The Pakistan Credit Rating Agency Limited

Rating Report

Nagina Cotton Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
28-Sep-2019	A-	A2	Stable	Maintain	-
30-Mar-2019	A-	A2	Stable	Maintain	-
23-Nov-2018	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflect Nagina Cotton Mills Limited's improving business profile as depicted in better margins and profitability. The Company's revenues are on growing trajectory over the years, a factor of continuous BMR translating into operational efficiencies and higher production volumes. Textile industry in general and spinning industry in particular suffer from low international commodity prices. Moreover, lower demand for cotton yarn from China owing to trade war with USA has suppressed the demand in international market. Similarly, imposition of sales tax in local market may slowdown sales. However, rupee devaluation and subsidized rates for gas and electricity has provided breather to local textile industry. These factors, coupled with consistent BMR in recent years has strengthen the business profile of the Company. Meanwhile, its financial profile is constrained by stretched working capital cycle, significant leveraging, in turn, higher finance cost eventually translating into adequate coverages. Going forward, the Company's leveraging is expected to increase due to debt based BMR, however, SBP's concessionary rates borrowing will insulate the financial risk profile of the Company. Nagina Cotton intends to gradually build a sizable investment portfolio. This, exposes the Company to market risk as exhibited by historic volatility in stock exchange. Meanwhile, the Company was able to limit its losses because of its conservative approach in stock allocation. Any significant decline in investments leading to losses, and eventually equity erosion, will impact the financial profile of the Company. The assigned ratings derive comfort from Nagina Cotton's association with Nagina Group.

The ratings are dependent on the Company's ability to generate sufficient cash flows to fulfill its financial obligations, while sustaining business margins. At the same time, prudent management of investment portfolio is critical.

Disclosure

Name of Rated Entity	Nagina Cotton 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 | Spinning(Sep-19)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Nagina Cotton Mills Limited (Nagina Cotton) was incorporated in 1967 as a public limited company.

Background Nagina Cotton is the pioneer company of Nagina Group. Over the period the Group has managed to grow from a single spinning company to multiple spinning entities and a weaving company.

Operations Nagina Cotton's current operational capacity comprises 53,748 Spindles. The total energy requirement of the Company is ~6.4MW which is Wholly met through captive plant. Furthermore, the Company has a HESCO connection as backup.

Ownership

Ownership Structure Nagina Cotton is majorly (~87%) owned by Nagina Group, through group companies and sponsoring individuals. The remaining stake of the Company 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 the next generation is yet to be seen. Meanwhile, third generation is already in business, serving at various positions.

Business Acumen Nagina Group is one of the oldest medium-sized textile houses in Pakistan. Operating under Ellahi's for five decades, developing credential expertise in spinning and weaving over the period of time. The Group has adequately expanded its capacities despite competitive textile industry.

Financial Strength Nagina Group comprises three listed public limited companies, namely; Ellcot Spinning Mills, Prosperity Weaving Mills and Nagina Cotton Mills Limited and has six private limited companies. This portrays adequate financial strength of the Group to support the Company, if needed.

Governance

Board Structure Nagina Cotton's board constitutes nine members out of which five are non-executive, three occupy executive roles, including the CEO and CFO, while one director is independent.

Members' Profile Mr. Shahzada Ellahi Shaikh – the Chairman – holds a bachelor's degree in Economics and International Relations. The board member carries vast knowledge and extensive experience of textile industry, 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 in relevant matters and ensure proper oversight. Attendance of board members remained strong and meeting minutes were formally documented. Out of total, seven directors are Nagina Group nominees (including six sponsoring family individuals). Their dominance on board along with control over key management positions poses limited challenge to the management, thus, hampers effective governance.

Financial Transparency M/s. Deloitte Yousuf Adil, Chartered Accountants are the external auditors of the Company. They have expressed unqualified opinion on the financial statements of the Company for the periods ending FY18 and 1HFY19.

Management

Organizational Structure Management control vests with Ellahi Family, with well-defined reporting line. The Company's organizational structure is broadly divided into five operational departments with all HoD's reporting directly to the CEO.

Management Team The management team is headed by the CEO, Mr. Shaukat Ellahi who holds a graduate degree from Colombia University, in Economics and Political Science. Mr. Shaukat Ellahi is associated with Nagina Cotton since its inception, he is well verse with the textile business and has strong business acumen.

