The Pakistan Credit Rating Agency Limited

Rating Report

LOTTE Kolson (Pvt.) Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
31-Dec-2018	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflect the Company's association with Lotte Corporation, one of the biggest conglomerates in South Korea, and expected group support. Promising consumer sentiment in conjunction with higher production has led to growth in revenues over the years. Ratings draw strength from the Company's established market presence in the snacks industry and experienced management team. The Company recently commenced operations of its state-of-the-art 'Chocopie' plant. However, utilization remains low due to slow market pickup. Meanwhile, margins have come under pressure recently owing to aggressive marketing campaigns to promote new products and increasing raw material costs, aggravated by rupee devaluation. The Company witnessed weak business performance owing to intense competition and losses incurred from operations. The Company has an adequate financial profile, represented by strong working capital management, moderately leveraged capital structure and weak coverages.

The ratings are dependent on the Company's ability to improve utilization of new plant, resulting in better margins, while maintaining working capital discipline. Any deterioration in margins and/or coverages will put pressure on the ratings. Continued support from Lotte Corporation, technically and financially, is critical for ratings.

Disclosure

Name of Rated Entity	LOTTE Kolson (Pvt.) 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 | Consumer Goods(Dec-18)
Rating Analysts	Adnan Dilawar | adnan@pacra.com | +92-42-35869504

Profile

Legal Structure Lotte Kolson (Private) Limited (the Company) is a private limited company.

Background The Company was formerly known as KS Sulemanji Esmailiji & Sons (Private) Limited and was renamed to Lotte Kolson (Private) Limited after it was fully acquired by Lotte Corporation, a multinational conglomerate headquartered in South Korea, in 2014.

Operations The Company is involved in the manufacture and sale of five product categories, namely, snacks, biscuits, pasta, cakes and gum. Production facilities are located in Karachi, Islamabad and Lahore, whereas, the head office is located in Karachi. The Company has been investing in capacity enhancement and recently set up a new plant in Phool Nagar, Punjab.

Ownership

Ownership Structure Major shareholding of the Company lies with Lotte Corporation (96.5%). Remaining shareholding lies with Mr. Dong Bin Shin (3.49%), son of the founder, Mr. Shin Kyuk-Ho, whereas, Mr. Noh Mang Ko (Chairman), Mr. Abdul Latif (Non-executive director) and Mr, Jeung Hoon Lee (CFO) hold one share each.

Stability The Company is expected to go under ownership changes in the coming year as the Group plans to realign its businesses under a holding company structure. Going forward, major shareholding of the Company will rest with Lotte Confectionery, a Group Company.

Business Acumen Lotte Corporation, is a Korean multinational conglomerate which has business ventures spread across the globe, in addition to having a strong footprint in South Korea and Japan. The Corporation has business interests in food, retail, chemicals, infrastructure and finance, among other areas. Moreover, the Group has established a strong presence in Pakistan and operates in the confectionery, chemical, beverages and construction industries.

Financial Strength The Company is considered to have strong financial strength on the back of support from Lotte Corporation. The Corporation is one of the largest conglomerates in South Korea and had an asset base of ~KRW 24,072bln (~PKR 2,968bln) as on September 2018, with revenues amounting to ~KRW 6,889bln during 9MFY18 (~PKR 850bln).

Governance

Board Structure Board of Directors comprises four members which includes the Chairman, two executive directors and a non-executive director. However, the Company lacks representation of independent members.

Members' Profile Members of the Board have significant experience between them and specialize in retail and production, in addition to confectionery. Moreover, Mr. Noh Mang Ko (Chairman) has exposure of international confectionery markets and also acts as the Chairman of Lotte India. As of August 2018, Mr. Humair Ijaz resigned from the directorship of the Company. He was replaced with Mr. Jeung Hoon Lee, the Chief Financial Officer and Company Secretary.

Board Effectiveness The Company has no board committees in place, however, the Board meets twice a year.

Financial Transparency A. F. Ferguson & Co., Chartered Accountants, classified in Category 'A' by the SBP with a satisfactory QCR rating, are the external auditors of the Company. They have expressed an unqualified opinion on the financial statements.

