The Pakistan Credit Rating Agency Limited

Rating Report

Sargodha Jute Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
30-Oct-2019	A-	A2	Stable	Maintain	-
30-Apr-2019	A-	A2	Stable	Maintain	-
20-Dec-2018	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflect Sargodha Jute Mills Limited’s strong profile in jute industry emanating from robust market share and margins. Pakistan's jute industry depends 100% on raw jute imports from Bangladesh. The prices of raw jute fluctuate in the international market and have been on a rising trend lately. This, coupled with devaluation of rupee in FY19, has increased the cost of raw material for the industry. The company was able to pass on these increased costs to consumers. The gross margins of the company improved in FY19 as management had purchased raw material earlier in anticipation of higher prices. The higher jute product prices impacted demand as the top-line declined by ~20% in FY19. The top-line growth is expected to remain subdued in FY20 due to imposition of sales tax and condition of CNIC for purchasers, going forward. The margins of the company may come under pressure as the volumes contract and further increase in costs is passed to an extant. The capital structure of the company is moderately leveraged comprising short-term borrowings only. The coverages of the company came under pressure due to significant increase in finance cost on the back of higher benchmark rate. The company manages its working capital adequately with cushion at trade level available. The ratings also incorporate strong financial strength of sponsoring family.

The ratings are dependent on the company's ability to maintain its revenues and margins. At the same time, diversification in top-line and products is critical. Substantial decrease of margins leading to lower profitability and/or deterioration in coverages will have implications on the ratings.

Disclosure	
Name of Rated Entity	Sargodha Jute Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-19),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-19),Criteria | Rating Modifier(Jun-19)
Related Research	Sector Study | Jute(Dec-18)
Rating Analysts	Ateeb Riaz | ateeb.riaz@pacra.com | +92-42-35869504

Profile

Legal Structure Sargodha Jute Mills Limited (Sargodha Jute or the Company) was incorporated in Pakistan on February 10, 1981, as an unlisted Public Limited Company under the repealed Companies Act, 1913 (now the Companies Act, 2017).

Background The Company was established in 1981 by Mian Muhammad Aslam (late). The group had twelve textile mills, one jute mill and one sugar mill. Later on, the operations of Sargodha Jute were handed over to Mian Parvez Alsam son of Mian Muhammad Aslam. Business started with annual production of 5,000 metric tons in 1984 and over a period, with expansion and improvement in operating systems, the mill has been able to achieve annual production of ~30,500 metric tons.

Operations The principal activity of the Company is manufacturing, selling and dealing in jute products while using latest machinery. The jute product portfolio of the Company includes yarn, hessian cloth, sacking bags and twines.

Ownership

Ownership Structure Mr. Parvez Aslam and his family members collectively own majority (~75%) shares of the Company. Mr. Irfan Aslam and Mr. Imran Aslam, sons of Mr. Parvez Aslam, each own ~28% shares of the Company. The remaining shareholding of the Company is held by associate Company, Shahzad Textile Mills Limited (25%).

Stability There is no formal succession plan but the ownership of shares and business roles are equally divided between the two brothers (Mr. Imran Aslam and Mr. Irfan Aslam), sons of Mr. Parvez Aslam. Mr. Irfan Aslam is CEO of Sargodha Jute Mills Limited and Mr. Imran Aslam is CEO of Shahzad Textile Mills Limited. However, documentation of succession planning or formation of a holding company will bode well for the Company's stability.

Business Acumen Mr. Irfan Aslam is the CEO of Sargodha Jute and is looking after the Company’s operations for more than two decades. His ability to take strategic decisions and seize opportunities on the right time has kept the entity on the right track.

Financial Strength Mr. Irfan Aslam has 25% shareholding in his associate company Shahzad Textile Mills Limited. Shahzad Textile’s net assets are worth ~PKR 2bln. Moreover, on personal level he is an active investor in real estate, stock market and foreign exchange market. The net worth of assets in personal possession of Mr.Irfan Aslam is ~PKR 1bln. So the entity can get timely support from its sponsors, if needed.

Governance

Board Structure The board of the Company consists of only three members, out of which two are from the sponsoring family. Mr. Irfan (CEO) and Mr. Ahsan (COO) are the two executive directors. Mr. Imran (Chairman) is the non-executive director.

Members’ Profile Mr. Irfan Aslam has more than two decades of experience in jute business and is a foreign university graduate. Mr. Imran Aslam is in textile business and is CEO of Shahzad Textile Mills Limited. Ahsan Ahmad Khan - COO Sargodha Jute Mills - has 27 years of working experience with Sargodha group.

Board Effectiveness The effectiveness of the board is being compromised due to the size of the board and domination by the sponsoring family. Secondly, board meetings are done on "as and when needed" basis. Absence of independent directors and board committees does not bodes well with board's effectiveness.