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. In addition to this, daily and weekly reports are generated for top management with main focus on production and liquidity position of the Company. Whereas, on monthly basis the Company's P&L is presented and discussed in the meetings.

MIS The Company has in place Oracle based Enterprise Resource Planning (ERP) system with comprehensive MIS reporting.

Control Environment The Company is compliant with multiple safety and quality assurance standard, majorly including; 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 The export performance of Pakistan's textile industry remained stagnated during FY19, despite ~34% currency devaluation and incentives introduced by the government to promote exports. Even though leading textile categories including ready-made garments, bed ware, knitwear and cotton cloth displayed double-digit volumetric growth, the hit to unit prices on account of exporters having to share the benefit of the currency depreciation with buyers in the extremely competitive international market, curbed overall growth. Meanwhile, cotton yarn exports fell by ~18% YoY. This decline was driven by falling yarn prices due to decreasing trend in international cotton prices during the year, as well as volumetric decline owing to the US-China trade war. The withdrawal of zero rating status may cause liquidity crunch for the companies with majority exports. This, along with restriction on sales to unregistered person has resulted in a slowdown in textile's operations, in local market.

Relative Position Nagina Group has a long operating history in Pakistan and has developed prominent position in local spinning industry. Currently, the Group's spinning capacity stands at 115,446 spindles which strengthens Nagina Cotton's market position.

Revenues Since FY16, the Company's revenues are on growing trajectory. The similar trend continued in 9MFY19, as the Company's revenues clocked in at PKR 4,976mln, posting a growth of ~18%. This is mainly attributable to rupee devaluation, which has pushed local yarn prices. This, coupled with lower demand in international market have made local sales more feasible, eventually resulting in declined exports of the Company.

Margins The Company's gross margin has posted a notable growth (9MFY19: 10.5%, 9MFY18: 7.3%) on account of subsidized utilities and better pricing in local market a factor of rupee devaluation. This was followed by higher than proportionate increase in operating margins (9MFY19: 6.7%, 9MFY18: 3.4%), achieved, on account of lower distribution cost, a factor of declined exports. The Company received dividend income of ~PKR 8mln (9MFY18: PKR 15mln). Despite the increase in finance cost by 82% on YoY basis, the Company's net margins have improved (9MFY19: 3.0%, 9MFY18: 1.1%) as it booked a net profit of PKR 147mln (9MFY18: PKR 45mln) in 9MFY19.

Sustainability The Company is in process of replacing 18,000 obsolete spindles. Upon completion, it will yield automation, energy efficiency and wider product range, eventually adding to the Company's margins. Despite this, the Company's profitability is expected to remain limited; constrained by higher finance cost and lower demand of yarn in international market, especially China. The Company has an investment portfolio of ~PKR 496mln, constituting 26% of its equity base in 9MFY19.

Financial Risk

Working Capital In 9MFY19, the Company's reliance on STB has increased (9MFY19: PKR 1,884mln, 9MFY18: PKR 1,734mln), on the back of higher cotton prices. At the same time, STB remains well covered when compared to net trade assets (9MFY19: 38%, 9MFY18: 37%), portraying a sufficient room for further borrowing. Meanwhile, the considerable increase in receivable days (9MFY19: 57days, 9MFY18, 41days), lead to higher working capital cycle (gross – 9MFY19: 144days, 9MFY18: 125days, net – 9MFY19: 140days, 9MFY18 121days).

Coverages During 9MFY19, the Company's operating cash flows (FCFO) increased by ~64% (9MFY19: PKR 425mln, 9MFY18: PKR 258mln), largely led by improved profitability. Meanwhile, the interest expense almost doubled, resulting in slightly deteriorated interest coverage (9MFY19: 2.9x, 9MFY18: 3.1x); though remains modest. On the contrary, debt coverage has witnessed an improvement (9MFY19: 1.5x, 9MFY18: 1.3x). Going forward, higher reliance on STB for working capital may stretch the Company's coverages, amid higher interest rates.

Capitalization Nagina Cotton has highly leveraged capital structure ~57.5% in 9MFY19 (9MFY18: 59.5%), the total debt stood at PKR 2.58bln with STB constituting 72.8%. Going forward, the leveraging of the Company is expected to increase on account of expansion. The Company has sanctioned a loan through LTFF for current CAPEX, with comfortable debt servicing.

