The Pakistan Credit Rating Agency Limited

Rating Report

Zahidjee Textile Mills Limited

Report Contents

1. Rating Analysis
2. Financial Information
3. Rating Scale
4. Regulatory and Supplementary Disclosure

Rating History

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

Rating Rationale and Key Rating Drivers

The ratings reflect the growing business profile of Zahidjee Textile. The Company mainly operates in the spinning segment, followed by a weaving unit. Continuous expansion and BMR activities have led to significant growth in operations in recent years. Meanwhile, full operations of recently completed spinning unit, complimented by the currency devaluation, have benefited the Company’s topline while margins remain in line with industry peers. The Company's financial risk profile remains strong, characterized by rising cash flows and, in turn, strong coverages, driven by augmented profitability. Excess cash has been utilized for partial retirement of debt, keeping leveraging at modest levels. Borrowing at concessionary SBP rates has also provided some respite in rising interest rate environment. Going forward, the Company aims to undertake further expansion into spinning, financed through a mix of internal and external sources. Recent induction of independent directors on the Board has improved governance structure.

The ratings are dependent on sustaining business margins as well as strong coverages and financial profile. Meanwhile, management of debt levels during upcoming capacity expansion is considered important. Going forward, buildup of a non-core income stream will have positive implications on ratings along with better governance framework.

Disclosure	
Name of Rated Entity	Zahidjee Textile 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 | Spinning(Sep-19)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Zahidjee Textile Mills Limited (Zahidjee Textile) is a listed, public limited concern incorporated in 1990.

Background Zahidjee Textile was established in 1990 when Mr. Muhammad Sharif, Chairman of the Company, purchased a sick spinning concern in Faisalabad and renamed it to Zahidjee Textile Mills Limited. Gradually, the Company was expanded by setting up additional spindles as well as a weaving unit.

Operations The Company is primarily engaged in the production and sale of cotton and blended (Poly cotton) yarns, greige fabric and processed fabric and captive power generation with an installed capacity of ~13.5MW. Production facilities are situated at three different locations in Faisalabad.

Ownership

Ownership Structure The Zahid family directly holds ~96% stake in the Company. During FY19, Mr. Zahid transferred a portion of his shareholding to his son, Mr. Ahmad Zahid, taking their respective shareholdings to ~73% and ~22% (FY18: ~83% and ~12%).

Stability Though there is no formal succession plan, it is decided that Mr. Ahmad Zahid will be the successor. Going forward, this is expected to reflect in the pattern of shareholding with further increase in Mr. Ahmad Zahid's stake, while Mr. Zahid will remain the largest shareholder.

Business Acumen The Zahid family has over four decades of experience in textile trading and manufacturing. In addition, the family has interests in investment banking.

Financial Strength The Zahid family also owns Zahidjee Towers (Pvt.) Limited along with a number of real estate properties at prime locations in Lahore and Faisalabad. The sponsor has shown willingness and ability to support the business if the need arises.

Governance

Board Structure Zahidjee Textile's Board of Directors comprises seven members and is Chaired by Mr. Muhammad Sharif. During FY19, the Company restructured its Board, replacing some family members with independent directors. The Board now comprises four members of the sponsor family and three independent members.

Members' Profile Mr. Muhammad Sharif has over five decades of experience in yarn trading. Of the recently inducted directors, one is Mr. Sharif's son, Mr. Ahmad Zahid, while the two independent directors each possess over twenty years of experience in textile and diversified sectors including chemicals and electronic appliances.

Board Effectiveness Board meetings have full attendance of directors, boding well for the Board's effectiveness. Meanwhile, quality of discussion disclosed in meeting minutes has room for improvement.

Financial Transparency RSM Avais Hyder Liaquat Nauman Chartered Accountants is the external auditor of the Company, placed in category "B" on the State Bank's panel of auditors. The auditor has expressed an unqualified opinion on the financial statements of the company for the year ended June 30th, 2019.

Management

Organizational Structure Zahidjee Textile has a lean organizational structure, divided into various departments reporting to the COO, Mst. Ayesha Shehryar, and CFO, Mr. Anwar ul Haq. Departmentalization is done based on the various production units, wherein the Head of each manufacturing and power unit oversees complete functions of their respective units.

Management Team CEO – Mr. Muhammad Zahid – has overall thirty-five years of experience in the textile sector and is actively involved in day-to-day decision making in the Company while Mr. Zahid's daughter, Mst. Ayesha Shehryar, is the Chief Operating Officer. The management team constitutes well experienced, seasoned individuals.

