The Pakistan Credit Rating Agency Limited

Rating Report

Fazal Cloth Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
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	-
29-Jun-2017	A-	A2	Stable	Maintain	-
08-Sep-2016	A-	A2	Stable	Maintain	-
09-Oct-2015	A-	A2	Stable	Maintain	-
10-Oct-2014	A-	A2	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

Fazal Cloth Mills Limited (Fazal Cloth) enjoys a strong business profile as a leading producer of yarn and cloth. The Company's large size yielding economies of scale, diverse customer base, and broad product portfolio in spinning & weaving segments provides a competitive advantage. In recent years the Company has been able to capitalize on additional capacities thereby generating incremental volumes, mainly in spinning segment, eventually translating into improved margins and profitability. Lately, the Company maintained its trend of revenue growth but profitability came under pressure due to high finance cost. The operations of the Company suffered on account of the COVID-19 outbreak as the entire textile chain came to a halt due to lockdowns in Pakistan and internationally. Production resumed since the Government allowed export-oriented sector to start operations and the Company restarted operations at full capacity. However, the last quarter (April-June) of FY20 remained challenging as demand was low and prices of yarn reduced. The demand for textile chain is recovering as economies open up in Pakistan and export destinations. Meanwhile prices have also improved on both local and international fronts recently. The Company is expected to benefit from these improved dynamics as it has exhausted its piled up inventory and order flow remains strong. Fazal Cloth has a leveraged capital structure and adequate coverages. In order to relieve pressure on cashflows caused by the pandemic and economic slowdown, the Company availed SBP's moratorium relief and deferred principal repayments for one year. Reduction of 625bps in interest rates by SBP shall provide respite in this regard. The Company's merger with its wholly-owned subsidiary – Fazal Weaving – is near completion and awaits Court's order. Post-merger, all assets, and liabilities of Fazal Weaving will be transferred to Fazal Cloth. The Company continues to lend support to its associate company "Fatima Energy" through loans and capital injection as it still requires time to mature.

The ratings are dependent on the Company’s ability to maintain strong business profile amidst current circumstances. Meanwhile, management of financial obligations, particularly working capital, during and after the pandemic, is imperative. Improvement in margins and coverages will be considered positive for the ratings. Materialization of investments into positive cashflows and managing related obligations prudently is important.

Disclosure

Name of Rated Entity	Fazal Cloth Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-20),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria | Rating Modifier(Jun-20)
Related Research	Sector Study | Composite(Nov-19)
Rating Analysts	Adil Kaleem | adil.kaleem@pacra.com | +92-42-35869504

Profile

Legal Structure Fazal Cloth Mills Limited (Fazal Cloth) was incorporated in 1966 as a public limited company. Meanwhile, Fazal Cloth is undergoing a merger with Fazal Weaving – wholly owned subsidiary – the process is near completion. Post merger, all assets and liabilities of the Company will be transferred to Fazal Cloth.

Background Fazal Cloth is the flagship company of Fazal Group, engaged in the manufacturing and marketing of different varieties of yarn and greige fabric. The Company's production facilities are located in the vicinity of Multan and Muzaffargarh.

Operations The Company operates with spinning (9MFY20: 212,916 spindles; 3,660 rotors, 888 MVS spindles, and 119 doubling machines) and weaving unit (9MFY20: 224 air jet looms). The Company has two gas-fired captive power generation plants with total capacity of 44MW along with a renewable energy generator of 1.63MW. Furthermore, three independent solar power projects are also underway, which will produce 2.4MW additionally. The Company's in-house production is sufficient to meet its energy requirement. Meanwhile, diesel generators and MEPCO connections are used as alternative sources.

Ownership

Ownership Structure The Company's majority stakes are owned by Fazal Group and Fatima Group (~45% each). The remaining shareholding rests with financial institutions (~6%) and general public (~4.7%). Herein "Group means members of 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. This portrays structured line of succession. However, the transfer of ownership to the next generation is not 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 sponsoring Groups have a prominent position in Pakistan's corporate sector, with interests in textile, fertilizer, energy and trading. The Group has strong financial muscle, portraying its ability to support Fazal Cloth, if needed.

Governance

Board Structure The Company's board comprises seven members, including the Chief Executive Officer (CEO). The board has equal representation (three each) of Fazal Group and Fatima Group, while three members are independent directors.

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 which benefits the board in efficient decision making.

Board Effectiveness Attendance of board members in meetings has remained strong and meeting minutes were appropriately documented. Moreover, the Company's board has two committees, namely: (i) Audit and (ii) Human Resource & Remuneration, to assist on relevant matters.

