RATING REPORT

Suraj Cotton Mills Limited (SCML)

REPORT DATE:

February 3, 2020

RATING ANALYSTS:
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RATING DETAILS		
	Initial Rating	
Rating Category	Long-term	Short-term
Entity	A+	A-1
Rating Date	*January 9, 2020*	
Rating Outlook	Stable	

COMPANY INFORMATION	
Incorporated in 1984	External auditors: E&Y Ford Rhodes, Chartered Accountants
Public Limited Company	Chairman of the Board: Mr. Khalid Bashir
Key Shareholders (with stake 5% or more):	Chief Executive Officer: Mr. Nadeem Maqbool
Crescent Powertec Limited– 44.19%	
Mr. Adil Bashir– 6.95%	
Mrs. Humaira Iqbal – 6.40%	
Mr. Ahsan Bashir– 5.78%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Corporates (May 2016)
https://www.vis.com.pk/kc-meth.aspx

OVERVIEW OF THE INSTITUTION

Suraj Cotton Mills Limited was established as a public limited company in December 1984. The company is involved in manufacturing of yarn and griege fabric through its integrated spinning and weaving facilities.

Profile of the Chairman

Mr. Khalid Bashir has over 42 years of association with textile and sugar industry, as well as with financial institutions. He has led the Board of Directors of Crescent Group and held directorships at other companies. He also serves as a member of APTMA electing committee.

Profile of the CEO

Mr. Nadeem Maqbool has 25 years of experience in textile industry. Apart being director at various companies, he also acted as the Chairman of APTMA (Southern Region).

Financial Snapshot

Total Equity: end-FY19: Rs. 6.1b; end-FY18: Rs. 5.6b; end-FY17: Rs. 5.3b

Assets: end-FY19: Rs 11.8b; end-FY18: Rs. 11.2b; end-FY17: Rs. 9.6b

Profit After Tax: FY19: Rs. 858.6m; FY18: Rs. 565.5m; FY17: Rs., 505.8m

RATING RATIONALE

Suraj Cotton Mills Limited (SCML) consists of four operating units of integrated spinning and weaving facilities at different locations. Majority of the shareholding is held by its associated company and sponsoring family. The ratings assigned reflect positive trajectory of sales, supported by augmentation in margins emanating from operational efficiencies and economies of scale. The ratings also incorporate sound liquidity profile, adequate coverages and comfortable leverage indicators. However, the ratings remained constrained by vulnerability of spinning sector to raw material prices and any adverse changes in regulatory duties. Further, corporate governance framework has room for improvement.

Decline in cotton production and yarn exports on a timeline basis: Demand driven price risk is largely curtailed on account of production of premium products being sold to a loyal customer base, reinforced by effective marketing strategies. The lower end of textile value chain is faced with many challenges. Increase in distribution cost owing to higher fuel prices has also skewed the domestic players towards local markets. Cotton trade has also been affected as the Federal Board of Revenue imposed 10 percent sales tax on cotton that would be collected at the ginners' level while withholding tax was increased to 4.5 percent from one percent.

Another crucial challenge faced by spinning sector is the lower production of cotton bales. The federal committee on agriculture fixed cotton production target at 15 million bales for the ongoing season, which appears ambitious considering the last year's output of 12 million bales. Cotton production and area under cultivation is also falling primarily as growers have partially shifted to sowing sugarcane which guarantee minimum support price. In the previous fiscal year 2018-19, area under cotton cultivation dropped to 2.37 million hectares compared to 2.7 million hectares in the preceding year – a reduction of 12.1%. The main reasons behind reduction in cotton output is continuous decline in area of cotton production, non-availability of good seeds, excessive rains, pests' attacks, low returns and lack of awareness in farmers regarding cotton production dynamics. During the ongoing year, Punjab Agricultural Department has fixed a quota of 2.85 million-acre land for production of 15 million cotton bales to tackle the issue of lower area of production.

