RATING REPORT

Khalid Shafique Spinning Mills Limited (KSSML)

REPORT DATE:
April 14, 2020

RATING ANALYSTS:
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RATING DETAILS				
	Latest Rating		Previous Rating	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	BBB	A-2	BBB	A-2
Rating Date	*April 14, 2020*		*February 18, 2019*	
Rating Outlook	Rating Watch-Negative		Stable	

COMPANY INFORMATION	
Incorporated in 1992	External Auditors: Ilyas Saeed & Co., Chartered Accountants
Unlisted Public Company	Chairman of the Board/CEO: Ch. Khalid Shafique
Majority Shareholders:	
Ch. Khalid Shafique – 75.51%	
Mr. Shargeel Khalid – 17.13%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Corporates (May 2019) **https://www.vis.com.pk/kc-meth.aspx**

OVERVIEW OF THE INSTITUTION

Khalid Shafique Spinning Mills Limited (KSSML) is a public limited unlisted company incorporated in Pakistan in April, 1992 under the repealed Companies Ordinance, 1984 (now Companies Act, 2017). The principal activity of the company is manufacturing and sale of yarn. The registered office is located at M.M. Alam Road, Gulberg II, Lahore.

Profile of the Chairman/CEO

Ch. Khalid Shafique serves as the Chairman of the Board and CEO. He is a qualified Chartered Accountant from the Institute of Chartered Accountants of Pakistan. He has over 30 years of experience in the textile sector.

Financial Snapshot

Total Equity: end-FY19: Rs. 756.0m; end-FY18: Rs. 686.8m; end-FY17: Rs. 637.8m

Assets: end-FY19: Rs. 1.4b; end-FY18: Rs. 1.3b; end-FY17: Rs. 1.0b

Profit After Tax: FY19: Rs. 69.8m; FY18: Rs. 50.0m; FY17: Rs. 10.9m

RATING RATIONALE

Khalid Shafique Spinning Mills Limited (KSSML) is a small-sized spinning unit, with majority owned and managed by the sponsoring family. The ratings assigned take into account a steady increase in topline supported by volumetric increase in sales along with higher yarn prices. Overall liquidity indicators have remained adequate. The ratings also factor in sustained level of cash flows, despite elevated finance cost and sound coverages. Leverage indicators have remained low; though some increase has been witnessed by end-1HFY20 due to debt procurement for working capital needs. However, the ratings are constrained by relatively small equity base, nearly full capacity utilization, vulnerability of spinning sector to raw material prices and any adverse changes in regulatory duties. With the advent of corona virus pandemic, the demand outlook for local and international consumption of yarn looks weak. The ratings are dependent upon maintenance of profit margin, debt service coverage, and gearing ratios at an adequate level.

Decline in cotton production and yarn exports on a timeline basis: 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.

Cost pressures for the industry are reflective of global and local cotton production data which shows scaled down cultivation area and production at both ends. Resultantly, local cotton prices have gone up. With respect to spinning segment, dependence on imported cotton, particularly from India, had been on the higher side given its identical quality with the local cotton. However, sprained relations with India and significant rupee devaluation would further spike up raw material costs for the spinning segment. Margins and financial performance of the players in the industry have depicted volatility due to inherent cyclicality of crop levels and oscillations in cotton prices. Recently, plant shutdowns have been witnessed across country; continuation of current pandemic for a prolong period would have negative connotations for economy in general and textile sector in particular.

Continuous BMR to improve operational efficiency and nearly full capacity utilization: Total operational and installed spindles of KSSML were 33,408 (FY18: 33,408) at end-FY19. Actual production of yarn after conversion into 20s count stood at 12.2 million Kgs (FY18: 12.2 million Kgs), with capacity utilization remained stagnant at 98.6% (FY18: 98.5%) during FY19. The company has added machinery costing Rs. 49m during FY19, comprising HFJ compact spinning system, Murata's automatic cone winder and raw cotton analyzer model, to improve operational efficiencies. The management contemplates to add draw frames of around Rs. 65m and a godown costing Rs. 6m, during the ongoing year as a part of regular BMR; 70% of the aforementioned addition has already been made.

