pakistan stood at USD ~ 13.53bln, a 9% YoY growth. Re-imposition of custom duty and sales tax on cotton imports in FY19 budget, coupled with exclusion of tax rebate on yarn and greige fabric has further stretched the industry margins. However, rupee devaluation in recent times provide breather to textile ventures with net exports.

Relative Position Nagina Cotton is associated with Nagina Group, the Group maintains considerable position in Pakistan's spinning and weaving sector with (spindles 140,676 and looms 324), consequently strengthening Nagina Cotton's market position. However, on standalone basis Nagina Cotton's share in local spinning industry is minimal.

Revenues During FY18, company's revenues grew by 12% YoY to ~PKR 5,879mln (FY17: ~PKR 5,242mln) in line with the industry. The company's sale mix has shifted towards local sales ~49% (FY17: 37%), due to better pricing in local market. With regard to export revenues, Asian region remained the key market with ~88% (China ~54% and Bangladesh ~34%) share in exports. In the domestic market, top ten customer concentration is high (~52%), though it has fallen drastically as compared to previous year (FY17: 97%).

Margins The company's gross margins improved (FY18: 8.7%, FY17: 6.7%), due to lower than proportionate increase in cost of sales (~9.7%). This can be attributable to prudent inventory procurement and constant BMR activities in recent years, followed by better operating margins (FY18: 5.1%, FY17: 2.6%). The finance costs increased by ~82%, as a result of higher STB. While, the company received dividend income of PKR 31mln, providing comforts to its bottom line. Resultantly, net profitability increased to (FY18: ~PKR 158mln, FY17: ~PKR 78mln), posting a growth of ~102%.

Sustainability The company has incurred BMR of almost PKR 550mln to increase operational efficiencies, a key factor in order to improve margins in stretched textile industry. Going forward, the company is planning a BMR of PKR 1.8bln (sanctioned through LTFF), comprising 18,000 spindles, which includes addition in capacity and replacement of obsolete spindles with latest RX300 spindles.

Financial Risk

Working Capital The company meets its working capital requirements through a mix of internal cash generation and short term borrowings. The company's reliance on STB has significantly increased (FY18: PKR 1,362mln, FY17: PKR 310mln), on the back of higher inventory procurement. At the same time, STB remains well covered when compared to net trade assets (FY18: 43%, FY17: 78%), portraying a sufficient room to borrow. Meanwhile, the considerable increase in receivable days (FY18: 44days, FY17, 27days), lead to higher working capital days (gross - FY18: 110days, FY17, 81days, net - FY18: 106days, FY17 77days); though remain strong.

Coverages During FY18, the company's operating cash flows (FCFO) increased by ~68% (FY18: PKR 394mln, FY17: PKR 234mln) – largely due to improved profitability. However, the interest expense almost doubled, resulting in slightly deteriorated interest coverage (FY18: 3.4x, FY17: 3.6x); though remains adequate and debt coverage marginally improved (FY18: 1.5x, FY17: 1.3x). Going forward, the rise in intrest rate may stretch the company's coverages.

Capitalization Nagina Cotton has a intermediately leveraged capital structure (~53.7%) at end-June18 (end-June17: 41%). Total debt stood at PKR 2,169mln, mainly comprising current debt ~ 69.5%.

PKR mln

Nagina Cotton Mills Limited

BALANCE SHEET	30-Jun-18	30-Jun-17	30-Jun-16
	FY18	FY17	FY16
Non-Current Assets	**1,440**	**1,555**	**1,441**
Investments (incl. Associates)	**661**	**549**	**284**
Equity	447	535	120
Debt Securities (incl. income funds)	200	-	150
Investment Property	14	15	14
Current Assets	**2,830**	**1,553**	**1,332**
Trade Receivables	954	455	330
Others	934	381	278
Total Assets	**4,931**	**3,657**	**3,057**
Debt/Borrowings	**2,169**	**1,216**	**826**
Short-Term	1,362	310	112
Long-Term (incl. Current Maturity of Long-Term Debt)	807	905	715
Other Short-Term Liabilities	795	600	439
Other Long-Term Liabilities	100	85	75
Shareholder's Equity	**1,867**	**1,756**	**1,718**
Total Liabilities & Equity	**4,931**	**3,657**	**3,057**
INCOME STATEMENT			
Turnover	**5,879**	**5,242**	**4,268**
Gross Profit	514	353	151
Operating Expenses	(216)	(214)	(188)
Operating Profit	298	139	(37)
Other Expenses/Income	43	36	39
Financial Charges	(117)	(64)	(66)
Net Income	**158**	**78**	**(93)**
Cash Flow Statement			
Free Cash Flows from Operations (FCFO)	394	234	51
Net Cash changes in Working Capital	(778)	(49)	(414)
Net Cash from Operating Activities	(432)	153	(406)
Net Cash from InvestingActivities	(167)	(539)	90
Net Cash from Financing Activities	898	371	264
Net Cash generated during the period	300	(15)	(53)
Ratio Analysis			
Performance			
Turnover Growth (v.s same period last year)	12.1%	22.8%	-87.2%
Gross Margin	8.7%	6.7%	3.5%
Net Margin	2.7%	1.5%	-2.2%
ROE	2.3%	4.5%	-2.1%
Coverages			
Debt Service Coverage (times) (FCFO/Gross Interest+CMLTD+Uncovered STB)	1.5	1.3	0.3
Interest Coverage (times) (FCFO/Gross Interest)	3.4	3.6	0.8
Debt Payback (Total LT Debt Including Uncovered Total STBs) / (FCFO - Gross Interest	2.9	5.3	-45.8
Liquidity			
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	106	77	88
Leveraging (Total Debt/Total Debt+Equity)	53.7%	40.9%	32.5%

Rating Scale

Credit Rating Scale & Definitions

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

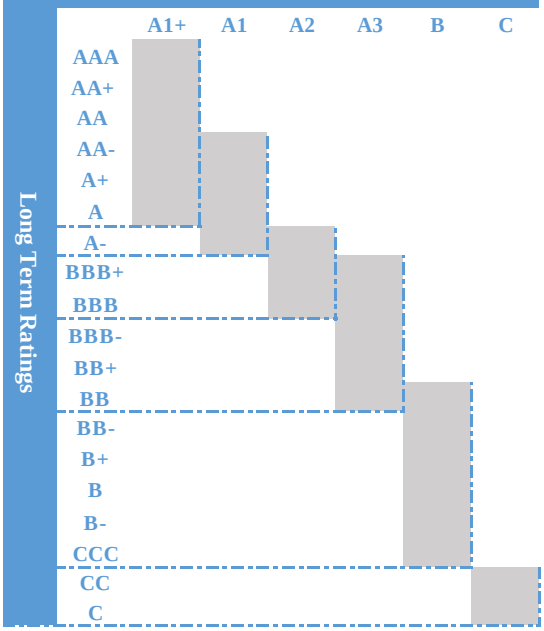
Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings

A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.

Short Term Ratings



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.

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