Financial Transparency The external auditors of the Company are M/s Horwath Hussain Chaudhry & Co., Chartered Accountants. They expressed an unqualified opinion on the Company’s annual financial statements for the year ended June 30, 2019. State Bank of Pakistan has classified them in “Category-A” on its panel of auditors.

Management

Organizational Structure The organizational structure of the Company is currently divided into two main divisions, Head Office and Mills. The CFO reports to the CEO while the purchase manager and general manager commercial from Head Office and mill managers from the mill all report to COO of the Company Mr. Ahsan Ahmad Khan.

Management Team Mr. Irfan Aslam (CEO) holds the authority to take strategic decisions. Second supporting hand of the Company is Ahsan Ahmad Khan (COO). He has vast experience in jute business and is responsible for day to day operations.

Effectiveness The Company has an adequate IT infrastructure and related controls. The Company maintains a comprehensive MIS reporting system to keep track of activities including a range of reports on cash position, receivable position, payable position, production, inventory status reports and segment wise profit & loss.

MIS Sargodha Jute Mills uses oracle based ERP system by the name of Wizmen. Regular reporting of sales figures, raw materials positions, payables, receivables and income statement on monthly basis is shared with the top management.

Control Environment The Company is ISO 9001-2015 certified. In the presence of quality management system, the Company has established Quality Control department which regularly conducts quality control activities at every stage of the production process

Business Risk

Industry Dynamics Pakistan’s jute industry depends 100% on the imported raw jute as the country is not self-sufficient in growing this rare commodity. Total quantity of jute imported in FY19 was ~68,000 MT (FY18: ~88,000 MT and FY17: ~67,000 MT). The jute industry is in the mature stage and therefore stable growth (5-8%) is expected, going forward.

Relative Position There are only a handful of companies operating jute industry. Sargodha Jute has the second largest market share in the industry with almost 40% share. Thal Jute Mills is another main player and holds ~40% market share. The remaining 20% is divided between White Pearl Jute Mills, Indus Jute and Madina Jute. Installed capacity of the Company is currently 30,500 MT, whereas, installed capacity of Thal Jute is 33,800 MT.

Revenues Sargodha Jute’s revenues come from four main product categories (sacking bags, hessian cloth, twines and yarn). Sacking bags have major contribution of ~44% in revenues of the Company, followed by hessian ~22%, twines ~15% and yarn ~9%. The remaining ~10% comprises of hessian bags and sacking cloth. The Company’s revenue for FY19 declined by ~20% and clocked in at PKR 3,061mln (FY18: PKR 3,803mln). Currency devaluation increased the cost of raw materials. Although the Company was able to pass on this increase in cost, buyers responded unfavorably to price hikes and the Company saw a volumetric decline in sales.

Margins The Company’s gross profit for the year stood at PKR 465mln (FY18: PKR 499mln) and the gross profit margin increased to 15.2% (FY18: 13.1%) as the management had procured raw material earlier at lower cost. The operating profit margin increased to 10.5% (FY18: 8.9%) as a result of better cost management. The net profit for FY19 clocked in at PKR 87mln (FY18: PKR 115mln). The net profit margin dropped to 2.9% from 3.0% in FY19. The reduction in net profit margin was a result of higher finance costs (FY19: PKR 150mln, FY18: PKR 88mln) on the back of increasing benchmark rate.

Sustainability Sargodha Jute does not plan any further expansion in near future as Jute industry is already reached its maturity level. The demand for jute products is expected to remain subdued due to higher prices and imposition of 17% on local sales.

Financial Risk

Working Capital In FY19, gross working capital days increased to 170 days (FY18: 134 days). This was due to increase in inventory days (FY19: 123 days, FY18: 109 days) and trade receivable days (FY19: 46 days, FY18: 25 days). Trade receivable days increased due to the government’s CNIC regulations, which caused traders to buy from the Company in bulk in June. Net working capital days increased to 166 days in FY19 (FY18: 130 days). The Company’s trade leverage cushion increased to 10.8% (FY18: 4.9%) as a result of decrease in short term borrowings (FY19: PKR 1,116mln, FY18: PKR 1,461mln). Thus increasing the Company’s room to borrow to PKR 139mln in FY19 (FY18: PKR 78mln).

Coverages During FY19, the Company's cashflows increased slightly to PKR 283mln (FY18: PKR 274mln). Even though the Company’s total borrowings decreased to PKR 1,132mln (FY18: PKR 1,546mln), total finance costs increased significantly (FY19: PKR 153mln, FY18: PKR 92mln) on the back of higher benchmark rate. As a result, the interest coverage ratio for the year dropped to 1.9x (FY18: 3.1x) and the debt coverage ratio dropped to 1.8x (FY18: 2.8x).

Capitalization The Company’s capital structure is moderately leveraged and declined during the year (FY19: 43.3%, FY18: 52.1%). Total borrowings of the Company decreased to PKR 1,132mln (FY18: PKR 1,546mln). Short term borrowings also declined (FY19: PKR 1,116mln, FY18: PKR 1,461mln). Short term borrowings constitute 98.5% to the total amount of borrowings.