Financial Transparency M/s. KPMG Taseer Hadi & Co., Chartered Accountants serves as the external auditor for Fazal Cloth. They had expressed unqualified opinion on financial reports for the period FY19.

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. 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 has deployed an Oracle based ERP, with comprehensive reporting. ERP was implemented in 2004, since then consistent up-gradation is underway.

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 Textile exports of the country dropped by ~8% for 11MFY20 to stand at ~USD 11.6bln as compared to ~USD 12.6bln in 11MFY19 due to slowdown in demand for textile products internationally, instigated by Covid-19 led lock downs in major export destinations. Going forward, prevailing uncertainty in the dynamics of textile sector due to Covid-19 outbreak globally, lifting of lock downs in most countries, contraction in local and international demand is expected to affect the entire textile value chain. Locally, textile sector will find comfort in relief measures introduced by State Bank of Pakistan such as, deferment of loan payments for one year, low interest rates and salary refinance scheme.

Relative Position Fazal Cloth is one of the largest composite textile unit in Pakistan, with significant spinning capacity, when compared to peers. Post-merger, the spinning capacity of Fazal Cloth will increase, in turn, will cause a healthy growth in revenue. At group level, Fazal Group has a considerable presence in local textile industry.

Revenues Revenues recorded a growth of ~9% YoY (9MFY20: PKR 26,969mln; 9MFY19: PKR 24,810mln), on account of improved prices. During 9MFY20, focus on exports increased comprising ~40% of the total revenues (9MFY19: ~20%). The sales mix depends upon prevailing demand and pricing, where the Company seeks the best mix to optimize revenue.

Margins During 9MFY20, gross margin of the Company improved (9MFY20: 13.0% ; 9MFY19: 11.8%) on the back of better prices. This translated in to improved operating margin (9MFY20: 11.0%; 9MFY19: 10.3%), However, net margin experienced a sharp decline YoY (9MFY20: 2.1%; 9MFY19: 4.2%), as net income reduced (9MFY20: PKR 554mln; 9MFY19: PKR 1,051mln) due to higher finance cost (9MFY20: PKR 1,928mln; 9MFY19: PKR1,346mln).

Sustainability Due to COVID-19 outbreak and subsequent lockdown, Fazal Cloth had to shut down all of its operations as per government directive till 7th April, 2020. Since the government has eased the lockdown from 11th May, demand has improved, however, recovery in sales of the Company remains unclear. The Company has availed SBP's moratorium relief and deferred its principal repayments for one year.

Financial Risk

Working Capital The Company fulfills its working capital needs through both; ST borrowing and internal cashflows. In 9MFY20, due to higher inventory levels (9MFY20: PKR 14,755mln 9MFY19: PKR 12,127mln), net working capital cycle increased (9MFY20: 164 days; 9MFY19: 154 days). Increased inventory level augmented the trade assets (9MFY20: PKR 20,922mln; 9MFY19: PKR 17,339mln), resulting in larger room-to-borrow (9MFY20: PKR 6,428mln; 9MFY19: PKR 6,254mln). However, despite the incline in trade assets, ST trade leverage adequacy (9MFY20: 31%; 9MFY19: 36%) dipped on account of a higher proportionate increase in ST borrowing (9MFY20: PKR 12,429mln; 9MFY19: PKR 10,411mln).

Coverages During 9MFY20, the Company built up its free cash flows (9MFY20: PKR 4,016mln; 9MFY19: PKR 3,265mln) on the back of improved operational perfomance. However, higher financ cost (9MFY20: PKR 1,928mln; 9MFY19: PKR 1,346mln) led to a decline in coverages - interest coverage (9MFY20: 2.2x; 9MFY19: 2.6x); debt coverage (9MFY20: 1.1x; 9MFY19: 1.2x). Going forward, deferment of principal for one year and decrease in policy rate by 625bps will support cashflows.

Capitalization In 9MFY20, the leverage of the Company increased (9MFY20: ~56%; 9MFY19: ~52%) on the back of higher borrowing (9MFY20: PKR 26,374mln; 9MFY19: PKR 22,537mln). Out of the total debt, ST borrowing consitutes ~47%, whereas ~17% is borrowed at SBP's concessionary rates. The Company also benefits from a spread of -3.2% over KIBOR and utilizes only approximately half of the ST borrowing limit available i.e. ~PKR 23bln.