Management

Organizational Structure The organizational structure of the Company is split between twelve departments. Some of the major departments include sales, supply chain, production, quality and finance, with the highest concentration of employees in the sales department. Each department head is required to report to the Chief Financial Officer in addition to the Chief Executive, both of whom report to the Chairman. Additionally, General Manager Operations and General Manager Technical report directly to the Chairman. The complexity of the organizational structure hinders the effective flow of communication which may lead to miscommunication.

Management Team Management team comprises experienced individuals in the retail industry and represents a good skill mix. Mr. Khayyam Rajput, the Chief Executive Officer, holds an MBA and specializes in sales, marketing and general management. He has recently joined the Company and has previously worked for multi-nationals.

Effectiveness In order to ensure efficient operations, the Company has in place a management committee which meets twice a month. Meetings are chaired by the Chief Executive Officer and are attended by all functional heads. Purpose of the Committee is to improve efficiency in operations while ensuring compliance.

MIS The Company has deployed Oracle 12-C as its Enterprise Resource Planning (ERP) system and operates a total of five modules. The Company is expected to implement SAP 6.0 as its primary ERP system going forward.

Control Environment The Company has a strong control environment represented by strict quality control measures, with an increased emphasis on hygiene, and an efficient internal audit department. Findings are reported to the Chief Executive Officer, in addition to headquarters. Additionally, tests are conducted by headquarters once every year to ensure efficiency in operations and reporting standards.

Business Risk

Industry Dynamics The confectionery, biscuits and snacks industry in Pakistan is largely dominated by domestic players and is highly price elastic. Distinction between products lies in mass marketing. Pakistan has a large retail base though highly fragmented and dominated by small retailers, competing in terms of location, personal relationships and product ranges etc. Moreover, increasing consumer sentiment with growth in middle and upper income class has had a positive impact on the industry.

Relative Position The Company has high brand recognition in the snacks industry with its product 'Slanty'. However, the market is dominated by well established brands such as 'Lays'. Although, the Company holds a strong position in the pasta industry, it is yet to establish a notable presence in other product categories.

Revenues Sales are made locally and only a small portion is exported. Revenue stream is concentrated in five products, out of a total of 18 products, accounting for 84% of total revenue in FY17. During FY17, revenue grew by ~14% and stood at ~PKR 10,451mln. Growth in revenue can be seen as an effect of increased production and solid performance by the Company's leading brands. During 9MFY18 the Company posted revenues worth ~PKR 8,441mln and is expected to perform better this year.

Margins The Company has been able to maintain an increasing trend in gross profits over the years, however, gross margin has declined and remained stagnant in FY17, standing at 23% (FY16: 23%; FY15: 25%). Decline in margin is attributable to increased cost of production due to higher input costs, such as, raw materials, ~14% of which are imported. Moreover, a higher conversion cost further squeezed margins. A similar trend was observed for operating margins which came down to 7% in FY17 (FY16: 7%; FY15: 11%). A decline in margin can be traced to high selling and marketing expenses, which the Company engaged in to market its products more effectively. During 9MFY18, downward trend in margins persisted and gross margin stood at ~20% owing to increased cost of production. Similarly, operating margin came to 0.7%. Rising operating costs coupled with a substantial increase in financial charges led to a net loss of ~PKR 263mln in 9MFY18.

Sustainability Going forward, the Company is expected to engage in aggressive marketing and promotional activities to market its new products more effectively. Moreover, the Company will look to increase capacity utilization for its new Chocopie plant.

Financial Risk

Working Capital Due to the largely cash based nature of the industry, the Company was able to maintain a strong working capital position. The Company maintains a low number of average trade debtors days of 02 days in 9MFY18, however an increasing trend was observed for inventory days as the Company engages in strategic procurement of raw materials. Owing to high creditor days the Company posted net working capital days amounting to 02 days during 9MFY18. Moreover, a mismatch was observed in the debt mix.

Coverages The Company has been able to maintain stable cashflows over the years. Coverages remained strong in FY17 owing to low finance costs and good profitability. However, increased finance costs due to utilization of credit lines coupled with current maturity of long term debt have put coverages under stress. During 9MFY18, interest coverage and total debt coverage stood at 1.4x and 0.4x (FY17: 5.7x & 1.7x), respectively, indicating the Company's weak ability to meet financial obligations.