Effectiveness While there are no formal management committees, all Unit Heads report to the CEO daily to discuss day-to-day developments and issues. The Company maintains adequate IT infrastructure and related controls.

MIS Zahidjee Textile has deployed an Oracle based ERP solution – Oracle EBS in 2012. This allows the Company to streamline the flow of information from the dispersed operations and timely decision-making.

Control Environment Daily reports regarding the company's performance are submitted to higher management. Through MIS, the Company is also able to monitor working capital management and exposure to related parties with automated limits and periodic review.

Business Risk

Industry Dynamics Pakistan's textile exports displayed negative YoY growth of ~1% in dollar terms in FY19. While some leading textile categories displayed strong volumetric growth, the hit to unit prices on account of exporters having to share the benefit of the currency depreciation with buyers in the extremely competitive international market, curbed overall growth. Meanwhile, cotton yarn exports witnessed a ~18% decline, driven by falling yarn prices as well as the US-China trade war. Recent economic policies including the reimposition of 10% duty on ginned cotton, removal of zero-rated status of the textile sector and sharp rise in interest rates has pressurized margins of industry players. Meanwhile, cotton production is yet again expected to fall short of the target. This will decidedly result in the need to import 4-5mln bales which, given the current tax structure of imported cotton, is likely to impact margins of textile companies.

Relative Position In FY19, Zahidjee Textile contributed 0.8% to the Country's greige fabric exports. The company is small in size relative to competitors in the spinning sector; however, it has experienced rapid growth in revenues and profitability in recent years, with margins remaining largely in line with industry peers.

Revenues Zahidjee Textile's topline is dominated by pure cotton yarn (~47%), followed by Poly cotton yarn (~37%) and fabrics (~16%). While yarn is completely sold locally, almost all fabric production is exported, mainly to USA and Italy. The Company's topline displayed significant growth of ~30% in FY19, to stand at ~PKR 13.5bln. The growth emanated mainly from: i) strong local demand resulting in volumetric growth in yarn sales, ii) full impact of capacity expansion in spinning and iii) currency devaluation. Meanwhile, the Company's customer concentration in local sales is considered moderate while that in exports is high.

Margins Despite strong revenue growth, gross margin showed modest YoY growth of ~1%, clocking in at ~11% mainly due to higher cost of sales booked as a result of an adjustment in depreciation expense. Meanwhile, operating margin was maintained at ~9% (FY18: ~8%) as operating expenses were largely maintained, depicting operational efficiency. However, the Company's finance cost surged ~74% on account of higher short-term borrowing in 2QFY19 to finance inventory needs post the rise in cotton prices. Nevertheless, the bottomline showed robust growth, clocking in at ~PKR 782mln (FY18: ~PKR 326mln) complimented by a deferred tax reversal while net margin clocked in at ~6% (FY18: ~3%).

Sustainability The Company incurred BMR in FY19, aimed at reducing power costs and is currently in the process of upgrading its weaving segment through the replacement of old looms. These measures are expected to result in improved margins, going forward. The spinning capacity enhancement of FY18 has contributed to high revenue growth. Going forward, the Company is planning installation of more spindles for the manufacturing of finer count yarn which will take total spinning capacity to ~130,000 spindles, to be financed through a mixture of internal and external sources.

Financial Risk

Working Capital Zahidjee Textile's working capital needs emanate from financing inventories and trade receivables for which the company relies on a mix of internal cash flows and short term borrowings. Working capital needs increased seasonally in 2QFY19, resulting in high short-term borrowing, which was largely repaid by the end of FY19. Cash conversion cycle remained stagnant YoY at ~95 days. Meanwhile, the company maintains an ample borrowing cushion at trade assets level.

Coverages During FY19, Zahidjee Textile's free cash flows grew by ~68% to ~PKR 1,666mln, owing to the surge in profitability. While debt-servicing coverage showed a slight YoY decline to stand at 4.4x (FY18: 4.6x), core debt coverage improved to 3.0x in FY19 (FY18: 2.4x) despite an increase in finance cost on account of higher short-term borrowing over the year.

Capitalization The company's leveraging declined YoY to stand at ~42% (FY18: ~48%) as it utilized its free cash flows to retire a significant portion of short-term borrowing while some portion of long-term borrowing was also paid off. In absolute terms, total borrowing amounted to ~PKR 4.2bln in FY19 (FY18: ~PKR 4.7bln), comprising predominantly of STBs (~71%). With planned expansion involving the installation of a new spinning unit to be financed through a debt:equity mix of 60:40, leveraging can be expected to rise, going forward.

