The Pakistan Credit Rating Agency Limited

Rating Report

Shahzad Textile Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
30-Apr-2020	BBB+	A2	Stable	Maintain	YES
30-Oct-2019	BBB+	A2	Stable	Maintain	-
30-Apr-2019	BBB+	A2	Stable	Maintain	-
27-Dec-2018	BBB+	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

Shahzad Textile Mills Limited - a public listed company - manufactures ring spun cotton yarn and synthetic blended yarns. Meanwhile, the Company has also added Socks to its product profile. The ratings reflect the Company’s modest, albeit improving business profile. Recent rationalization of yarn capacity and addition of sock manufacturing unit are expected to bring efficiency and growth as the Company moves into value added segment. The revenue and margins of the Company decreased on comparable basis as the outdated unit no. 3 was phased out. The new sock unit is now operational and is expected to supplement revenues. The profitability of the Company remained low as exports suffered from lower demand for cotton yarn owing to the US-China trade war. The Company's maintains a low-leveraged capital structure, strong coverages and lean working capital cycles. Although these indicators have suffered due to lower sales and profitability but remain robust.
The Rating Watch signifies the prevailing uncertainty due to the outbreak of COVID-19 pandemic. This has impacted the entire textile chain as demand contracts due to shutdown in domestic and global markets and tough economic conditions. Recent SBP measures will provide some respite in this regard. The Company’s production facilities have been shut down in line with the provincial Government’s directive of lockdown, with the exception of sock manufacturing unit as it has verified export orders. PACRA is closely monitoring the situation and will take rating action accordingly.

The ratings depend on sustaining operations and resumption of production activities. Maintaining business margins post-expansion into socks manufacturing is important. Meanwhile, prudent working capital management and maintaining financial discipline will remain critical.

Disclosure

Name of Rated Entity	Shahzad 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	Adil Kaleem | adil.kaleem@pacra.com | +92-42-35869504

Profile

Legal Structure Shahzad Textile Mills Limited (Shahzad Textile) is a public listed company, incorporated in 1978.

Background The Company was established in 1981 by Mian Muhammad Aslam (late) and was part of then Sargodha Group. The Group had twelve textile mills, one jute mill and one sugar mill. The group entities were later split among sons of Mian Muhammad Aslam (late). Operations of Shahzad Textile Mills were handed over to his son Mian Parvez Aslam and passed on to his son (third generation) Mian Imran Aslam.

Operations The Company comprised of three spinning units. Unit # 1 & 4 focus on PV yarn, while Unit # 2 produces polyester cotton yarn. The Company's current capacity is 63,648 spindles, as it has phased out one of its spinning unit (Unit # 3) and installed a socks manufacturing unit in the same premises with a capacity of 100 knitting machines. The power requirements of the Company stand at ~4.7MW, which is met through mix and match of in-house power generation (capacity: ~8.9MW) and LESCO's (sanctioned limit: 7.2MW) connection, whichever is more feasible.

Ownership

Ownership Structure Shahzad Textile is a family owned business with Mr. Pervez Aslam's family members collectively owning majority (~97.7%) shareholding. The remaining stake rests with general public (~2.1%) and corporates (0.2%).

Stability Fourth generation of Aslam family has joined the business. Although, there is no formal succession plan, the shareholding and business roles are equally divided between Mr. Imran Aslam and Mr. Irfan Aslam (brothers). Formation of a group holding company would be beneficial in clarifying the succession planning.

Business Acumen Mr. Imran Aslam - the CEO and major shareholder - has been managing the Company's operations for more than two decades. His ability to take strategic decisions and to seize opportunities on the right time has kept the entity on the right track.

Financial Strength Mr. Imran Aslam has ~28% shareholding in Sargodha Jute Mills Limited, an associated company. Sargodha Jute's net assets were worth ~PKR 1.48bln (FY18: PKR 1.75bln) in FY19. Other than that, on personal level he is an active investor in real estate and stock market. The net worth of Mr. Imran Aslam is ~PKR 758mln. This portrays adequate financial muscles of sponsors to support the Company, if need arises.

Governance

Board Structure The overall control of the Company vests in seven members' board with Mian Pervez Aslam as Chairman of the board. The Company's board comprises two executive directors, three non-executive directors while two members are independent directors.

Members' Profile Mian Parvez Aslam – the Chairman – carries with him over 40 years of experience and has been associated with the board since its incorporation. The board comprises professionals with diverse expertise.

Board Effectiveness Shahzad Textile has two board committees: Audit Committee and HR & Remuneration Committee (HR&R). The audit committee meets on quarterly basis to approve financial statements prior to board meetings. HR&R meets at least once in a financial year and may meet more often, if requested by the board. Meanwhile, director's attendance has remained strong and meeting minutes were formally recorded.

