The Pakistan Credit Rating Agency Limited

Rating Report

Fazal Cloth Mills Limited

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Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
07-Sep-2023	A	A1	Stable	Maintain	-
07-Sep-2022	A	A1	Stable	Upgrade	-
05-Nov-2021	A	A2	Stable	Upgrade	-
25-Jul-2021	A-	A2	Positive	Maintain	-
25-Jul-2020	A-	A2	Stable	Maintain	-
26-Jul-2019	A-	A2	Stable	Maintain	-
24-Jan-2019	A-	A2	Stable	Maintain	-
24-Jul-2018	A-	A2	Stable	Maintain	-
22-Jan-2018	A-	A2	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

Fazal Group is one of the oldest textile houses in Pakistan and Fazal Cloth Mills Limited is the flagship company of the Group. The company enjoys a strong business profile as one of the leading producers of yarn and fabric. The spinning product portfolio comprises specialized varieties including, multi-count/multi-twist, double, and zero twist yarns along with Organic, Supima, Lycra, Giza, and USA cotton yarns. Whereas, the weaving product portfolio comprises greige fabric. The yarn has the lion’s share in the top line of the company. The Company's large size yielding economies of scale, diverse customer base, and broad product portfolio in spinning and weaving segments provide a competitive advantage. Over the years, the Company has been able to capitalize on additional capacities thereby generating incremental volumes, mainly in the spinning segment, eventually translating to improved margins and profitability in the recent year. During 9MFY23, the revenue increased to PKR 56.6bln (9MFY22: PKR 47.6bln). The share of the export sales declined to 11% (9MFY22: 33%). The company’s major export base is in Europe followed by the U.S. and Asia Pacific. Whereas, the bottom line decreased to PKR 533mln (9MFY22: PKR 4.8bln) due to the increase in the overall cost structure. In recent quarters, higher costs of raw materials consumed, surging other costs mainly comprising exchange losses along with a sizable increase in finance costs have affected the net profitability. Margins reflected attrition YoY. Moreover, the financial matrix reveals moderate leveraging, a decline in coverage YoY, and a relatively stretched working capital cycle. The management aims to improve the financial performance of the company in the upcoming quarters for which a strategy has been formulated comprising efficient procurement of raw materials and enhancing the export penetration. Moreover, the management is confident that the company’s capacity utilization levels shall remain healthy. Further, management’s view included comfort driven from the large established export base of the Company. During FY23, textile exports were valued at $16.5 billion compared to $19.33 billion, reflecting a dip of 15% YoY – the declining trend has been witnessed by the start of FY23. The exports tumbled attributable to high energy costs, shortage of cotton, and uncertainty in the foreign exchange rate. The suppressed demand pattern exhibited by export avenues was also a challenge. During FY23, value-added products such as knitwear, bedwear, towels, and ready-made garments witnessed a decline of 13% YoY. The basic textiles including raw cotton, cotton yarn, and cotton cloth posted a drop of 21% YoY.

The ratings are dependent on the company’s ability to maintain a strong business profile amidst current circumstances. The sustainability of relative position along with improved margins and profitability will remain vital.

Disclosure

Name of Rated Entity	Fazal Cloth Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Rating(Jun-22),Methodology | Correlation Between Long-term & Short-term Rating Scales(Jun-22),Methodology | Rating Modifiers(Jun-22)
Related Research	Sector Study | Composite and Garments(Dec-22)
Rating Analysts	Sehar Fatima | sehar.fatima@pacra.com | +92-42-35869504

Profile

Legal Structure Fazal Cloth Mills Limited was incorporated in 1966 as public limited company.

Background The Company operates with eight spinning units (274,524 spindles, 8,820 open-end rotors, 1,752 MVS spindles/rotors, and 119 doubling machines) and a weaving unit (224 air jet looms). Fazal Cloth has two gas-fired captive power generation plants, with a total capacity of 51MW and 7.2MW diesel-powered plants as a backup along with a renewable energy plant (11.53MW).

Operations Fazal Cloth is the flagship company of Fazal Group. The company is engaged in the manufacturing and marketing of different varieties of yarn and greige fabric.

Ownership

Ownership Structure The Company's majority stakes are owned by Fazal Group and Fatima Group (44.6% each). The remaining shareholding vests with financial institutions (6.8%) and general public (4%). Herein "Group means members of the family without reference to any law of Pakistan".

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

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

Financial Strength The sponsors have a prominent position in Pakistan's corporate sector, with interests in textile, fertilizer, energy and trading. This portrays strong financial strength of the sponsors and provider of financial support to Fazal Cloth, if needed.

Governance

Board Structure The Company's board comprises nine members, including the Chief Executive Officer (CEO). The board includes 3 executive directors, 3 nonexecutive directors along with three independent directors. Representation of two families provides adequate challenge to operational decision.