Increase in topline backed by higher yarn prices and volumetric increase in sales: Topline increased to Rs. 3.1b (FY18: Rs. 2.4b) during FY19, driven by volumetric increase in sales to 203,897 bags vis-à-vis 178,917 bags in FY18, along with higher yarn prices. Cotton yarn constituting 53% (FY18: 57%) of the total sales, remained the main revenue driver. Meanwhile, PC yarn contributed 46% (FY18: 34%) to the total sales. The company has sold 99,823 bags (FY18: 94,478 bags) of cotton yarn at an average rate of Rs. 16,718/bag (FY18: Rs. 14,621/bag), while 104,073 bags of PC yarn (FY18: 67,833) were sold at an average rate of 13,537/bag (FY18: Rs. 12,103/bag) during FY19. PV yarn, constituting a smaller proportion of total sales of around 6% during FY18, has been discontinued during FY19 due to lower gross margins. The company has also sold raw material (imported cotton), from preceding year's stock, for Rs. 21.8m (FY18: Rs. 25.4m) during FY19. Customer concentration, measured in terms of sales to top ten clients, increased to 51% (FY18: 40%); according to the management, the concentration risk is mitigated to a certain extent as the company holds long-term relationships with majority of its clients.

Gross margins increased to 7.3% (FY18: 6.7%) on account of higher yarn prices and overall rationalization in cost of sales during FY19. The latter increased to Rs. 2.9b (FY18: Rs. 2.3b) during FY19. Cost of raw material consumed, constituting 75% (FY18: 74%) of the total cost of sales increased to Rs. 2.1b (FY18: Rs. 1.7b) during the review period, owing to higher raw material prices. During FY19, KSSML procured Rs. 7.6 million Kgs of cotton, entirely from local market, (FY18: 7.3 million Kgs*(local)*) at an average rate of Rs. 8,637.3/maund (FY18: Rs. 6,608/maund), while around 2.0 million Kgs polyester (FY18: 2.6 million Kgs) was procured at an average rate of Rs. 191/Kg (FY18: Rs. 146/Kg). On account of local currency depreciation resulting in higher cost, the company has not imported raw cotton during the outgoing year; the same constituted 6% of total procurement during FY18, at an average rate of Rs. 8,100/maund.

Administrative expenses increased to Rs. 41.7m (FY18: Rs. 31.1m), mainly due to higher depreciation expense allocated to administrative expenses and increase in salaries, wages and benefits during FY19. Further, selling and distribution expenses increased to Rs. 12.4m (FY18: Rs. 10.7m) during FY19, due to inflationary pressure. Finance cost stood higher at Rs. 72.6m (FY18: Rs. 33.9m) during the review period, owing to increase in average total borrowings along with higher markup rates during the outgoing year. Accounting for taxation, net profit increased to Rs. 69.8m (FY18: Rs. 50m) during FY19. With some increase in yarn prices, the company reported net sales of Rs. 1.5b during 1HFY20.

With increase in cash flows and minimal reliance on long-term financing, debt service coverage remained adequate: Despite higher profit before taxation, non-cash adjustments and positive difference between incurred and paid finance cost, Funds from Operations (FFO) increased slightly to Rs. 131.3m (FY18: Rs. 128m) during FY19, mainly due to higher taxes paid during FY19. This along with some decrease in overall debt levels, FFO to total debt increased slightly to 0.31x (FY18: 0.28x) during FY19. On the other hand, FFO to long-term debt though decreased, considered adequate at 1.82x (FY18: 2.84x) by end-FY19. Also given increase in interest paid, debt service coverage ratio albeit decreased, remained sound at 2.38x (FY18: 3.36x), during the review period.

Stock in trade stood at Rs. 537.5m (FY18: 544.3m), due to a steady level of raw material and finished goods stock at end-FY19, in order to control carrying cost. Trade debts increased to Rs. 139.3m (FY18: Rs. 115.6m) by end-FY19. Aging analysis of trade debts showed that, all receivables fall due within 60 days' bracket. Around 40% of sales are made on the cash basis, while up to 45 days are provided for credit sales. Advances, deposits and prepayments stood higher at Rs. 59.5m (FY18: Rs. 46.0m) at end-FY19, mainly due to higher amount of sales tax refundable. Moreover, trade and other payables remained largely at prior year's level at Rs. 164.5m (FY18: Rs. 161.4m) on account of some decrease in creditors and increase in accrued expenses. Around 95% payment to cotton suppliers is made upon delivery and remaining 5% is payable on close of season, while polyester suppliers are paid 100% in advance. On the other hand, around 80% of stores and spare are purchased on credit, with credit terms of 30-90days. Current ratio increased to 1.46x (FY18: 1.32x) by the end-FY19. Coverage of short-term borrowings via stock in trade and trade debts, also witnessed an increase to 1.90x (FY18: 1.63x) by end-FY19. Further, the company has not recorded liability amounting Rs. 45.2m in respect of principal arrears of GIDC and late payment surcharge for FY19; as the Supreme Court reserved its judgment on the GIDC on February 20, 2020, the management is hopeful for its reversal.