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Financial Summary
PKR mln

Fazal Cloth Mills Limited	Mar-20	Jun-19	Jun-18	Jun-17
Textile	9M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	25,118	24,024	22,356	17,988
2 Investments	-	-	-	-
3 Related Party Exposure	7,638	6,985	5,717	5,535
4 Current Assets	22,156	18,662	15,119	12,677
a Inventories	*14,755*	*10,942*	*8,124*	*6,420*
b Trade Receivables	*4,728*	*5,432*	*4,842*	*4,243*
5 Total Assets	54,911	49,671	43,192	36,201
6 Current Liabilities	4,599	3,746	2,772	2,098
a Trade Payables	*2,065*	*1,411*	*689*	*313*
7 Borrowings	26,374	21,723	17,884	16,213
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	3,262	3,278	2,521	2,380
10 Net Assets	20,676	20,925	20,015	15,509
11 Shareholders' Equity	20,676	20,925	20,015	15,509
B INCOME STATEMENT				
1 Sales	26,969	36,341	31,288	26,555
a Cost of Good Sold	*(23,472)*	*(31,999)*	*(28,553)*	*(24,773)*
2 Gross Profit	3,497	4,342	2,735	1,782
a Operating Expenses	(536)	(541)	(564)	(691)
3 Operating Profit	2,961	3,801	2,171	1,091
a Non Operating Income	*(135)*	*457*	*414*	*379*
4 Profit or (Loss) before Interest and Tax	2,826	4,258	2,585	1,470
a Total Finance Cost	*(1,928)*	*(1,894)*	*(1,144)*	*(879)*
b Taxation	*(344)*	*(849)*	*(228)*	*(203)*
6 Net Income Or (Loss)	554	1,516	1,214	388
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*4,016*	*5,020*	*3,226*	*1,438*
b Net Cash from Operating Activities before Working Capital Changes	*1,926*	*3,225*	*2,180*	*801*
c Changes in Working Capital	*(3,508)*	*(3,226)*	*(1,464)*	*(3,330)*
1 Net Cash provided by Operating Activities	(1,582)	(2)	716	(2,529)
2 Net Cash (Used in) or Available From Investing Activities	(2,475)	(3,493)	(2,280)	(2,248)
3 Net Cash (Used in) or Available From Financing Activities	4,262	3,587	1,515	4,808
4 Net Cash generated or (Used) during the period	204	93	(48)	31
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-1.1%	16.1%	17.8%	--
b Gross Profit Margin	13.0%	11.9%	8.7%	6.7%
c Net Profit Margin	2.1%	4.2%	3.9%	1.5%
d Cash Conversion Efficiency (EBITDA/Sales)	14.5%	15.3%	11.4%	7.6%
e Return on Equity (ROE)	3.6%	7.4%	6.8%	2.5%
2 Working Capital Management				
a Gross Working Capital (Average Days)	182	147	138	122
b Net Working Capital (Average Days)	164	137	132	117
c Current Ratio (Total Current Assets/Total Current Liabilities)	4.8	5.0	5.5	6.0
3 Coverages				
a EBITDA / Finance Cost	2.1	3.1	3.4	2.5
b FCFO / Finance Cost+CMLTB+Excess STB	1.1	1.3	1.1	0.6
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	4.8	3.7	4.6	13.8
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	56.1%	50.9%	47.2%	51.1%
b Short-Term Borrowings / Total Borrowings	0.5	0.5	0.4	0.5
c Average Borrowing Rate	10.2%	9.1%	6.2%	5.0%

Credit Rating

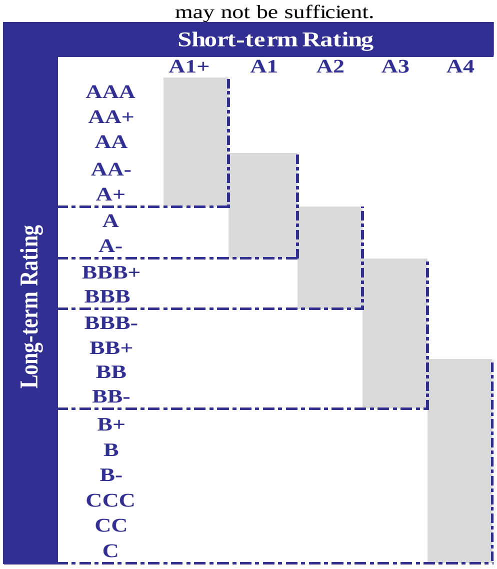
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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):

Entities

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

Instruments

a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating

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