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
27-Dec-2019	A-	A2	Stable	Maintain	-
27-Jun-2019	A-	A2	Stable	Maintain	-
31-Dec-2018	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflect Lotte Kolson (Pvt.) Limited's (Lotte Kolson or 'the Company') association with Lotte Corporation, one of the biggest conglomerates of South Korea, and expected group support. Promising consumer demand in conjunction with higher production led to growth in revenues in the industry over the years. The Company's revenue growth remained restricted mainly due to government regulations applicable on distributors and impact on its low price items, especially Slanty. Utilization of the Company's state-of-the-art 'Choco Pie' plant remains low, though improving, due to slow market pick up of the product despite aggressive marketing campaigns. Meanwhile, margins have come under pressure recently owing to increasing raw material costs, aggravated by rupee devaluation. High marketing expenses led to operating loss. The Company's revenues and margins are expected to improve with launch of new products and better off take of existing products. The Company has a moderately leveraged capital structure with long term loan at fixed low rate. Coverages remain weak due to suppressed cash flows. Repayment of long term loan is expected to be paid through internal cash generation. The ratings draw strength from the sponsor's financial strength and demonstrated ability to provide support.

The ratings are dependent on the Company's ability to improve revenue growth and utilization of new plant. Better margins and maintenance of working capital is essential. Any further deterioration in margins and/or coverages will put pressure on the ratings. Continued support from Lotte Confectionery, 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-19),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-19),Criteria | Rating Modifier(Jun-19)
Related Research	Sector Study | Food Products(Dec-19)
Rating Analysts	Ateeb Riaz | ateeb.riaz@pacra.com | +92-42-35869504

Profile

Legal Structure Lotte Kolson (Private) Limited (the Company) was incorporated in 1975 as a private limited company.

Background The Company was formerly known as KS Sulemanji Esmailiji & Sons (Private) Limited. It was renamed to Lotte Kolson (Private) Limited after it was 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, i) Snacks, ii) Biscuits, iii) Pasta, iv) Cakes, and v) Gum. Production facilities are located in Karachi, Islamabad and Lahore, whereas, the head office is 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 Confectionery (96.5%). Remaining shareholding lies with Mr. Dong Bin Shin (3.5%), 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 (executive director) hold one share each.

Stability The Company went through an ownership change as the Group realigned its businesses under a holding company structure. During the period, ownership share of Lotte Corporation (96.5%) was transferred to Lotte Confectionery, its subsidiary.

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 owing to support from Lotte Confectionery. The corporation is the fifth largest conglomerate in South Korea. Lotte Confectionery has recently made an equity injection.

Governance

Board Structure Board of Directors comprises four members that include the Chairman, two executive directors and a non-executive director. The Company lacks representation of independent members.

Members' Profile Members of the Board have significant experience 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 Director (Overseas Strategy) in Lotte Confectionery, South Korea.

Board Effectiveness The Company has no board committees in place. The Board meets twice a year to discuss matters pertaining to current performance and future strategy, with minutes of meetings being captured in a formal manner.

Financial Transparency A. F. Ferguson & Co., Chartered Accountants are the external auditors of the Company. The auditor has expressed an unqualified opinion on the financial statements for the year ending 31st December, 2018.

Management

Organizational Structure The organizational structure of the Company is split between twelve departments. Some of the major departments are sales, supply chain, production, quality and finance. Each department head is required to report to the CEO, who reports to the Chairman. The CFO has additional reporting to Chairman in Korea because CFO is a Korean national and this is required for communication purpose.

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 joined the Company in 2018 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 CEO 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 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 CEO, in addition to headquarters in Korea. 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 it is highly fragmented and dominated by small retailers, competing in terms of location, personal relationships and product ranges etc. Overall industry is growing at a good pace.

Relative Position The Company has robust brand recognition in the snacks industry with its product 'Slanty' and in biscuits as well. However, the snacks 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 The Company sources its revenue from five product categories, namely,i) Snacks, ii) Biscuits, iii) Pasta, iv) Cakes, and v) Gum, with 'Slanty' contributing over 50%. Utilization of the Company's new 'Choco Pie' plant remains low due to slow pick up of the product despite aggressive marketing campaigns. During 9MCY19, the Company's revenue grew by 2.1% and clocked in at PKR 8,753mln (CY18: PKR 11,434mln). The CNIC regulation imposed by the government caused revenues to slow down as a significant portion of the Company's distributors were unregistered. While other products and brands are showing healthy growth in their revenues, the Company's growth remained passive due to declining revenue of Rs. 5 'Slanty', as it contributes significantly to total revenue.

Margins During 9MCY19, the Company's gross margin declined to 15% (9MCY18: ~20%) due to higher cost of raw materials such as sugar, wheat flour and imported materials. The Company suffered a loss at the operating level as the margin stood at –1.7% during 9MCY19 (CY18: -1.3%, 9MCY18: 0.7%), the Company mitigated the trickle-down effect of decline in margins by controlling its operating costs. Finance costs increased during the year (9MCY9: PKR 329mln, 9MCY18: PKR 226mln) due to higher markup on running finance. The net loss clocked in at PKR 545mln (CY18: PKR 22mln, 9MCY18: PKR 263mln) during 9MCY19.