Improvement in capitalization indicators on back of higher equity base and overall decrease in debt levels: Tier-1 equity increased to Rs. 756.0m (FY18: Rs. 686.8m) on back of profit retention. Directors' loan amounting Rs. 136m (FY18: Rs. 136m) continues to provide support to the equity base. Long-term borrowings *(including current maturity)* constituted term finance obtained for import of machinery, increased to Rs. 72m (FY18: Rs. 45m) by end-FY19. The aforementioned long-term facilities are scheduled to be retired by end-FY21. Short-term borrowings decreased to Rs. 355.5m (FY18: Rs. 404.8m) by end-FY19. The same stood higher at Rs. 962.5m by end-1HFY20, in line with higher working capital requirements, as the company procured majority of raw material by end1HFY20. Mark-up on these facilities ranged from 1-3 months KIBOR *plus* 1.75% per annum. Gearing and leverage indicators decreased slightly to 0.57x and 0.83x (FY18: 0.65x and 0.94x) respectively, by end-FY19. With procurement of raw material, gearing increased by end-1HFY20. The level of borrowings may not be reduced to normal levels given slowdown in expected sales during 4QFY20.

Khalid Shafique Spinning Mills Limited — Appendix I

BALANCE SHEET (PKR Millions)	FY17	FY18	FY19	1HFY20
Property, Plant & Equipment	521	554	543	520
Store, Spares and Loose Tools	29	32	29	28
Stock-in-Trade	321	544	538	1,530
Trade Debts	84	116	139	82
Advances, Deposits & Prepayments	33	46	60	60
Advance Income Tax	23	14	14	3
Cash & Bank Balances	14	24	56	42
Other Assets	5	5	8	8
Total Assets	1,030	1,335	1,386	2,273
Trade and Other Payables	105	161	165	422
Long Term Debt *(including current maturity)*	16	45	72	54
Short Term Debt	249	405	356	963
Other Liabilities	22	37	38	52
Tier-1/Total Equity	638	687	756	783
Paid-up Capital	160	160	160	160
INCOME STATEMENT	**FY17**	**FY18**	**FY19**	**1HFY20**
Net Sales	2,166	2,424	3,076	1,530
Gross Profit	87	163	224	113
Profit Before Tax	25	82	92	42
Profit After Tax	11	50	70	27
Funds from Operations	50	128	131	73
RATIO ANALYSIS	**FY17**	**FY18**	**FY19**	**1HFY20**
Gross Margin (%)	4.0	6.7	7.3	7.4
Net Margins (%)	0.5	2.1	2.3	1.7
Current Ratio (x)	1.35	1.32	1.46	1.20
Net Working Capital	129	189	263	294
FFO to Total Debt (x)	0.19	0.28	0.31	0.14*
FFO to Long Term Debt (x)	3.11	2.84	1.82	2.72*
Debt Leverage (x)	0.61	0.94	0.83	1.90
Gearing (x)	0.42	0.65	0.57	1.30
DSCR (x)	1.62	3.36	2.38	2.28
ROAA (%)	1.5	5.3	4.1	1.9*
ROAE (%)	2.4	9.4	7.8	4.4*
(Stock in Trade+Trade Debt) to Short-Term Borrowing Ratio (x)	1.63	1.63	1.90	1.68

**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	Khalid Shafique Spinning Mills Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
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.
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Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
14/04/2020	BBB	A-2	Rating Watch-Negative	Maintained
18/02/2019	BBB	A-2	Stable	Initial

Due Diligence Meetings Conducted

	Name	Designation	Date
1	Mr. Muhammad Ashraf	General Manager Finance	20th March, 2020