The Pakistan Credit Rating Agency Limited

# Rating Report

# Ellcot Spinning Mills Limited

**Report Contents**



**Rating History**

| Dissemination Date | Long Term Rating | Short Term Rating | Outlook | Action | Rating Watch |
|---|---|---|---|---|---|
| 28-Dec-2018 | A- | A2 | Stable | Maintain | - |
| 30-Jun-2018 | A- | A2 | Stable | Maintain | - |
| 28-Dec-2017 | A- | A2 | Stable | Initial | - |

## Rating Rationale and Key Rating Drivers

The ratings reflects Ellcot Spinning Mills Limited's (Ellcot) improving business profile in harmonization with textile industry dynamics in recent times. The company's revenues have taken a hit in past few years mainly due to price decline in exports and local segments. Recently, revenues have started to pick up, benefiting from improved local industry dynamics. On standalone basis, the rupee devaluation has provided a requisite breather to the company to sustain its business margins, as the company's exports have increased during the year. Moreover, re-imposition of custom duties and sales tax on cotton & yarn imports, coupled with increasing interest rates has made the local textile industry competitive. The management is cognizant of this and intends to strengthen its performance by improved efficiency and expanding volumes. For the purpose the company has recently incurred a BMR, in turn, the comapny's leveraging has increased. Ellcot intends to gradually build a sizable investment portfolio. This exposes the company to market risk as exhibited by recent volatility in stock exchange. Any significant decline in investments leading to losses, and eventually equity erosion, will impact the financial profile of the company. The management's ability to manage this risk is critical. The assigned ratings derive comfort from Ellcot's association with Nagina Group.

The rating is dependent on the company's ability to uphold its financial profile, while strengthening business margins. The company's ability to generate cash flows to fulfill its financial obligations is critical for the ratings. At the same time, prudent management of investment portfolio is important.

**Disclosure**

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

## Profile

**Legal Structure** Ellcot Spinning Mills Limited (Ellcot), was incorporated in 1991 as a public limited company.

**Background** Ellcot is associated with Nagina Group since its inception. The company's manufacturing facility is located in District Kasur, Punjab.

**Operations** The company's current operational capacity comprises 61,728 Spindles. The total energy requirement of the company clocks in at ~6MW which is wholly met through captive plant; comprising ~5.3MW gas-based, ~3MW diesel-based and ~4.6MW furnace oil-based grantors. Furthermore, the company has a LESCO as alternative sources.

## Ownership

**Ownership Structure** Ellcot is majorly (~58%) owned by Nagina Group, through group companies and sponsoring individuals. The remaining stake rests with financial institutions and general public.

**Stability** The considerable positions in Nagina Group are held by Ellahi Family. The Group has a structured line of succession, however the transfer of ownership to next generation is not documented. Moreover, third generation is already in business, serving at various capacities.

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

**Financial Strength** Nagina Group comprises three listed public limited companies – Ellcot Spinning Mills, Prosperity Weaving Mills and Nagina Cotton Mills Limited – and six private limited companies, portraying adequate financial strength to support its group entities, if needed.

## Governance

**Board Structure** Ellcot's board comprises seven members out of which five members are non-executive and one member occupies an executive role - the CEO, while one director is independent. Five directors are Nagina Group nominees. The sponsors dominance on board along with control over key management positions poses challenge to the management, thus, hampers effective governance.

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

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

**Financial Transparency** M/s. Rahman Sarfaraz Rahim Iqbal Rafiq, Chartered Accountants are the external auditors of the company. They have expressed unqualified opinion on the financial statements of the company for the year ended June 30, 2018.

## Management

**Organizational Structure** The management team is headed by Mr. Shaukat Ellahi Shaikh (CEO), with defined reporting line to ensure smooth operations and efficiency. Moreover, the company has seven functional departments, while all HOD's reports directly to CEO.

**Management Team** Mr. Shafqat Ellahi is one of the sons of Mr. Shaikh Enam Ellahi. He holds a graduate degree from Colombia University and has been associated with the company since its inception. He is well verse with the textile business and has strong business acumen, supported by a team of seasoned professionals supplementing his expertise.

**Effectiveness** The management meetings are held on daily basis with follow-up points to resolve or pro-actively address operational issues, if any, eventually ensuring smooth flow of operations.