Sustainability Going forward, the Company plans to introduce new products in the biscuits and pasta segments. Moreover, the Company is going to add new production lines for those products that have higher demand. The Company expects to generate strong revenue in 2020.

Financial Risk

Working Capital Due to the cash based nature of the industry, the Company maintained average trade receivable days at around 5 days. An increasing trend for inventory days (9MCY19: 39 days, 9MCY18: 30 days) was observed due to higher raw material prices. The Company also added new product lines for which additional inventory was needed. The trade payable days remained in-line with previous year and stood at 32 (9MCY8: 35 days). During 9MCY19, the Company's net working capital days amounted to 11 (9MCY18: -1 day). The Company has short term trade leverage of 41%, showing sufficient room to borrow against working capital.

Coverages The Company's free cash flows declined to PKR 514mln (9MCY18: PKR 564mln) on the back of declining profitability. Although borrowings declined (9MCY19: PKR 4,250, 9MCY18: PKR 5,000mln) during the period, the finance cost increased (9MCY19: PKR 330mln, 9MCY18: PKR 226mln) on the back of higher rate on short term borrowings. As a result, the interest coverage ratio declined significantly to 1.6x (9MCY18: 2.5x) and the debt coverage ratio declined slightly to 0.5x in 9MCY19 (9MCY18: 0.7x).

Capitalization The Company has a moderately leveraged capital structure with a leveraging ratio of ~40% in 9MCY19 (CY18: ~49%). Leveraging decreased due to equity injection of ~PKR 1.5bln as well as gradual repayment of the Company's long-term loan. The leveraging of the Company is expected to decline further, going forward with scheduled debt repayments. Debt obligations will be met through internal generation. However, group support is expected, if needed.

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Financial Summary
PKR mln

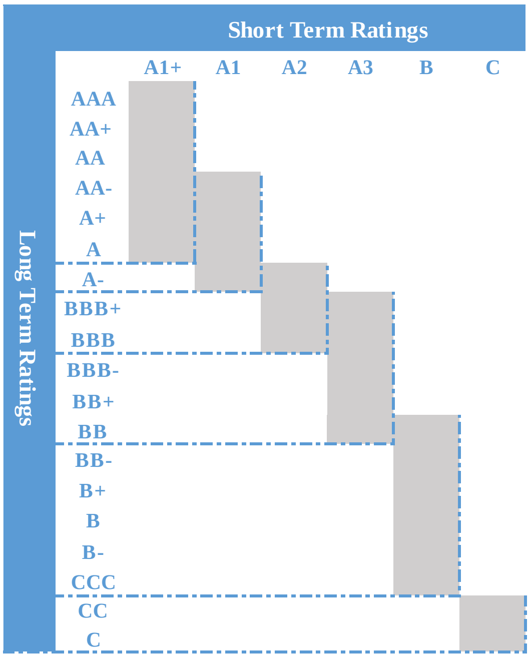
LOTTE Kolson (Pvt.) Limited	Sep-19	Dec-18	Dec-17	Dec-16
##	9M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	9,766	10,517	9,973	5,167
2 Investments	140	140	140	140
3 Related Party Exposure	-	-	-	-
4 Current Assets	2,892	2,454	2,160	2,199
5 Total Assets	12,798	13,112	12,273	7,507
6 Current Liabilities	1,911	1,571	1,833	1,649
7 Borrowings	4,250	5,396	4,665	500
8 Related Party Exposure	-	415	-	-
9 Non-Current Liabilities	93	86	433	525
10 Net Assets	6,543	5,643	5,342	4,833
11 Shareholders' Equity	6,543	5,643	5,342	4,833
B INCOME STATEMENT				
1 Sales	8,753	11,434	10,451	9,172
a Non Operating Income or (Expense)	*(20)*	*(119)*	*(24)*	*12*
a Total Finance Cost	*(330)*	*(350)*	*(12)*	*(12)*
6 Net Income Or (Loss)	(546)	(22)	521	566
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*514*	*497*	*1,024*	*1,089*
b Net Cash from Operating Activities before Working Capital Changes	*103*	*177*	*840*	*1,077*
c Changes in Working Capital	*(434)*	*72*	*(433)*	*265*
1 Net Cash provided by Operating Activities	(331)	249	407	1,342
2 Net Cash (Used in) or Available From Investing Activities	(47)	(1,046)	(5,331)	(1,441)
3 Net Cash (Used in) or Available From Financing Activities	362	731	4,165	500
4 Net Cash generated or (Used) during the period	(16)	(66)	(759)	402
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	2.1%	9.4%	13.9%	--
b Gross Profit Margin	15.0%	18.1%	23.3%	22.6%
c Net Profit Margin	-6.2%	-0.2%	5.0%	6.2%
e Return on Equity (ROE)	-11.9%	-0.4%	10.2%	11.7%
2 Working Capital Management				
b Net Working Capital (Average Days)	11	8	-8	-15
3 Coverages				
a EBITDA / Finance Cost	2.3	2.3	130.2	123.1
b FCFO / Finance Cost+CMLTB+Excess STB	0.5	0.4	91.7	90.1
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	16.3	31.6	4.4	0.5
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	39.4%	48.9%	46.6%	9.4%

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