The Pakistan Credit Rating Agency Limited

Rating Report

Fazal Cloth Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
26-Jul-2019	A-	A2	Stable	Maintain	-
24-Jan-2019	A-	A2	Stable	Maintain	-
24-Jul-2018	A-	A2	Stable	Maintain	-
22-Jan-2018	A-	A2	Stable	Maintain	-
29-Jun-2017	A-	A2	Stable	Maintain	-
08-Sep-2016	A-	A2	Stable	Maintain	-
09-Oct-2015	A-	A2	Stable	Maintain	-
10-Oct-2014	A-	A2	Stable	Maintain	-
22-Oct-2013	A-	A2	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

Fazal Cloth Mills Limited (Fazal Cloth) enjoys a strong business profile in the volatile environment of textile industry. The Company’s large size yielding economies of scale, diverse customer base and broad product portfolio in spinning & weaving segments provides competitive advantage. This has helped the Company to sustain its position despite volatile textile dynamics in previous years. The withdrawal of custom duty and sale tax on cotton imports and subsidized gas rates for textile sector have helped the industry margins, largely offsetting higher interest cost. With better industry dynamics and focused marketing efforts, the Company has been able to capitalize on additional capacities thereby generating incremental volumes, mainly in spinning segment, eventually translating into improved margins and profitability. The management is contemplating a gradual entry into value-added segment – dyeing and finishing - once implemented, it is likely to further strengthen business profile of the Company. The overall financial profile of the Company is considered adequate. It has a intermediately leveraged structure and adequate coverages, although coverages have improved on the back of strong cashflows in 9MFY19. The Company keeps sizeable cushion in short-term borrowing lines as part of its financial strategy to mitigate any liquidity crunch. The recent withdrawal of zero rated facilities on exports is expected to impact the liquidity position of the Company, though it will remain manageable. The Company is in process of merging its wholly owned subsidiary – Fazal Weaving – with and into Fazal Cloth. The process is near completion and is expected to conclude by end-July 2019. Post-merger, all assets and liabilities of Fazal Weaving will be transferred to Fazal Cloth. This will have a limited impact on the overall leveraging of the Company as Fazal Cloth's financial profile is characterized by strong equity base.

The ratings are dependent on the Company’s ability to maintain strong margins. Meanwhile, management of financial obligations, particularly working capital, amid rising interest rates, is considered important. Improvement in business and financial profile, mainly coverages, will be considered positive for the ratings. any material deterioration in margins and/or coverages will impact the ratings negatively.

Disclosure

Name of Rated Entity	Fazal Cloth Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	PACRA_Methodology_Corporate_FY19(Jun-19),PACRA_Crtieria_LT ST Relationship_FY19(Jun-19),PACRA_Criteria_Rating Modifiers_FY19(Jun-19)
Related Research	Sector Study | Textile(Oct-18)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Fazal Cloth Mills Limited (Fazal Cloth) was incorporated in 1966 as a public limited company. Meanwhile, Fazal Cloth is undergoing a merger with Fazal Weaving – wholly owned subsidiary – the process is near completion and it is expected to conclude by end-July 2019. Post merger, all assets and liabilities of the Company will be transferred to Fazal Cloth.

Background Fazal Cloth is the flagship company of Fazal Group, engaged in the manufacturing and marketing of different varieties of yarn and gerige fabric. The Company's production facilities are located in the vicinity of Multan and Muzaffargarh.

Operations The Company operates with seven spinning units (199,044 spindles, 3,660 rotors, 936 MVS spindles and 119 doubling machines) and a weaving unit (224 air jet looms). The Company has two gas-fired captive power generation plants with total capacity of 44MW along with a renewable energy generator of 1.63MW. The Company's in-house production is sufficient to meet its energy requirement. Meanwhile, diesel generators and MEPCO connections are used as alternative sources.

Ownership

Ownership Structure The Company's majority stakes are owned by Fazal Group and Fatima Group (~45% each). The remaining shareholding rests with financial institutions (~6%) and general public (~4.7%). Herein "Group means members of family without reference to any law of Pakistan".

Stability The considerable positions in the Company are held by Sheikh Naseem's family, where the third generation is gradually being inducted into the business. The Group has a holding company in place and the responsibilities are clearly defined among family members. This portrays structured line of succession. However, the transfer of ownership to the next generation is not documented yet.

Business Acumen The sponsoring Groups have over seven decades of presence in Pakistan's textile industry, developing expertise over time. This has helped the Company to sustain through the volatility of textile industry. Mr. Rehman Naseem is a textile veteran and he is well known among his peers for strong acumen of textile, especially spinning.

Financial Strength The sponsoring Groups have a prominent position in Pakistan's corporate sector, with interests in textile, fertilizer, energy and trading. The Group has strong financial muscle, portraying its ability to support Fazal Cloth, if needed.

Governance

Board Structure The Company's board comprises seven members, including the Chief Executive Officer (CEO). The board has equal representation (three each) of Fazal Group and Fatima Group, while one member is an independent director.

