December 24, 2020

KGK Jewellery Manufacturing Limited (KJML): Rating assigned

Summary of rating action

Instrument*	Current Rated Amount ($ million)	Rating Action
Short-term, Fund based limits	25.0	[ICRA]A4+; Assigned
Total	**25.0**	

**Instrument details are provided in Annexure-1*

Rationale

The rating assigned takes into consideration diverse presence of the KGK Group in the mining, diamonds and jewellery sector, backed by the extensive experience of the promoters. The company benefits from the group's integrated supply chain from mining to rough diamond procurement to diamond manufacturing and its geographically diversified business globally. The KGK group also benefits from its long-term supply contracts signed with all the major diamond mining companies including De Beers, Alrosa, SODIAM, and Rio Tinto Diamonds among others, in six countries. The rating also factors in the financial support given by the Group's immediate holding company, 'United Pacific Excel limited' (ultimate holding company being 'Sino Charm Limited'). The rating is, however, constrained by the low margins at both the operating and net levels and high working capital intensity. The revenues of the company were impacted in FY2020 with the company reporting HK$1,301.7 million (HK$1,409.5 million in FY2019), indicating a 7.6% year-on-year decline amid slowdown in demand due to the US–China tariff war and macro-economic challenges further accentuated by the Covid-19 pandemic. The business remained impacted in 6M FY2021 by disruptions in operations during H1 FY2021 because of the pandemic with recovery expected during the other half of the fiscal. In 6M FY2021, the company reported revenues of HK$ 584.1 million on the back of sales to USA and Hong Kong, which comprise ~87% of the overall revenues. The OPM margins have been low, albeit stable, ranging at 1.5–1.9% over the last four years, considering the low value addition in the nature of the business. The rating is further constrained by the stiff competition from unorganised as well as organised players, resulting in limited pricing power that puts pressure on profitability.

While ICRA expects recovery in revenues during the second half of FY2021, any second wave of the pandemic during the current fiscal and macro-economic weakness affecting consumer spending might impact its revenue trajectory. ICRA would continue to monitor the extent/severity of the impact of the same on KJML's credit profile.

Key rating drivers and their description

Credit strengths

Extensive track record of the promoters and the Group in the gems and jewellery business – The company's promoters, the Kothari family, have extensive experience in this business sector, with the Group being present in the overall gems and jewellery value chain. Since its inception in 1905, four generations of the Kothari family have been managing the business. The Group is present in 17 countries across the globe, including USA, the UAE and India, among others. The company's diamond and jewellery manufacturing facilities as well as sourcing centres are spread across the globe.

Moderate customer concentration risk - KJML has a moderately diversified customer base with ~60% of its total revenues driven by its top 10 customers in FY2020. KJML's large customer base spanning various countries can be attributed to the relationships that it has nurtured by operating in the diamond and jewellery industry for more than five decades.

Credit challenges

Weak financial risk profile – The margins of the company have been low at both the operating level and the net levels, in the range of 1.8–2.2% and 0.5–0.6%, respectively which along with high working capital intensity has resulted in low return on capital employed (ranging 3.6%-3.8%) over the last five years. The gearing and TD/OPBITDA of the company has remained high at 3.5 times and 23.4 times as on March 31, 2020. The revenues in FY2020 saw a decline of 7.6% due to the ongoing Covid-19 pandemic, which impacted sales in Q4 FY2020 (as countries like USA and Japan Middle-east were already under lockdown). In H1 FY2021, the company has reported revenues of HK$584.1 million on the back of sales to USA and Hong Kong, which comprise ~87% of the overall revenues. The OPM has remained in line with earlier years at 2.0% in H1 FY2021.

High working capital requirement – The company's working capital intensity remains high as reflected by net working capital / operating income (NWC/OI) of 61.2% during FY2020 due to traditionally long, albeit stable, receivable cycle and moderate inventory levels. Nevertheless, there have been no bad debts in the company in the past.

