

RATING (AUGUST 2011)
Fazal Cloth Mills Limited (FCML)

ENTITY	NEW	PREVIOUS
Long Term	A-	A-
Short Term	A2	A2

FINANCIAL DATA

PKR (mln)

	31-Mar-11*	30-Jun-10
Total Assets	16,142.0	10,892.8
Pure Equity	3,042.9	2,240.3
Adj. Equity**	5,214.4	4,598.3
Turnover	13,914.0	11,211.0
Net Income	720.9	526.9
EBITDA/Interest	3.0	2.4
Long-term Debt/FCFO	1.7	1.2
Total Debt/Total Debt+Equity(%)	63.3	48.1
Gross Margin (%)	12.5	14.0
RoE (%)	26.0^	12.1

**Un-audited results for nine months*
***Including revaluation surplus on fixed assets*
^Simple annualized
ANALYSTS

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PROFILE

■ Fazal Cloth Mills Limited (FCML), incorporated in 1966 and listed on Karachi and Lahore Stock Exchanges, is engaged in the manufacturing and marketing of different varieties of yarn with a capacity of 141,816 spindles. The major shareholder of the company are Fazal Group (FaG) and Fatima Group (FG), holding ~ 45% and ~44% respectively. FaG, enjoying management control of FCML, is also engaged in the business of cotton ginning, ring spinning, and greige fabric manufacturing. FG, with close to seven decades of experience in textile business, has interests in sugar, fertilizer and foreign trade.

■ FCML has a seven member board. With the exception of one member - a nominee of NIT - all members are from the families of major shareholders. There are three executive directors on the board. The CEO, Mr. Sheikh Naseem Ahmed, is also the chairman of the board. The top management, mainly dominated by the CEO and his two sons, is supported by a team of professionals with relevant experience in the textile industry.

RATING RATIONALE AND KEY DRIVERS

■ The ratings reflect FCML's improved profitability, emanating from favorable supply/demand equilibrium in the global market. The ratings continue to take support from the company's seasoned management team, having sound understanding of the industry dynamics and quality support infrastructure. Although the company's leveraging is on rise to finance ongoing expansion in the spinning capacity and establishment of a weaving unit, relatively strong core cashflows are expected to keep this at a manageable level.

■ The ratings are dependent on the successful execution of the expansion projects within the expected timeline without major cost overruns. The ratings depend upon effective management of the company's financial risk profile. In the meantime, continued competitiveness of the company through volatile global economic fundamentals remains important.

ASSESSMENT

■ The country's textile sector experienced significant growth in the recent period, primarily attributed to improve exports (FY11: USD 13.8bln, 35% YoY). This had limited volumetric expansions and was mainly driven by hike in prices, as the cost of basic raw material – cotton – observed a rising trend in the wake of supply constraints. During FY11, ready-made garment segment was the major contributor in terms of both value and quantity after Knitwear. The highest price rise was witnessed for yarn products, which almost doubled though the export quantity declined as domestic demand went up. Lately, in the hopes of improved global supply, cotton prices have eased off significantly, causing inventory losses to most players. It is expected that cotton pricing would show relatively stable pattern over the near term. Nevertheless, key risks faced by the industry remain volatility in cotton pricing, continued power shortage, rising inflation, high interest rate and weak law & order situation.

■ During three quarters of FY11, FCML observed significant growth in its turnover on back of high yarn prices. However, owing to proportionally high rise in cotton pricing during the period, the company witnessed a slight reduction in its gross margin. Nevertheless the company's gross profit went upward substantially in absolute terms. Although the company's operating expenditure rose on YoY basis, it declined slightly as a percentage of top line due to sizeable expansion therein. The company's finance cost escalated as quantum of borrowings increased. However, its impact was diluted due to dividend income received by the company during the period. This enabled the company to post historic net income during 9MFY11. The company incurred loss on inventory in the last quarter of FY11; nevertheless the additional capacity is expected to help the company to absorb the impact.

■ Going forward, FCML intend to strengthen its position in the spinning segment while diversifying into textile value chain. In this regard, the company is in the process of expanding its spinning capacity by 31,200 spindles out of which 16,800 spindles are operational since March 2011. The rest 14,400 spindles are expected to start production in October, 2011. Moreover, the company plans to install a new weaving unit having capacity of 117 Air jet looms, by the same timeline. While providing tax benefits, this would ensure consumption of in-house resource (yarn) and easing on logistics – hence augmented margins. To meet the additional energy requirements (5.5MW), FCML plans to install three Gas Fired Generators. In the wake of shortage of the resource, this initiative remains susceptible to risk though FCML has so far been able to manage energy supply efficiently.

■ FCML's investment book (PKR 642mln), constituting ~21% of its pure equity base at end-Mar11, comprises two types of portfolio: strategic (PKR 538mln) and trading portfolio (PKR 104mln). The company owns 5.7% holding in Pak Arab Fertilizers Limited and 1.9% holding in Fatima Fertilizer Company Limited (FFCL) as its strategic investments. The company carries an unrecognized gain of PKR 955mln on its strategic portfolio as at end-Mar11.

■ FCML, apart from the short term borrowing, is a relatively leveraged company. The upcoming projects' estimated cost is ~PKR 3.7bln. Hereof, the company plans to finance ~PKR 2.6bln through borrowings while the remaining through internal resources. Consequently, though this would increase the quantum of overall borrowing, it would not impact the company debt/equity ratio. The repayment of the loans is spread over 8 years, with varied grace periods (from 1 to 2). This would enable the company to effectively deploy its additional capacity to be able to repay the loan amount. However, the surplus cash being generated through existing operations would function as a primary source for debt repayment. The company, as a practice, keeps cushion in its ability to raise short term borrowings which may be utilized at the time of urgent need of funding.