Members' Profile Mr. Sheikh Naseem Ahmad – the Chairman – is a graduate and carries over five decades of experience in textile industry. Moreover, the board members have vast knowledge and extensive experience of the textile value chain which benefits the board in efficient decision making.

Board Effectiveness Attendance of board members in meetings has remained strong and meeting minutes were appropriately documented. Moreover, the Company's board has two committees, namely: (i) Audit and (ii) Human Resource & Remuneration, to assist on relevant matters.

Financial Transparency M/s. KPMG Taseer Hadi & Co., Chartered Accountants serves as the external auditor for Fazal Cloth. They have expressed unqualified opinion on financial reports for the periods FY18 and 1HFY19.

Management

Organizational Structure The management control of the Company vests with Fazal family. The Company has six functional departments with well-defined organizational structure and clear segregation of responsibilities.

Management Team Mr Rehman Naseem – the CEO – is a Columbia University graduate and carries over two decades of experience in the textile sector. Moreover, Fazal Cloth employs a team of experienced professionals which bodes well for the Company's sustainable growth.

Effectiveness The Company has formed three-member executive committee at operational level and it is headed by the CFO. Routine management issues are discussed in these meetings to proactively address and resolve financial and legal bottlenecks. Additionally, reports on pre-determined key indicators are prepared for the senior management for ad-hoc reviews.

MIS The Company has deployed an Oracle based ERP, with comprehensive reporting. ERP was implemented in 2004, since then consistent up-gradation is underway.

Control Environment Fazal Cloth is accredited with various International certifications for compliance. The Company is following latest Quality Assurance Standards for yarn and fabric production. Few of the prominent certification includes ISO 9001, Lycra assured, Fair Trade and Organic exchange.

Business Risk

Industry Dynamics Pakistan's textile exports stagnated in 11MFY19 (~0.1% growth YoY). Even though major segments including cotton cloth, knitwear, garments and bed-wear displayed strong volumetric growth, a unit price dip resulting from sharing currency devaluation benefits with export clientele, curbed overall growth. Cotton yarn also displayed double-digit volumetric decline on account of the US-China trade war.

Relative Position Fazal Cloth is one of the largest composite textile unit in Pakistan, with significant spinning capacity, when compared to peers. Post-merger, the spinning capacity of Fazal Cloth will increase, in turn, considerable revenue growth. At group level, Fazal Group has a considerable presence in local textile industry. Furthermore, Fazal Cloth was a notable yarn exporter in FY18 with 6% share in total yarn exports.

Revenues During 9MFY19, the Company's top-line clocked in at ~PKR 26,690mln, posting a growth of ~6%. The Company's exports as a percentage of total sales stood at 19% (9MFY18: 39%); declined, due to attractive prices in local market. The revenue growth is largely attributable to better prices of yarn in local market and better export market for gerige fabric. In addition to this, continuous BMR activities led to higher volumetric growth. The sales mix of the Company continued to be dominated by Spinning segment.

Margins The Company's gross margin has shown improvements (9MFY19: 11.9%, 9MFY18: 9.9%), owing to better pricing and cost efficiency through BMR. Additionally, the subsidized gas and electricity tariffs have further lowered the conversion cost. Collectively, these factors have translated into higher gross margins. The Company's distribution expense has declined over the year due to lower exports. This led to improved operating margins (9MFY19: 10.3%, 9MFY19: 7.3%). The Company's net non-operating income has considerably increased, owing to interest income of PKR 162mln and exchange gain of PKR 120mln. These factors have largely offset-ed the impact of significantly increased finance cost, eventually leading to improved net margin (9MFY19: 4.3%, 9MFY18: 2.5%). The Company registered a profit of PKR 1,051mln (9MFY18: PKR 586mln).

Sustainability Balancing, Modernization and Replacement (BMR) is a regular feature at the Company. In 9MFY19, Fazal Cloth has incurred a BMR of PKR 2.3 bln, for the purpose of mechanical up-gradation and capacity enhancement. The Company maintains a sizable investment portfolio, constituting ~31% of its equity base and PKR 6,370mln in quantum during 9MFY19. Investments comprises strategic holdings and loans to associated companies. Post-merger, net leveraging of Fazal Weaving will have a minimal impact on Fazal Cloth because of its strong business profile.

Financial Risk

Working Capital In 9MFY19, the Company's inventory days have increased (9MFY19: 84days, 9MFY18: 66days), owing to increased raw material prices and higher inventory requirement due to capacity expansion. Meanwhile, the Company's receivables and payables have remained intact. These factors have widened the net working capital cycle (9MFY19: 157days, 9MFY18: 134days).

Coverages During 9MFY19, the Company's operating cashflows (FCFO) have considerably improved (9MFY19: PKR 3,265mln, 9MFY18: PKR 2,161mln) as the Company enjoyed higher profitability. However, significant increase in finance cost has lowered the interest coverage (9MFY19: 2.6x, 9MFY18: 2.9x). This was followed by marginally improved debt coverage (9MFY19: 1.2x, 9MFY18: 1.0x), achieved, on the back of lower than proportionate increase in CMLTD against FCFO. In addition to this, the Company's STB remained well covered against net trade assets, portraying significant room for further short term borrowing.