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

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

## Business Risk

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

**Relative Position** Ellcot is associated with Nagina Group, the Group maintains a considerable position in Pakistan's spinning and weaving sector, consequently strengthening the company's market position. However, on standalone basis Ellcot's share in local spinning industry is minimal.

**Revenues** During FY18, the company's revenues clocked in at PKR 5,563mln, posting a growth of ~14% YoY, owing to continuous BMR activities and better pricing in local market. The company's sales mix continued to be dominated by local sales ~79% (FY17: 95%). Top ten customers' revenue concentration in local market is high (FY18: ~69%, FY17: ~67%). Whereas, during 1QFY19 the company's revenues increased by ~23.4% on QoQ basis, majorly lead by rupee devaluation and better industry dynamics.

**Margins** The company's gross margins improved during the year (FY18: 7.3%, FY17: 6.5%), owing to lower than proportionate increase in cost of sales (~13.2%). This is attributable to prudent inventory procurement and constant BMR activities in recent years, followed by better operating margins (FY18: 4.2%, FY17: 3.6%). The finance costs increased by ~98%, on the back of higher short term borrowing. Meanwhile, the company received a dividend amounting to PKR 30mln, providing comforts to its bottom line, while on account of taxation the company's profitability robust and landed at ~PKR 131mln (FY17: ~PKR 78mln), posting a growth of ~67%. In 1QFY19, the company's margins continues to improve (gross - 1QFY19: 7.3%, operating - 1QFY19: 3.0%), an impact passed on from higher revenues.

**Sustainability** The company has incurred BMR of PKR 1,406mln in FY18, which include replacement of 25,200 obsolete spindles with fully automated latest spindles. This will reduce labor cost by ~60% and production volumes will increase by 20%, eventually ensuring manufacturing efficiency.

## Financial Risk

**Working Capital** Though the company's reliance on short term borrowing has significantly increased (FY18: PKR 2,227mln, FY17: PKR 923mln), majorly led by higher inventory procurement. At the same time, STB remains well covered when compared to net trade assets. Meanwhile, the considerable increase in inventory and receivables lead to higher net working capital days (FY18: 122days, FY17 82days). The working capital cycle picked up in 1QFY19, reflected from higher working capital days (net – 1QFY19: 145days, 1QFY18 89days), owing to seasonal inventory procurement.

**Coverages** During FY18, the company's operating cash flows (FCFO) increased by ~52% (FY18: PKR 341mln, FY17: PKR 268mln) – largely due to improved profitability. However, the interest expense almost doubled, consequently, both interest and debt coverages declined (FY18: 3.0x, FY17: 4.6x) and (FY18: 1.5x, FY17: 2.1x) respectively; though remained adequate. While the interest coverage declined in 1QFY19 to stand at ~2.5x, owing to higher interest cost, while debt coverage marginally improved ~1.7x. Going forward, rise in interest rate may stretch the company's coverages.

**Capitalization** Ellcot has a significantly leveraged capital structure (~72.7%) at end-June 18 (end-June 17: 50.7%), increased on account of recent BMR amounting to ~PKR 1,406mln. In 1QFY19 the company's leveraging slightly decreased (~69.3%), mainly led by decreased short term borrowing. Consequently, the current debt increased (~51% at end-Sep 18).