Financial Transparency The External Auditors of the Company are M/s Horwath Hussain Chaudhry & Co., Chartered Accountants. They have expressed an unqualified opinion on the Company's financial statements of FY19.

Management

Organizational Structure The organizational structure of the Company is divided into two main divisions: Head Office and Mills. HoD's from both divisions report directly to the CEO.

Management Team Mr. Imran Aslam manages day to day operations as CEO of the Company. Mr. Imran is supported by a team of experienced professionals. Most of the senior management has been associated with the Company for a reasonably long time.

Effectiveness Shahzad Textile maintains adequate IT infrastructure and related controls. Management meets on daily basis as cheque signatory is the CEO himself and holds the authority of the final approvals. This ensures close monitoring. Moreover, monthly meetings are conducted in order to review performance of all units.

MIS Shahzad Textile has in place oracle based local ERP system by the name of Wizmen.

Control Environment The Company places emphasis in sustainable quality of yarn. For this, it is compliant with the latest version of ISO 9001-2008 Certification. This enhances the trust of new customers and retains old clients as well.

Business Risk

Industry Dynamics During 8MFY20, textile exports increased by 5.30% period on period. The US-China trade war earlier in the year disrupted cotton prices across the globe. Considering that China accounts for more than 50% of Pakistan's cotton yarn exports, lesser demand from China negatively impacted the spinning industry. Yarn exports reduced by 0.86% in 8MFY20. Additionally, the withdrawal of zero rated sales tax status from textile sector, coupled with the high interest rates, has impacted liquidity and profitability. The COVID-19 outbreak in early 2020 has affected the entire textile chain. Export orders have been postponed or cancelled as major export destinations remain in lockdown to contain the virus. Several domestic players have shutdown production or are partially operational. Recent government initiatives are expected to provide some relief. However, prevailing uncertainty due to global lockdown will have implications for the industry dynamics.

Relative Position The Company's yarn production stood at ~38,000 MT in FY19 , out of which 15% was exported i.e. ~5,700 MT. Whereas, the total cotton yarn exports of Pakistan clocked in at 433,583 MT (Market Share = 1.3%). Meanwhile, on stand alone basis the Company has minimal share in local market.

Revenues In 1HFY20, revenue of the Company decreased to PKR 2,578mln (1HFY19: PKR 3,326mln), reducing by 22.5%. During the same period, exports also diminished to 0.6% of the total revenue, at ~PKR 15mln (1HFY19: PKR 678mln). Shahzad Textile had shut down unit no. 3 to make way for a sock unit in its place. The sock manufacturing plant will be solely export oriented. However, the shut down of unit no. 3 and lower exports resulted in lower revenue. The new sock unit is now fully operational and expected to contribute to the top line.

Margins During 1HFY20, gross margin of the Company increased slightly to 7.3% (1HFY19: 7.0%), due to higher yarn prices. However, the operating margin decreased (1HFY20: 3.9%; 1HFY19: 4.6%), on account of lower sales and higher expenses. This translated in to a significant reduction in net margin (1HFY20: 0.6%; 1HFY19: 2.6%), resulting in net income of PKR 16mln (1HFY19: 86mln). Whereas, the finance cost had increased to PKR 30mln during the same period (1HFY19: 25mln). Shahzad Textile also received ~PKR 3.5mln as share of net profit from its associate Company.

Sustainability Shahzad Textile has currently shut down almost all of its operations as per government directive. The government has eased the lockdown from 15th April, 2020, and has allowed export oriented textile industry to resume production. However, full resumption of operations and recovery in sales of the Company remains unclear. The eventual easing and opening up of domestic and global lockdowns is important in this regard, although its timeline is not certain. The Company may opt to avail SBP initiatives to seek support in the short-term.

Financial Risk

Working Capital During 1HFY20, net working capital cycle of the Company reduced marginally to 42 days (1HFY19: 43 days) as result of relatively lower inventory level. The Company maintains sufficient cushion at trade level (~38%) with slight drop in ST borrowings (1HFY20: PKR 526mln; 1HFY19: PKR 568mln).

Coverages Due to lower profitability in 1HFY20, free cash flows of the Company reduced (1HFY20: PKR 124mln; 1HFY19: PKR 170mln). This, coupled with the increase in finance cost (1HFY20: PKR 30mln; 1HFY19: PKR 25mln), caused the interest coverage to decline to 5.1x (1HFY19: 6.7x). Debt coverage experienced a similar trend (1HFY20: 2.8x; 1HFY19: 3.7x) but along with the interest coverage, remained strong.