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

Board Effectiveness Attendance of board members in meetings remains strong and meeting minutes were appropriately recorded. Moreover, the Company's board have three committees, namely (i) Audit, (ii) Human Resource & Remuneration, and (iii) Strategic Planning Committee to assist board on relevant matters. Audit Committee, in addition to an independent Chairman, comprises members from sponsoring family (non-executive directors).

Financial Transparency M/s. KPMG Taseer Hadi & Co., Chartered Accountants serves as external auditor for Fazal Cloth. They have expressed unqualified opinion for FY22. whereas an audit of financial statements for FY23 is underway. Moreover, the Company has an internal audit department which reports directly to Mr. Rehman Naseem (CEO).

Management

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

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

Effectiveness The Company has formed three-member executive committee at operational level and it is headed by the CFO, Mr. Muhammad Azam serves as the group chief financial officer and has an enriched experience over two decades. Routine management issues are discussed in these meetings to proactively address and resolve financial and legal bottlenecks. Additionally, reports on pre-determined key indicators are prepared for the senior management for ad-hoc reviews.

MIS The Company is using fully integrated ERP software from Oracle Corporation upgraded to version R-12.2.7. Modules implemented are Payables, Receivables, Fixed Assets, Cash Management, General Ledger, Purchase, Inventory, Cost Management, Order Management, Human Resource and Payroll.

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

Business Risk

Industry Dynamics During FY23, textile exports were valued at $16.5 billion compared to $19.33 billion, reflecting a dip of 15% YoY – the declining trend has been witnessed by the start of FY23. The exports tumbled attributable to high energy costs, shortage of cotton, and uncertainty in the foreign exchange rate. The suppressed demand pattern exhibited by export avenues was also a challenge. During FY23, value-added products such as knitwear, bedwear, towels, and ready-made garments witnessed a decline of 13% YoY. The basic textiles including raw cotton, cotton yarn, and cotton cloth posted a drop of 21% YoY. During the month of June 2023, cotton yarn exports increased by 7% MoM. The value-added exports reported a volumetric increase of 16% on a MoM basis.

Relative Position Fazal Cloth is one of the largest composite textile units in Pakistan, with significant spinning capacity, when compared to peers. At the group level, Fazal Group has a considerable presence in the local textile industry.

Revenues During 9MFY23, revenues recorded a growth of 19% YoY to stand at PKR 56,608mln (9MFY22: PKR 47,609mln). The company's export decreased by 37% to stand at PKR 13,712mln (9MFY22: PKR 21,899mln) comprising 24% of the total revenues (9MFY22: 46%). The sales mix depends upon prevailing demand and pricing, where the company seeks the best mix to optimize revenue.

Margins During 9MFY23, the gross margin decreased to 13.9% (9MFY22: 16.7%) due to the higher cost of raw materials. This translated into a declined operating margin clocking in at 12.5% (9MFY22: 15.3%). The finance cost increased by 70% to stand at PKR 3,170mln (9MFY22: PKR 1,864mln). Consequently, net margin declined to 0.9% (9MFY22: 10.2%), as net income decreased to stand at PKR 533mln (9MFY22: PKR 4,847mln).

Sustainability Going forward, uncertainty is prevailing in the textile sector due to increasing policy rates along with the surge in energy prices. This volatile situation has created hurdles in the pace of the textile sector's growth and has caused a slowdown in exports due to the loss of disposable income of consumers in Western countries. It has become very difficult for textile companies to pass on the increased cost of manufacturing. FCML is facing the same difficulties. Despite all of the difficulties, the company continues to operate its factories at full production. The management believes that slowly but surely the textile sector will regain full capacity over the next few months which will result in better margins.

Financial Risk

Working Capital The Company fulfills its working capital needs through both; ST borrowing and internal cash flows. At end-Mar23, due to higher raw material days clocking in at 90 days (end-Jun22: 81 days), the net working capital cycle increased to 157 days (end-Jun22: 136 days). The increased inventory and receivable levels augmented the trade assets to PKR 42,680mln (end-Jun22: PKR 36,723mln). ST trade leverage adequacy declined to 37% (end-Jun22: 48%).

Coverages During 9MFY23, the company witnessed a decline in its free cash flows (9MFY23: PKR 5,356mln 9MFY22: PKR 6,392mln). The finance cost paid increased to PKR 2,761mln (9MFY22: PKR 1,566mln) which led to a decline in interest coverage (9MFY23: 1.8x; 9MFY22: 3.7x).

Capitalization At end-Mar23, leveraging of the company increased to 51.0% (end-Jun22: 45.7%) due to higher total borrowing clocking in at PKR 41,516mln (end-Jun22: 34,077mln) out of which ST borrowing constitutes 51.2%. The equity base of the company decreased to stand at PKR 39,875mln (FY22: PKR 40,529mln).