The Pakistan Credit Rating Agency Limited

Sargodha Jute Mills Limited Jute	Jun-19 12M	Jun-18 12M	Jun-17 12M
A BALANCE SHEET			
1 Non-Current Assets	1,173	1,158	1,060
2 Investments	318	359	335
3 Related Party Exposure	1	1	1
4 Current Assets	1,739	2,099	1,583
a Inventories	*859*	*1,209*	*1,057*
b Trade Receivables	*408*	*370*	*151*
5 Total Assets	3,230	3,616	2,979
6 Current Liabilities	441	474	433
a Trade Payables	*29*	*34*	*48*
7 Borrowings	1,132	1,546	962
8 Related Party Exposure	-	-	-
9 Non-Current Liabilities	172	175	184
10 Net Assets	1,484	1,421	1,400
11 Shareholders' Equity	1,484	1,421	1,400
B INCOME STATEMENT			
1 Sales	3,061	3,803	3,333
a Cost of Good Sold	*(2,595)*	*(3,304)*	*(3,176)*
2 Gross Profit	465	499	157
a Operating Expenses	(144)	(161)	(146)
3 Operating Profit	321	338	11
a Non Operating Income	*(41)*	*(72)*	*(2)*
4 Profit or (Loss) before Interest and Tax	280	266	9
a Total Finance Cost	*(153)*	*(92)*	*(107)*
b Taxation	*(40)*	*(59)*	*(37)*
6 Net Income Or (Loss)	87	115	(135)
C CASH FLOW STATEMENT			
a Free Cash Flows from Operations (FCFO)	*283*	*274*	*(29)*
b Net Cash from Operating Activities before Working Capital Changes	*148*	*203*	*(79)*
c Changes in Working Capital	*325*	*(390)*	*(397)*
1 Net Cash provided by Operating Activities	473	(187)	(475)
2 Net Cash (Used in) or Available From Investing Activities	(47)	(95)	(105)
3 Net Cash (Used in) or Available From Financing Activities	(414)	519	563
4 Net Cash generated or (Used) during the period	12	237	(18)
D RATIO ANALYSIS			
1 Performance			
a Sales Growth (for the period)	-19.5%	14.1%	--
b Gross Profit Margin	15.2%	13.1%	4.7%
c Net Profit Margin	2.9%	3.0%	-4.1%
d Cash Conversion Efficiency (EBITDA/Sales)	12.4%	9.2%	0.8%
e Return on Equity (ROE)	6.0%	8.1%	-9.6%
2 Working Capital Management			
a Gross Working Capital (Average Days)	170	134	132
b Net Working Capital (Average Days)	166	130	127
c Current Ratio (Total Current Assets/Total Current Liabilities)	3.9	4.4	3.7
3 Coverages			
a EBITDA / Finance Cost	2.5	4.0	0.3
b FCFO / Finance Cost+CMLTB+Excess STB	1.8	2.8	-0.3
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	0.1	0.5	0.0
4 Capital Structure (Total Debt/Total Debt+Equity)			
a Total Borrowings / Total Borrowings+Equity	43.3%	52.1%	40.7%
b Short-Term Borrowings / Total Borrowings	1.0	0.9	1.0
c Average Borrowing Rate	11.2%	7.0%	10.6%

Rating Scale | Corporate

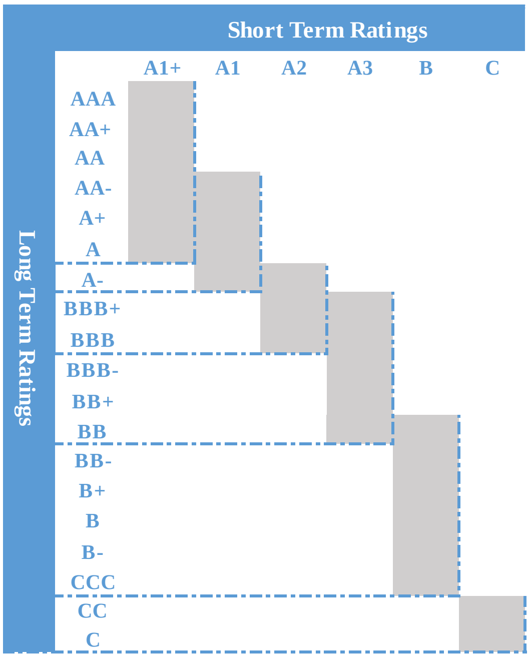
2019

Credit Rating Scale & Definitions

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

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

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



Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Regulatory and Supplementary Disclosure

(Credit Rating Companies Regulations,2016)

Rating Team Statements

(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**

i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)

ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)

iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions

(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)

(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)

(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business

(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)

(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.

(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)

(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)

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

(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest

(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity

(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)

(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)

(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)

(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)

(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review

(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)

(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)

(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)

(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)

Probability of Default

(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)

Proprietary Information