*PKR mln*

# Ellcot Spinning Mills Limited

| BALANCE SHEET | 30-Sep-18 | 30-Jun-18 | 30-Jun-17 | 30-Jun-16 |
|---|---|---|---|---|
| | 1QFY19 | FY18 | FY17 | FY16 |
| **Non-Current Assets** | **2,595** | **2,652** | **1,180** | **1,221** |
| **Investments (incl. Associates)** | **488** | **451** | **546** | **120** |
| Equity | 488 | 451 | 546 | 120 |
| Debt Securities (incl. income funds) | - | - | - | - |
| **Current Assets** | **2,689** | **3,151** | **1,628** | **1,530** |
| Inventory | 1,709 | 1,821 | 850 | 738 |
| Trade Receivables | 491 | 741 | 390 | 281 |
| Others | 490 | 589 | 387 | 510 |
| **Total Assets** | **5,772** | **6,254** | **3,354** | **2,870** |
| | | | | |
| **Debt/Borrowings** | **3,580** | **4,129** | **1,490** | **1,082** |
| Short-Term | 1,716 | 2,227 | 923 | 453 |
| Long-Term (incl. Current Maturity of Long-Term Debt) | 1,864 | 1,901 | 567 | 629 |
| Other Short-Term Liabilities | 468 | 441 | 293 | 251 |
| Other Long-Term Liabilities | 135 | 134 | 122 | 119 |
| **Shareholder's Equity** | **1,589** | **1,549** | **1,449** | **1,418** |
| **Total Liabilities & Equity** | **5,772** | **6,254** | **3,354** | **2,870** |
| | | | | |
| **INCOME STATEMENT** | | | | |
| **Turnover** | **1,469** | **5,563** | **4,869** | **4,228** |
| Gross Profit | 153 | 407 | 317 | 245 |
| Other Income | 1 | 16 | 7 | 6 |
| Financial Charges | (65) | (115) | (58) | (51) |
| **Net Income** | **44** | **131** | **78** | **72** |
| | | | | |
| **Cash Flow Statement** | | | | |
| Free Cash Flows from Operations (FCFO) | 160 | 341 | 268 | 169 |
| Net Cash changes in Working Capital | 517 | (1,352) | (234) | (323) |
| Net Cash from Operating Activities | 613 | (1,062) | 3 | (197) |
| Net Cash from InvestingActivities | (50) | (1,530) | (528) | (240) |
| Net Cash from Financing Activities | (548) | 2,593 | 369 | 465 |
| Net Cash generated during the period | 15 | 1 | (160) | 28 |
| | | | | |
| **Ratio Analysis** | | | | |
| **Performance** | | | | |
| Turnover Growth (v.s same period last year) | 23.4% | 14.3% | 15.2% | -7.9% |
| Gross Margin | 10.4% | 7.3% | 6.5% | 5.8% |
| Net Margin | 3.0% | 2.3% | 1.6% | 1.7% |
| ROE | 14.0% | 8.7% | 5.5% | 5.1% |
| **Liquidity** | | | | |
| Net Cash Cycle (Inventory Days + Receivable Days - Payable Days) | 145 | 122 | 82 | 79 |
| **Leveraging** (Total Debt/Total Debt+Equity) | 69.3% | 72.7% | 50.7% | 43.3% |

# Rating Scale

## Credit Rating Scale & Definitions

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

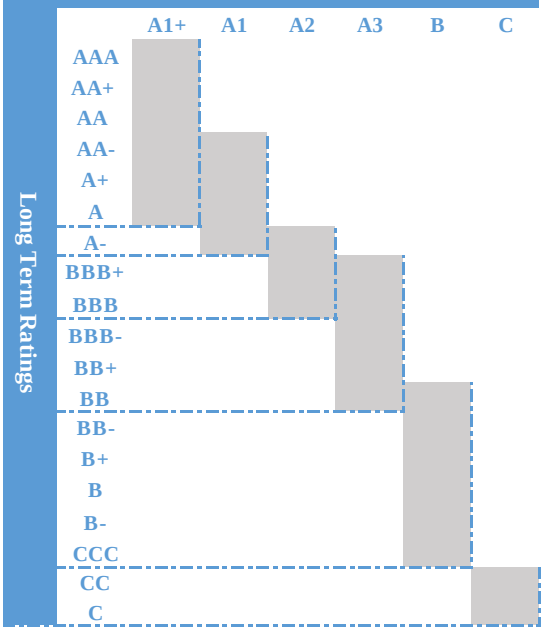
### Long Term Ratings

| | |
|---|---|
| AAA | **Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments |
| AA+<br>AA<br>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+<br>A<br>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+<br>BBB<br>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+<br>BB<br>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+<br>B<br>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<br>CC<br>C | **Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default. |
| D | Obligations are currently in default. |

### Short Term Ratings

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

### Short Term Ratings




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

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

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

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

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

**Disclaimer:** PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.

**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**
(23) All information contained herein is considered proprietary by PACRA. Hence, none of the information in this document can be copied or, otherwise reproduced, stored or disseminated in whole or in part in any form or by any means whatsoever by any person without PACRA's prior written consent