Capitalization The Company was completely funded by equity until FY15 after which it secured a line of ~PKR 4.5bln for capacity enhancements. The loan is to be repaid in 20 consecutive quarterly payments commencing from March 2019. Currently the Company maintains an aggressive capital structure with a debt-to-equity ratio of ~52% in 9MFY18. Majority of debt is long-term in nature, representing ~77% of total debt. The Company is expected to receive an equity injection worth PKR 1bln in FY19 for the purpose of principal repayment of long term loans.

LOTTE Kolson (Private) Limited

PKR mln

BALANCE SHEET	Sep-18	Dec-17	Dec-16	Dec-15
	9M	Annual	Annual	Annual
	Unaudited	*Audited*	*Audited*	*Audited*
Non-Current Assets	**10,313**	**9,973**	**5,167**	**4,517**
Investment Property	**140**	**140**	**140**	**140**
Current Assets	**2,306**	**2,160**	**2,199**	**1,477**
Total Assets	**12,759**	**12,273**	**7,507**	**6,134**
Debt	**5,499**	**4,665**	**500**	**-**
Short-term	499	215	-	-
Long-term (Inlc. Current Maturity of long-term debt)	5,000	4,450	500	-
Other liabilities	2,253	2,266	2,174	1,868
Shareholder's Equity	**5,007**	**5,342**	**4,833**	**4,266**
Total Liabilities & Equity	**12,759**	**12,273**	**7,507**	**6,133**
INCOME STATEMENT				
Turnover	**8,762**	**12,378**	**10,352**	**8,916**
Net Other Income	(64)	(24)	12	(30)
Financial Charges	(226)	(12)	(12)	(13)
Net Income	**(263)**	**521**	**566**	**566**
Cashflow Statement				
Free Cashflow from Operations (FCFO)	564	1,024	1,089	781
Net Cash changes in Working Capital	(57)	(433)	265	(38)
Net Cash from Operating Activities	194	407	1,342	724
Net Cash from InvestingActivities	(1,016)	(5,331)	(1,441)	(664)
Net Cash from Financing Activities	833	4,165	500	-
Net Cash generated during the period	10	(759)	402	61
Ratio Analysis				
Performance				
Turnover Growth	N/A	19.6%	16.1%	N/A
Gross Margin	19.7%	23.3%	22.6%	25.1%
Net Margin	-3.1%	5.0%	6.2%	7.1%
ROE	-14.6%	14.3%	14.5%	29.8%
Coverages				
Interest Coverage (FCFO/Gross Interest)	1.4	5.7	90.1	61.1
Core: (FCFO/Gross Interest+CMLTD+Uncovered Total STB)	0.4	1.7	90.1	61.1
Total: (TCF) / (Gross Interest+CMLTD+Uncovered Total STB)	0.4	1.7	90.1	61.1
Debt Payback (Total LT Debt Including UnCovered Total STBs) /	12.6	5.0	0.5	0.0
Liquidity				
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	2	-7	-6	-15
Capital Structure				
Leveraging (Total Debt/Total Debt+Equity)	52.3%	46.6%	9.4%	0.0%

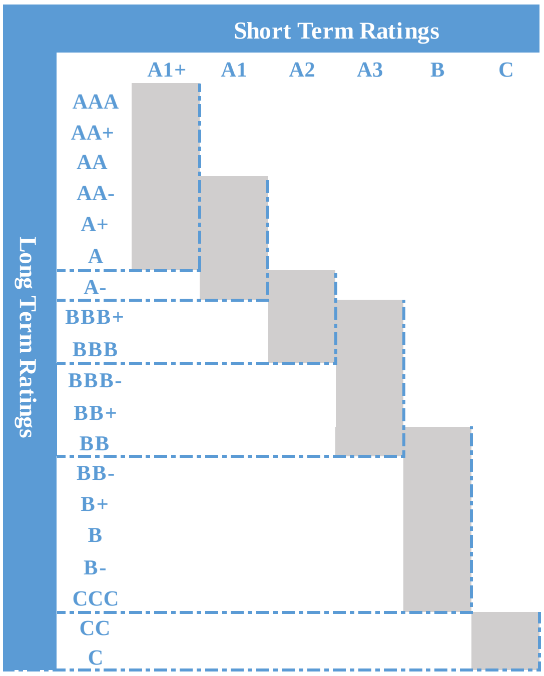
Rating Scale

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+ 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.

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Regulatory and Supplementary Disclosure

(Credit Rating Companies Regulations,2016)

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(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**

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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

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(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)

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(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)

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(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)

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