Capitalization Fazal Cloth has intermediately leveraged capital structure ~51.9% (9MFY18: 49.1%). The Company's total debt stands at PKR 22.5bln, out of which LTB constitutes 46.2%.

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Financial Summary
PKR mln

Fazal Cloth Mills Limited	Mar-19	Jun-18	Jun-17	Jun-16
Composite	9M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	23,847	22,356	17,988	16,814
2 Investments	-	-	-	-
3 Related Party Exposure	6,370	5,717	5,104	5,950
4 Current Assets	18,740	15,051	13,108	8,260
a Inventories	*12,127*	*8,124*	*6,420*	*5,113*
b Trade Receivables	*4,157*	*4,848*	*4,243*	*1,903*
5 Total Assets	48,957	43,124	36,200	31,024
6 Current Liabilities	2,827	2,703	2,098	2,193
a Trade Payables	*623*	*347*	*313*	*334*
7 Borrowings	22,537	17,884	16,213	11,335
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	2,720	2,521	2,380	2,279
10 Net Assets	20,873	20,015	15,509	15,217
11 Shareholders' Equity	20,873	20,015	15,509	15,217
B INCOME STATEMENT				
1 Sales	24,690	31,289	26,409	20,616
a Cost of Good Sold	*(21,762)*	*(28,264)*	*(24,606)*	*(18,862)*
2 Gross Profit	2,928	3,025	1,803	1,754
a Operating Expenses	(383)	(863)	(691)	(623)
3 Operating Profit	2,546	2,162	1,112	1,131
a Non Operating Income	*161*	*414*	*406*	*242*
4 Profit or (Loss) before Interest and Tax	2,707	2,576	1,518	1,373
a Total Finance Cost	*(1,346)*	*(1,134)*	*(879)*	*(917)*
b Taxation	*(311)*	*(228)*	*(203)*	*(306)*
6 Net Income Or (Loss)	1,051	1,214	436	150
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*3,265*	*3,226*	*1,563*	*1,700*
b Net Cash from Operating Activities before Working Capital Changes	*2,063*	*2,180*	*925*	*1,076*
c Changes in Working Capital	*(3,456)*	*(1,464)*	*(3,681)*	*367*
1 Net Cash provided by Operating Activities	(1,393)	716	(2,755)	1,442
2 Net Cash (Used in) or Available From Investing Activities	(2,863)	(2,280)	(2,021)	200
3 Net Cash (Used in) or Available From Financing Activities	4,401	1,515	4,808	(1,726)
4 Net Cash generated or (Used) during the period	145	(48)	31	(84)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	5.2%	18.5%	28.1%	-18.9%
b Gross Profit Margin	11.9%	9.7%	6.8%	8.5%
c Net Profit Margin	4.3%	3.9%	1.7%	0.7%
d Cash Conversion Efficiency (EBITDA/Sales)	14.5%	11.4%	8.1%	9.4%
e Return on Equity (ROE)	6.9%	6.8%	2.8%	1.0%
2 Working Capital Management				
a Gross Working Capital (Average Days)	162	138	122	135
b Net Working Capital (Average Days)	157	134	118	130
c Current Ratio (Total Current Assets/Total Current Liabilities)	6.6	5.6	6.2	3.8
3 Coverages				
a EBITDA / Finance Cost	2.9	3.4	2.6	2.3
b FCFO / Finance Cost+CMLTB+Excess STB	1.2	1.1	0.6	0.6
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	4.5	4.6	11.5	8.7
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	51.9%	47.2%	51.1%	42.7%
b Short-Term Borrowings / Total Borrowings	0.5	0.4	0.5	0.3
c Average Borrowing Rate	8.3%	6.2%	5.9%	7.0%

Rating Scale | Corporate

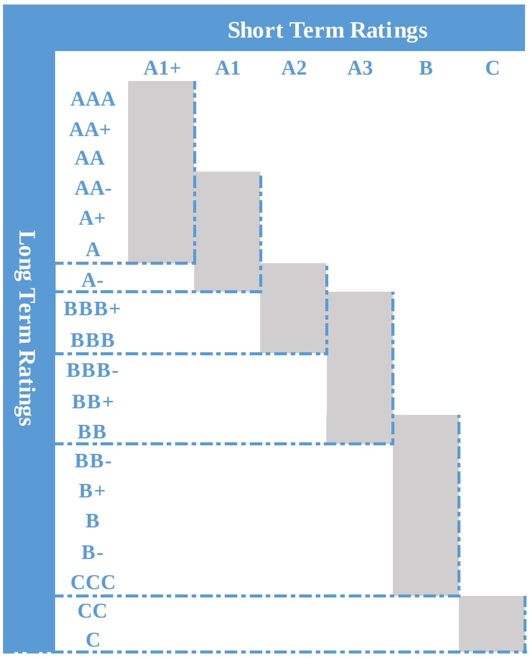
2019

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