Improvement in production on the back of capacity expansion: capacity utilization has remained high over the years: SCML manufactures yarn ranging from 40s count to 120s count. The yarn is produced both from local and imported cotton, though the import of raw material has declined during FY19 on account of local currency devaluation. The proportion of local and imported cotton was reported at 72:28 (FY18: 23:77; FY17: 65:35). Being an integrated facility, yarn required for the production of greige fabric is entirely met through in-house production. The company has a moderate concentration risk as top 10 customers contributed 31% (FY18: 29%; FY17: 33%) to total sales during FY19. With the addition of 30,000 spindles at Unit-IV during FY18, the company's total installed spindles increased to 122,304, leading to a total production capacity of yarn to 53,226,641 Kgs/annum by the end-FY19. Weaving units at Shahkot have 204 airjet looms installed, with a total production capacity of greige at 100,639,852 Sqm at the end-FY19. Capacity utilization has remained high at 97% (FY18: 94%; FY17: 92%) over the years.

Profitability underpinned by higher sales and increasing margins: During FY19, the company reported net sales of Rs. 14.0b (FY18: Rs. 11.1b; FY17: Rs. 8.3b), driven largely by notable increase in average selling prices of yarn to Rs. 208.7/pound (FY18: Rs. 174.8/pound; FY17: Rs. 161.5/pound) and greige fabric to Rs. 160.9/meter (FY18: Rs. 137.8/meter; FY17: Rs. 132.0/meter) along with increase in volumetric sales. Over the period of last three years, company's net sales have grown at a CAGR of 21.7%. As a result of higher average selling prices of all products and rationalization of overall production cost, gross margins increased to 11.4% (FY18: 8.2%; FY17: 6.4%) during FY19. In the total sales mix, proportion of local sales increased marginally to 92% (FY18: 91.6%) and waste sales increased to 5.3% (FY18: 4.4%) while export sales decreased to 2.7% (FY: 4%). Although administrative expenses have increased during FY19, decrease in distribution cost mainly on account of lower clearing and forwarding charges and other expenses related to lower imports of raw material and exports of goods, led to only marginal increase in operating expenses. Other expenses have also remained largely at prior levels. Due to higher mark-up rates, finance cost was recorded higher at Rs. 184.4m (FY18: 150.6m; FY17: Rs. 76.0m) during FY19. Other expenses, mainly comprising WPPF, WWF and fair value adjustment on short-term investments, have increased marginally to Rs. 157.1m (FY18: Rs. 145.0; FY17: Rs. 86.2m). While other income mainly emanating from dividend income from investment portfolio, profit from bank deposits, and gain on sale of fixed asset, increased to Rs. 107.6m (FY18: Rs. 96.6m) during FY19. Profit before tax improved considerably to Rs. 1.1b (FY18: Rs. 426.0m; FY17: Rs. 483.2m). After accounting for taxation, net profit for the year was recorded at Rs. 858.8m (FY18: Rs. 565.5m; FY17: Rs. 505.8m) during FY19.

Strong liquidity profile with adequate coverages: Notable improvement in cash generation has been witnessed over the past three years. Funds from Operations (FFO) has increased significantly on a timeline basis to Rs. 1.5b (FY18: Rs. 679.6m; FY17: Rs. 222.7m) mainly on the back of increasing profitability. With higher FFO and some decrease in borrowing levels, FFO to FFO to total debt increased to 0.41x (FY18: 0.17x; FY17: 0.08x). With reclassification of securities as long-term investments, previously held as short-term investments, through other comprehensive income under IFRS 9 and increase in trade payables, current ratio stood marginally lower at 1.9x (FY18: 2.1x). Trade debts plus inventory to short-term borrowing ratio improved on timeline basis to 5.72x (FY18: 3.47x; FY17: 4.69x).

Adequate capitalization indicators: Equity base of SCML enhanced to Rs. 6.1b (FY18: Rs. 5.6b; FY17: Rs. 5.3b) on back of profit retention. Around four fifth of the company debt profile comprised long-term borrowings. Long-term debt including current portion, stood marginally lower at Rs. 2.8b (FY18: Rs. 2.9b; FY17: Rs. 2.4b) by end-FY19. Despite increasing working capital requirements, short-term borrowings remained relatively low at Rs. 699m (FY18: Rs. 993.1m; FY17: Rs. 374.1m) at end-FY19 as the company mainly relies on internal sources. Gearing ratio and debt leverage of the company has improved to 0.58x and 0.94x (FY18: 0.70x & 0.99x; FY17: 0.52x & 0.81x), respectively by end-FY19. The debt repayment ability of the company is considered strong with DSCR recorded at 8.87x (FY18: 3.87x; FY17: 2.72x) during FY19.