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Nagina Cotton Mills Limited Spinning	Mar-19 9M	Jun-18 12M	Jun-17 12M	Jun-16 12M
A BALANCE SHEET				
1 Non-Current Assets	1,568	1,440	1,555	1,441
2 Investments	510	661	549	285
3 Related Party Exposure	-	-	-	-
4 Current Assets	3,516	2,830	1,553	1,332
a Inventories	*1,937*	*1,234*	*716*	*724*
b Trade Receivables	*1,111*	*954*	*455*	*330*
5 Total Assets	5,594	4,931	3,657	3,058
6 Current Liabilities	984	795	600	439
a Trade Payables	*74*	*61*	*57*	*54*
7 Borrowings	2,588	2,169	1,216	826
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	107	100	85	75
10 Net Assets	1,915	1,867	1,756	1,718
11 Shareholders' Equity	1,915	1,867	1,756	1,718
B INCOME STATEMENT				
1 Sales	4,976	5,879	5,242	4,268
a Cost of Good Sold	*(4,455)*	*(5,364)*	*(4,889)*	*(4,116)*
2 Gross Profit	521	514	353	151
a Operating Expenses	(187)	(216)	(214)	(188)
3 Operating Profit	334	298	139	(37)
a Non Operating Income	*8*	*43*	*36*	*39*
4 Profit or (Loss) before Interest and Tax	342	341	175	2
a Total Finance Cost	*(148)*	*(117)*	*(64)*	*(66)*
b Taxation	*(47)*	*(65)*	*(32)*	*(29)*
6 Net Income Or (Loss)	147	158	78	(93)
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*388*	*394*	*234*	*51*
b Net Cash from Operating Activities before Working Capital Changes	*301*	*346*	*202*	*8*
c Changes in Working Capital	*(696)*	*(778)*	*(49)*	*(414)*
1 Net Cash provided by Operating Activities	(395)	(432)	153	(406)
2 Net Cash (Used in) or Available From Investing Activities	(329)	(167)	(539)	90
3 Net Cash (Used in) or Available From Financing Activities	544	898	371	264
4 Net Cash generated or (Used) during the period	(180)	300	(15)	(53)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	12.9%	12.1%	22.8%	0.0%
b Gross Profit Margin	10.5%	8.7%	6.7%	3.5%
c Net Profit Margin	3.0%	2.7%	1.5%	-2.2%
d Cash Conversion Efficiency (EBITDA/Sales)	9.1%	7.9%	5.8%	2.9%
e Return on Equity (ROE)	10.4%	8.7%	4.5%	-5.4%
2 Working Capital Management				
a Gross Working Capital (Average Days)	144	104	77	95
b Net Working Capital (Average Days)	140	101	74	90
c Current Ratio (Total Current Assets/Total Current Liabilities)	3.6	3.6	2.6	3.0
3 Coverages				
a EBITDA / Finance Cost	3.4	4.3	5.3	2.1
b FCFO / Finance Cost+CMLTB+Excess STB	1.5	1.6	1.4	0.4
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	2.1	2.8	5.1	-107.7
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	57.5%	53.7%	40.9%	32.5%
b Short-Term Borrowings / Total Borrowings	0.7	0.6	0.3	0.1
c Average Borrowing Rate	7.6%	6.3%	5.6%	6.9%

Rating Scale | Corporate

2019

Credit Rating Scale & Definitions

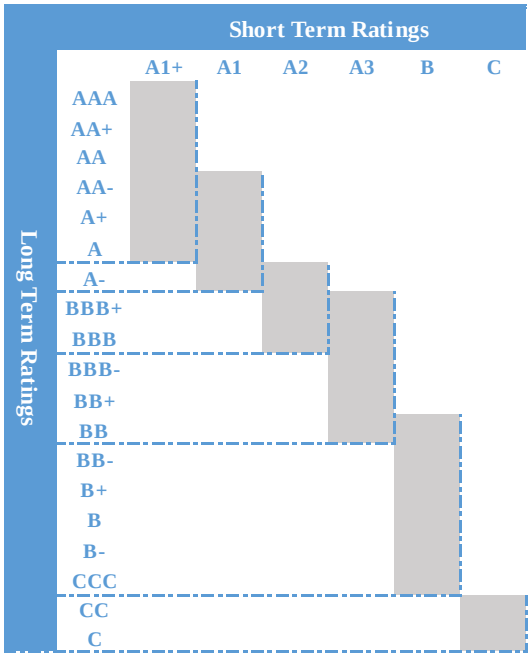
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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.

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