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Zahidjee Textile Mills Limited Textile Composite	Jun-19 12M	Jun-18 12M	Jun-17 12M
A BALANCE SHEET			
1 Non-Current Assets	6,089	6,211	5,533
2 Investments	73	88	67
3 Related Party Exposure	360	360	360
4 Current Assets	4,623	4,722	3,189
a Inventories	*2,604*	*2,987*	*1,813*
b Trade Receivables	*1,231*	*972*	*687*
5 Total Assets	11,146	11,381	9,149
6 Current Liabilities	643	936	700
a Trade Payables	*182*	*578*	*422*
7 Borrowings	3,944	4,583	3,015
8 Related Party Exposure	249	139	176
9 Non-Current Liabilities	395	552	417
10 Net Assets	5,915	5,171	4,842
11 Shareholders' Equity	5,915	5,171	4,842
B INCOME STATEMENT			
1 Sales	13,445	10,329	7,968
a Cost of Good Sold	*(11,983)*	*(9,295)*	*(7,160)*
2 Gross Profit	1,462	1,034	809
a Operating Expenses	(247)	(244)	(191)
3 Operating Profit	1,215	790	617
a Non Operating Income	*(82)*	*9*	*4*
4 Profit or (Loss) before Interest and Tax	1,133	799	621
a Total Finance Cost	*(389)*	*(224)*	*(207)*
b Taxation	*37*	*(249)*	*(197)*
6 Net Income Or (Loss)	782	326	217
C CASH FLOW STATEMENT			
a Free Cash Flows from Operations (FCFO)	*1,666*	*991*	*729*
b Net Cash from Operating Activities before Working Capital Changes	*1,305*	*768*	*539*
c Changes in Working Capital	*(199)*	*(1,398)*	*(802)*
1 Net Cash provided by Operating Activities	1,106	(629)	(263)
2 Net Cash (Used in) or Available From Investing Activities	(451)	(934)	(137)
3 Net Cash (Used in) or Available From Financing Activities	(596)	1,531	392
4 Net Cash generated or (Used) during the period	59	(32)	(9)
D RATIO ANALYSIS			
1 Performance			
a Sales Growth (for the period)	30.2%	29.6%	18.9%
b Gross Profit Margin	10.9%	10.0%	10.1%
c Net Profit Margin	5.8%	3.2%	2.7%
d Cash Conversion Efficiency (EBITDA/Sales)	12.9%	10.2%	10.1%
e Return on Equity (ROE)	14.1%	6.5%	4.9%
2 Working Capital Management			
a Gross Working Capital (Average Days)	106	114	95
b Net Working Capital (Average Days)	95	96	76
c Current Ratio (Total Current Assets/Total Current Liabilities)	7.2	5.0	4.6
3 Coverages			
a EBITDA / Finance Cost	4.6	4.8	4.0
b FCFO / Finance Cost+CMLTB+Excess STB	3.0	2.4	1.5
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	1.0	1.6	1.5
4 Capital Structure (Total Debt/Total Debt+Equity)			
a Total Borrowings / Total Borrowings+Equity	41.5%	47.7%	39.7%
b Short-Term Borrowings / Total Borrowings	0.7	73%	76%
c Average Borrowing Rate	8.4%	5.5%	6.7%

Rating Scale | Corporate

2019

Credit Rating Scale & Definitions

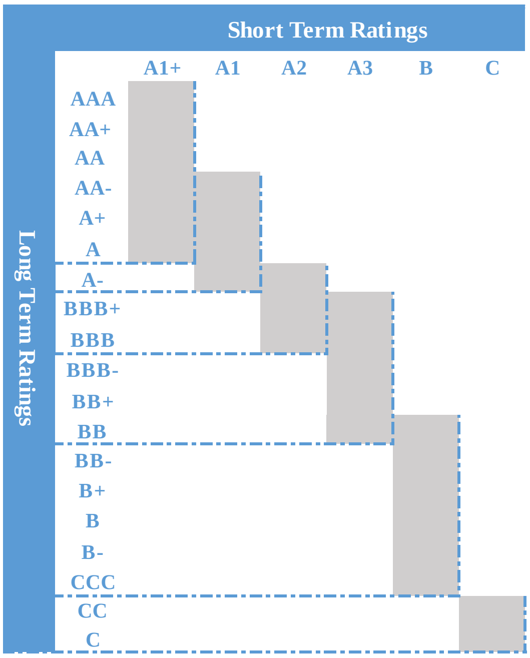
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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