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Fazal Cloth Mills Limited Textile | Composite	Mar-23 9M	Jun-22 12M	Jun-21 12M	Jun-20 12M
A BALANCE SHEET				
1 Non-Current Assets	44,374	41,544	38,440	25,137
2 Investments	40	-	-	-
3 Related Party Exposure	7,177	7,716	6,105	7,959
4 Current Assets	45,833	38,283	22,578	18,569
a Inventories	*30,525*	*26,813*	*15,470*	*11,844*
b Trade Receivables	*9,091*	*7,268*	*4,738*	*4,827*
5 Total Assets	97,423	87,543	67,124	51,665
6 Current Liabilities	10,731	8,149	5,039	3,787
a Trade Payables	*5,355*	*3,399*	*2,211*	*1,363*
7 Borrowings	41,516	34,077	22,432	23,643
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	5,302	4,787	4,956	3,392
10 Net Assets	39,875	40,529	34,697	20,842
11 Shareholders' Equity	39,875	40,529	34,697	20,842
B INCOME STATEMENT				
1 Sales	56,608	65,406	52,132	34,416
a Cost of Good Sold	*(48,751)*	*(54,238)*	*(44,127)*	*(30,315)*
2 Gross Profit	7,858	11,168	8,005	4,101
a Operating Expenses	(754)	(1,113)	(776)	(631)
3 Operating Profit	7,104	10,055	7,229	3,470
a Non Operating Income or (Expense)	*(2,572)*	*(1,233)*	*128*	*51*
4 Profit or (Loss) before Interest and Tax	4,532	8,821	7,357	3,521
a Total Finance Cost	*(3,170)*	*(2,923)*	*(1,795)*	*(2,558)*
b Taxation	*(829)*	*(1,288)*	*(131)*	*(562)*
6 Net Income Or (Loss)	533	4,610	5,432	401
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*5,356*	*8,998*	*7,952*	*4,590*
b Net Cash from Operating Activities before Working Capital Changes	*2,595*	*6,338*	*5,950*	*2,087*
c Changes in Working Capital	*(5,178)*	*(12,445)*	*448*	*(1,009)*
1 Net Cash provided by Operating Activities	(2,583)	(6,107)	6,398	1,078
2 Net Cash (Used in) or Available From Investing Activities	(4,113)	(4,993)	(1,474)	(2,534)
3 Net Cash (Used in) or Available From Financing Activities	7,132	11,331	(5,066)	1,545
4 Net Cash generated or (Used) during the period	436	230	(143)	89
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	15.4%	25.5%	51.5%	-5.3%
b Gross Profit Margin	13.9%	17.1%	15.4%	11.9%
c Net Profit Margin	0.9%	7.0%	10.4%	1.2%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	0.3%	-5.3%	16.1%	10.4%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Shareholders' Equity)]*	1.8%	12.3%	19.6%	1.9%
2 Working Capital Management				
a Gross Working Capital (Average Days)	178	151	129	175
b Net Working Capital (Average Days)	157	136	117	161
c Current Ratio (Current Assets / Current Liabilities)	4.3	4.7	4.5	4.9
3 Coverages				
a EBITDA / Finance Cost	2.2	4.3	5.4	1.8
b FCFO / Finance Cost+CMLTB+Excess STB	1.0	1.6	1.5	1.4
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	6.2	3.0	2.6	6.8
4 Capital Structure				
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	51.0%	45.7%	39.3%	53.1%
b Interest or Markup Payable (Days)	88.9	74.6	65.1	66.8
c Entity Average Borrowing Rate	10.7%	8.5%	6.9%	10.4%

Credit Rating

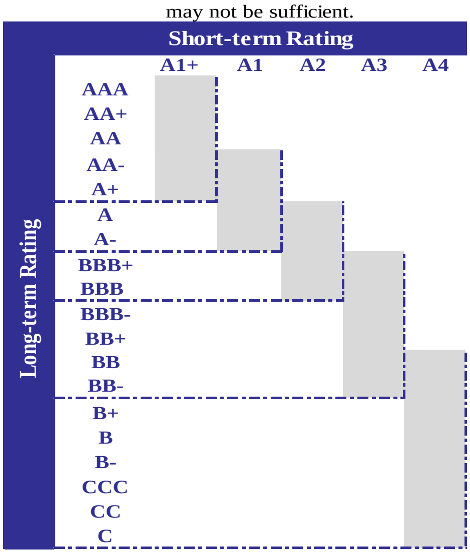
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
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 Rating

Scale	Definition
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
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

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 some material identifiable event with indeterminable rating implications. 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 rating 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) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) 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.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Companies Rating

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

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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 | Clause 11-(A)(p).
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(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
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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)
(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)
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