Strong internal and external auditors; corporate governance has room for improvement: The Board of Directors of SCML comprises seven members, excluding CEO, with majority representing the sponsoring family. The board has formed audit committee and HR and Remuneration committee. Four audit committee meetings were conducted during FY19, while one HR&R committee meeting was held during the same period. There is no independent and female director on the board as required by latest code of corporate governance for listed companies. The independent internal audit function of SCML is outsourced to M/s KPMG Taseer Hadi & Co. Chartered Accountants. External auditors of the company are E&Y Ford Rhodes, Chartered Accountants, which are in the 'A' category of SBP panel of auditors.

BALANCE SHEET	FY17	FY18	FY19	1QFY20
Property, plant & Equipment	4,953	5,483	5,349	5,237
Investment Properties	100	100	100	100
Investment in Joint Venture	50	50	50	50
Long-Term Investments	-	15	772	757
Store, Spares and Loose Tools	149	183	202	184
Stock-in-Trade	1,407	2,715	3,088	2,379
Trade Debts	371	732	913	1,092
Short-term Investments	1,909	1,052	134	1,299
Tax Refunds due from Government	375	572	615	515
Cash & Bank Balances	42	65	434	171
Other Assets	212	224	131	171
Total Assets	9,568	11,191	11,789	11,955
Trade and Other Payables	1,006	1,584	1,921	1,994
Long Term Debt *(*incl. current maturity)*	2,372	2,927	2,823	2,759
Short Term Debt	379	993	699	610
Other Liabilities	231	67	278	278
Total/Tier-1 Equity	5,280	5,620	6,068	6,313
Paid-up Capital	290	319	367	367
INCOME STATEMENT	**FY17**	**FY18**	**FY19**	**1QFY20**
Net Sales	8,313	11,096	13,974	3,425
Gross Profit	529	914	1,595	451
Operating Profit	263	625	1,304	367
Profit Before Tax	483	426	1070	320
Profit After Tax	506	566	859	260
Funds from Operations	223	680	1,459	457
RATIO ANALYSIS	**FY17**	**FY18**	**FY19**	**1QFY20**
Gross Margin (%)	6.4	8.2	11.4	13.2
Net Margins	6.1	5.1	6.1	7.6
Current Ratio (x)	2.5	2.1	1.9	1.9
Net Working Capital	2,662	2,905	2,530	2,831
FFO to Total Debt (x)	0.08	0.17	0.41	0.54*
FFO to Long Term Debt (x)	0.09	0.23	0.52	0.66*
Debt Leverage (x)	0.81	0.99	0.94	0.89
Gearing (x)	0.52	0.70	0.58	0.53
Debt Servicing Coverage Ratio (x)	2.72	3.87	8.87	-
ROAA (%)	6.2	5.4	7.5	8.8*
ROAE (%)	10.0	10.4	14.7	16.8*
(Stock in Trade+Trade Debt) to Short-Term Borrowing Ratio	4.69	3.47	5.72	5.69

**Annualized*

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix II

VIS Credit Rating Company Limited

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

REGULATORY DISCLOSURES					Appendix III
Name of Rated Entity	Suraj Cotton Mills Limited				
Sector	Textile				
Type of Relationship	Solicited				
Purpose of Rating	Entity Rating				
Rating History	**Rating Date**	**Medium to Long Term**	**Short Term**	**Rating Outlook**	**Rating Action**
	RATING TYPE: ENTITY				
	09/01/20	A+	A-1	Stable	Initial
Instrument Structure	N/A				
Statement by the Rating Team	VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.				
Probability of Default	VIS ratings opinions express ordinal ranking of risk, from strongest to weakest, within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.				
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Due Diligence Meetings Conducted		Name	Designation	Date	
	1	Mr. Farooq Ahmad	CFO	22-Oct-2019	
	2	Mr. Ansab Zafar	Manager Finance	22-Oct-2019	