Capitalization In 1HFY20, leverage of the Company increased to ~28% (1HFY19: ~23%) on account of higher LT borrowing (1HFY20: PKR 295mln; 1HFY19: PKR 38mln). ST borrowing in 1HFY20, was ~61% (1HFY19: 88%) of the total debt (1HFY20: PKR 863mln; 1HFY19: PKR 646mln). The Company's LT loans are on SBP concessionary rates, which bodes well in terms of lower interest cost.

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Financial Summary
PKR mln

Shahzad Textile Mills Limited	Dec-19	Jun-19	Jun-18	Jun-17
Textile	6M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	2,325	2,256	1,922	1,699
2 Investments	21	47	8	1
3 Related Party Exposure	375	370	390	371
4 Current Assets	1,303	986	1,110	838
a Inventories	*689*	*512*	*657*	*478*
b Trade Receivables	*100*	*73*	*103*	*93*
5 Total Assets	4,024	3,660	3,430	2,909
6 Current Liabilities	652	518	439	317
a Trade Payables	*73*	*53*	*39*	*35*
7 Borrowings	863	643	587	546
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	299	275	290	293
10 Net Assets	2,209	2,224	2,113	1,752
11 Shareholders' Equity	2,209	2,224	2,113	1,752
B INCOME STATEMENT				
1 Sales	2,578	6,071	5,464	4,511
a Cost of Good Sold	*(2,391)*	*(5,579)*	*(5,197)*	*(4,268)*
2 Gross Profit	188	492	268	243
a Operating Expenses	(86)	(166)	(156)	(145)
3 Operating Profit	101	326	112	98
a Non Operating Income	*(2)*	*(79)*	*43*	*2*
4 Profit or (Loss) before Interest and Tax	100	247	154	100
a Total Finance Cost	*(30)*	*(58)*	*(53)*	*(36)*
b Taxation	*(54)*	*(58)*	*(29)*	*(29)*
6 Net Income Or (Loss)	16	131	72	35
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*124*	*341*	*161*	*162*
b Net Cash from Operating Activities before Working Capital Changes	*98*	*294*	*136*	*146*
c Changes in Working Capital	*(161)*	*157*	*(89)*	*(202)*
1 Net Cash provided by Operating Activities	(63)	451	46	(56)
2 Net Cash (Used in) or Available From Investing Activities	(97)	(503)	(25)	(198)
3 Net Cash (Used in) or Available From Financing Activities	193	38	23	226
4 Net Cash generated or (Used) during the period	33	(14)	44	(28)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-15.1%	11.1%	21.1%	22.2%
b Gross Profit Margin	7.3%	8.1%	4.9%	5.4%
c Net Profit Margin	0.6%	2.2%	1.3%	0.8%
d Cash Conversion Efficiency (EBITDA/Sales)	6.7%	7.6%	4.5%	4.7%
e Return on Equity (ROE)	1.4%	6.0%	3.7%	2.0%
2 Working Capital Management				
a Gross Working Capital (Average Days)	49	40	44	42
b Net Working Capital (Average Days)	44	38	42	39
c Current Ratio (Total Current Assets/Total Current Liabilities)	2.0	1.9	2.5	2.6
3 Coverages				
a EBITDA / Finance Cost	7.2	9.8	5.5	7.3
b FCFO / Finance Cost+CMLTB+Excess STB	2.8	4.2	1.9	2.3
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	1.7	1.2	0.9	1.1
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	28.1%	22.4%	21.7%	23.8%
b Short-Term Borrowings / Total Borrowings	0.6	0.4	0.8	0.7
c Average Borrowing Rate	6.4%	7.7%	7.9%	5.4%

Rating Scale | Corporate

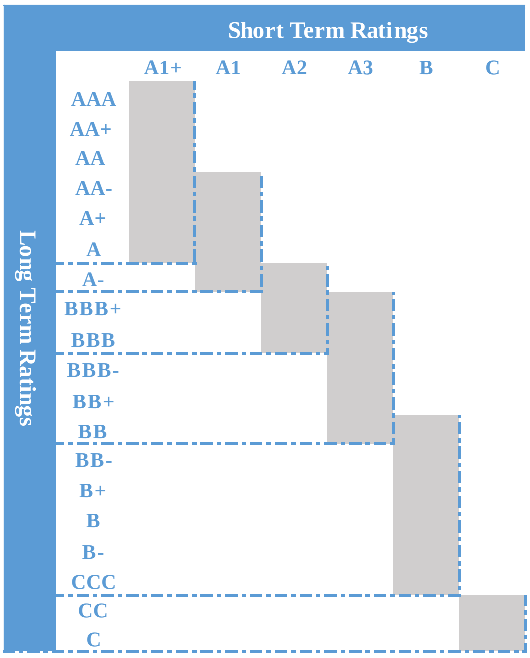
2019

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