Industry characterised by severe competition from unorganised and organised players - The gems and jewellery industry is highly fragmented because of low entry barriers on account of relatively low capital and technology requirements, attracting numerous organised and unorganised players. However, by virtue of its extensive experience in the diamond and jewellery industry the KGK Group has established healthy business relationships with its customers as well as suppliers.

Liquidity position: Adequate

KJML reported a working capital utilisation of 69% during the 12-month period that ended in October 2020, thereby resulting in an average unutilised working capital limit of $27.8 million during the period. However, working capital intensity would remain under pressure due to higher inventory levels and receivables. Moreover, KJML had cash and cash balance of HK$4.6 million as on September 30, 2020. The company's balance sheet is also supported by loans from immediate holding, 'United Pacific Excel Limited' (owns 98.9% stake in KGK Jewellery Manufacturing Limited) and loan from director, amounting to HK$131.9 million and HK$14.3 million, respectively, over the past few years. The loan from its immediate holding company and directors are interest free, unsecured and repayable with an option to convert the loans into non-voting ordinary shares of the company. These loans are sub-ordinated to bank loans, are expected to remain in the business over the long-term.

Rating sensitivities

Positive triggers – Any near-term rating upgrade would remain contingent upon the company's ability to demonstrate substantial improvement in scale and profitability and working capital intensity on a sustained basis.

Negative triggers – Negative pressure on KJML's rating could arise if there is any moderation in the company's profitability metrics or revenues, any strain in liquidity position arising from deterioration in the working capital profile or withdrawal of funds from capital/ unsecured loans. Interest coverage of less than 1.0 time on a sustained basis would trigger a downward rating action.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Impact of Parent or Group Support on an Issuer's Credit Rating
Parent/Group Support	Parent Company: United Pacific Excel Limited (ultimate holding company: Sino Charm Limited) ICRA expects KJML's parent company to extend timely financial support to it, should there be a need, given the operational linkages between them. There also exists a track record of the parent company having extended financial support to KJML in the form of unsecured loans.
Consolidation/Standalone	The rating is based on standalone financial statements of the company.

About the company

Based out of Hong Kong, KGK Jewellery Manufacturing Limited manufactures diamond and precious stones studded jewellery. Its immediate holding company, United Pacific Excel Limited, has a 98.9% stake in KJML (as on March 31, 2020). The remaining is held by the promoters, Mr. Sanjay Navrattan Kothari (0.56%) and Mrs. Manju Kothari (0.54%). The ultimate holding company, Sino Charm Limited, is registered in British Virgin Islands, which is wholly owned by Mr. Kothari. KJML has two subsidiaries, KGK Creation (Guangzhou) Limited and KGK Creations USA Inc. KGK Creation (Guangzhou) Limited, incorporated in 2004, is the manufacturing arm of KJML, to whom it supplies all raw materials and also pays its labour charges for manufacturing jewellery.

KGK Creations USA Inc. is the holding company of the jewellery operating companies in USA. The company has two subsidiaries, Martin Flyer and KGK Jewels LLC, through which it sells and distributes diamonds and jewellery. KJML holds 19.6% and the balance 80.4% is held by KGK Creations India Limited. The company has classified it as a subsidiary as it has considerable sales from this entity and, thus has large exposure to variability of returns.

Key financial indicators (audited)

	FY2019	FY2020
Operating Income (HK$ million)	1,409.5	1,301.7
PAT (HK$ million)	7.5	5.9
OPBDIT/OI (%)	1.8%	2.1%
PAT/OI (%)	0.5%	0.5%
Total Outside Liabilities/Tangible Net Worth (times)	4.3	4.3
Total Debt/OPBDIT (times)	23.2	23.4
Interest Coverage (times)	1.4	1.2

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2021)			
		Type	Amount Rated	Amount Outstanding	Rating 24-Dec-2020
1	Short-term, Fund based limits	Short Term	25.0	-	[ICRA]A4+

Amount in $ million

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (US$ million)	Current Rating and Outlook
NA	Short-term, Fund based limits	NA	NA	NA	25.0	[ICRA]A4+

Source: KGK Jewellery Manufacturing Limited

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About ICRA Limited:

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