RATING REPORT

Eastern Spinning Mills Limited

REPORT DATE:
December 30, 2021

RATING ANALYSTS:
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RATING DETAILS		
	Initial Rating	
Rating Category	**Long-term**	**Short-term**
Entity	A-	A-1
Rating Outlook	*Stable*	
Rating Action	Initial	
Rating Date	*December 30, 2021*	

COMPANY INFORMATION	
Incorporated in 1991	External auditors: Mushtaq & Co. Chartered Accountants
Public Limited – Unquoted	Chairman/CEO: Mr. Anjum Zafar
Key Shareholders (with stake 5% or more):	
Zakia Textile Mills (Pvt.) Limited – 99%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Corporates (August 2021)
https://docs.vis.com.pk/docs/CorporateMethodology202108.pdf

Eastern Spinning Mills Limited

OVERVIEW OF THE INSTITUTION

Eastern Spinning Mills Limited (ESML) was incorporated in 1991 and started commercial production in 1994. The company is mainly involved in manufacturing and sale cotton yarn.

Chairman/CEO Profile: Mr. Anjum Zafar serves as the Chairman of the Board and Chief Executive Officer (CEO) of the company. He has over 40 years of experience in leather, textile, and dairy industries.

RATING RATIONALE

Eastern Spinning Mills Limited (ESML) is an export-oriented spinning unit which manufactures a range of cotton yarn. ESML is a part of Eastern Group, a conglomerate having business interests in leather, textile, and dairy industries. Shareholding of the company is vested with the sponsoring family through a holding company named Zakia Textile Mills (Pvt.) Limited. The assigned ratings take into account moderate business risk profile of the company which is supported by extensive industry experience of sponsors and established relationships with the customers. The ratings draw comfort from low gearing and leverage indicators and sound debt service coverages. However, the ratings are constrained by vulnerability of the spinning sector to availability and prices of raw materials, exchange rate risk, and adverse changes in regulatory duties structure. The company is in the final planning stages of setting up a new spinning unit and civil work on the project is expected to start in January'2022.

<u>Rating Drivers</u>

Corporate Profile

ESML is a public limited – unquoted company which was incorporated in 1991 under the repealed Companies Ordinance, 1984 (now the Companies Act, 2017). ESML is a family-owned business with 100% shares held by the sponsoring family primarily through Zakia Textile Mills (Pvt.) Limited, which is the holding company with no standalone operations. ZTML holds 99% stake in the company that has remained largely unchanged since 1998. The company started commercial production of cotton yarn at unit-I in 1994. Spinning unit-II was established in 2001 to meet the growing demand for cotton yarn. The foundation of Eastern Group (EG) was laid by Mr. Zafar Iqbal (late) with the setting up a leather processing unit in 1969. Eastern Leather Company (Pvt.) Limited (ELCL) is the flagship company of EG which is involved in manufacturing and export of leather and related products. Meanwhile, Eastern Dairies (Pvt.) Limited (EDL) is involved in dairy farm operations with cows imported from the Netherlands and Australia.

The Board of Directors of the company consists of four members, all being the representative of sponsoring family. Mr. Anjum Zafar, who is the elder son of Mr. Zafar Iqbal, serves as the Chairman of the Board and Chief Executive Officer (CEO) of the company. He has over 42 years of experience in leather, textile, and dairy industries. He holds a Bachelor's degree in Science and has taken several trainings and short-term courses from renowned intuitions. Mr. Shaheen Zafar is the younger brother of Mr. Anjum Zafar and servers as Director of Operations. He has over 36 years of strategic planning and monitoring experience in textile, leather, and dairy industries. Remaining two directors are inactive members of the Board.

Production Facilities

ESML manufacture cotton yarn for knitting and hosiery industry. The company currently operates two spinning units located at separate locations. Unit-I was built at the time of the company's incorporation and unit-II was setup in 2001. The company has carried out periodic enhancements over the years. Going forward, the company plans to setup its third spinning unit. Unit-III will be constructed on a land already owned by the sponsors in near future.

The company has shifted towards higher count (up to 30 counts) and value added Slub yarns for knitting for export besides count of 10/s – 20/s over the past two years which has also impacted the production levels. Moreover, due to some slowdown in demand from the international markets amidst COVID-19 related issues, actual production levels have decreased slightly over the past two years.

Procurement and Credit Policy

Cotton is sourced from both local and international markets, and its mix depends on customer requirements. However, local cotton remains dominant in the mix, accounting for 83% (FY20: 87%) of total cotton procured during FY21. Average local cotton procurement price has gradually increased over the review period, though average price of imported cotton decreased slightly during FY21. The warehouses at both spinning units can store up to 125,000 bales of cotton, sufficient for one-year of yarn production. Local cotton procurement cycle runs from September to January whereas cotton imports depend on requirement. Cotton from the local market is purchased on advance payment terms, imports via L/Cs, and stores, spare parts, and loose tools on 60 days credit.

Profitability

Net sales of the company increased by 11% during FY21, driven largely by higher selling price as volumetric sales remained stagnant during the year. Revenue from exports increased by 13% due to higher average selling price as volumetric sales remained stable during FY21. Major export markets were China, Central America, and Turkey. Revenue from local sales increased marginally during the year as the impact of higher average selling price was largely offset by decrease in volumetric sales. Average local cotton purchase price was recorded higher during FY21 on account of notable decline in crop produce during previous season. Cotton imports were slightly higher on account of decline in average price. Since the increase in cost of goods sold was slower than top-line growth, the company registered 55% increase in gross profit as the margin recovered during FY21.

Operating expenses increased on account of higher distribution and administration expenses mainly on account of increase in freight charges and staff salaries, respectively. Decline in financial charges due to lower interest rate despite largely same levels of debt utilization during FY21. With the increase in revenue and improvement in margins profile, the company reported notable increase in net profit during the year. Sustained improvement in overall profitability profile is important from ratings perspective.

Liquidity

Liquidity is supported by internal cash flows generation. In line with improvement profits, the company generated higher funds from operations (FFO) during FY21 which led to notable improvement in the company's capacity to meet its debt obligations, as reflected in debt service coverage ratio (DSCR) of 3.01x (FY20: 0.91x). FFO-to-long term debt and FFO-to-total debt ratios also improved to 0.98x (FY20: 1.55x) and 0.45x (FY20: 0.38x), respectively, during FY21. Increase in current ratio to 3.3x (FY20: 2.8x) was led by a combination of higher trade receivables and some decline in trade payables and short-term borrowings by end-FY21. Net working capital cycle of the company is considered satisfactory and in line with the peers despite some stretch on account of increase in trade receivables by end-FY21.

Capitalization

Equity base accumulated by end-FY21 with the retention of profits as the company has very conservative payout policy. Total liabilities were unchanged which mainly comprised trade payables and borrowings. Debt profile of the company comprises a mix of short-term borrowings for partial working capital requirements and long-term loans for capex. Short-term borrowings have declined slightly by end-FY21. Working capital requirements are also met through internal capital generation as reflected in inventory-plus-receivables-to-short-term borrowings ratio of 4.0x (FY20: 2.91x; FY19: 2.50x) at end-FY21.

Total long-term debt has increased as the company mobilized new facility during the year in order to fund the capex on gas generator set for spinning unit-I, automatic winder process coner, and ring spinning frames. With largely stable debt levels and liabilities, the company's gearing and leverage ratios improved marginally to 0.38x (FY20: 0.41x) and 0.47x (FY20: 0.52x) by end-FY21. Going forward, the leverage indicators are expected to increase as the company is planning to mobilize LTFF facility of Rs. 2.5b in FY22 in order to fund the establishment of spinning unit-III. However, gearing is expected to remain less than 1.0x with satisfactory repayment capacity.

ISSUE/ISSUER RATING SCALE & DEFINITIONS — Annexure I

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 — Annexure II

Name of Rated Entity	Eastern Spinning Mills Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings
Rating History	see table below
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.
Disclaimer	Information herein was obtained from sources believed to be accurate and reliable; however, VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. For conducting this assignment, analyst did not deem necessary to contact external auditors or creditors given the unqualified nature of audited accounts and diversified creditor profile. Contents may be used by news media with credit to VIS.

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
12.30.2021	A-	A-1	Stable	Initial

Due Diligence Meetings Conducted

Name	Designation	Date
Mr. Sharafat Ali	CFO	November 05, 2021