RATING REPORT

Universal Leather (Private) Limited

REPORT DATE:
January 30, 2023

RATING ANALYSTS:
Muhammad Tabish
muhammad.tabish@vis.com.pk

Ali Yousuf
ali.yousuf@vis.com.pk

RATING DETAILS

Rating Category	Latest Rating		Previous Rating	
	Long-term	**Short-term**	**Long-term**	**Short-term**
Entity	BBB	A-3	BBB-	A-3
Rating Outlook	Stable		Positive	
Rating Date	*January 30, 2023*		*November 18, 2021*	
Rating Action	Upgrade		Maintained	

COMPANY INFORMATION

Incorporated in 1968	**External Auditors:** Mushtaq & Co Chartered Accountants
Private Limited Company	**Board Chairman/ CEO:** Mr. Shakil Ahmed
Key Shareholders (with stake 10% or more):	
Mr. Shakil Ahmed ~19.2%	
Mr. S.M. Saleem ~10.0%	
Mr. S.M. Naseem ~10.0%	

APPLICABLE METHODOLOGY(IES)

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

Universal Leather Private Limited

OVERVIEW OF THE INSTITUTION	RATING RATIONALE

Incorporated in 1968 as a public listed company, ULPL was converted into a private limited company in 2004. The company's primary business focus is leather tanning of cow and buffalo animals with facilities present in Karachi and Lahore.

Corporate Profile
Universal Leather (Private) Limited (ULPL), member of MIMA Group of Companies, with over five decades of operational track record specializes in leather products (shoes, garments & other accessories) made from cow/buffalo hides. Recently, the company received two major certifications; ISO 14001 and Leather Working Group certification. In addition, the company has installed water-saving plant to utilize it efficiently in tanning process. At present, staff strength stands at 81 employees. Entire energy requirement of 0.4MW is met primarily through solar power project, with remainder from national grid while diesel-powered generators serving as a backup.

ULPL has long-term investments in associated companies (MIMA Leather and MIMA Knit) presently valued at Rs. 122m, representing ~17% of total asset base.

Group Profile
The group sponsors possess extensive experience in the leather industry with shareholding held by various family members. Other business entities include MIMA Knit (socks), MIMA Leather (leather from goat and sheepskins), MIMA Apparel (clothing), HUB Leather, and HUB retail stores.

Operating Performance
The company has two manufacturing facilities located in Karachi and Lahore, with cumulative installed production capacity of 4.0m sq. ft. per annum. Post FY20, reduction in installed capacity was the result of a strategic shift in business model to focus on efficient product lines that benefit profitability. Capacity utilization currently stands at one-half while the shortfall in utilization of resources is in response to lower market demand.

<u>Key Rating Drivers:</u>

Leather industry – Overview
Pakistan's leather sector is predominantly export-oriented (as per Pakistan Tanners Association, ~95% export levels), accounting for ~3% of total exports and ~5% of GDP, with major export destinations including Germany, US, UK, Spain, Netherlands, and France. In terms of products, leather garments account for ~34% of total leather exports, followed by gloves (31%), leather tanned (19%), and leather footwear (13%). Market structure is competitive with more than 800 tanneries and 4 listed companies. Demand is primarily driven by the fashion industry, which includes footwear, clothing, bags, and belts, as well as the furniture and automotive industries. Given duty-free access to European Union (world's largest consumer of leather goods) under EU's Generalized Scheme of Preferences (GSP+), industry is expected to remain one of five key export-oriented sectors (along with textiles, sports goods, surgical goods, and carpets).

Business risk is supported by locally abundant raw material (animal hides and skins) and export-friendly government policies (in form of financing schemes and additional custom duty on import of leather products). However, lack of advanced technology results in higher production costs relative to international competitors. This along with lack of skilled labor force, lack of presence in global fashion market, and substitution by low-cost alternatives such as synthetic leather are the present risk factors.

Industry – Current export levels and future outlook

Leather exports in dollar terms have recouped to FY18 levels, following a dip during pandemic, owing to subsequent global economic recovery and resumption of international trade. Over the last two years, exports grew by ~25% driven by both increase in average unit prices and higher volumetric exports, with leather garments leading the way, followed by gloves and footwear. Demand for tanned leather remains subdued due to overall global demand contraction, availability of faux leather, and domestic industry challenges limiting product diversification.

Figure: Leather Exports Breakup (USD in m)

	FY18	FY19	FY20	FY21	FY22
Tanned leather	330.2	252.2	184.2	161.9	208.1
Leather garments	294.4	256.3	250.9	286.1	315.2
Leather gloves	225.9	217.9	212.8	260.1	287.2
Leather footwear	95.2	106.4	107.2	108.4	124.5
Others	12.6	11.4	10.3	16.5	18.7
Total	**948.3**	**844.3**	**765.3**	**833.2**	**953.7**

Source: Pakistan Bureau of Statistics (PBS)

Going forward, sector is expected to face challenges from regional competitors, particularly India, as well as rising inflation and finance costs. However, currency depreciation, government support, changing fashion trends and resumption of trade with China after ease in pandemic restrictions would keep the demand stable.

Strong volumetric uptick lead to healthy revenue growth in the outgoing fiscal year.

In line with industry trend, sales revenue following a dip during pandemic noted strong growth in the outgoing fiscal year, amounting to Rs. 749.7m (FY21: Rs. 420.0m). The growth was mainly attributable to sizeable uptick in export orders and increase in average prices over time, combined with currency depreciation. Given higher demand and better pricing, almost entire sales pertain to products made from cowhides with major focus towards shoes leather. Net sales in the first half of FY23 were around Rs. 400m, with a full-year target of Rs. 900m.

Figure: Overall Sales Data

	FY20	FY21	FY22
Quantity (sq. ft.)	1.8m	1.9m	2.8m
Rate (In Rs.)	*218*	*230*	*272*
Gross Sales (Rs. in m)	399.0	432.6	775.0

Exports continue to dominate the sales mix, representing around 98% of total sales, with Europe remaining the primary export destination as cold weather complements the use of leather products. Geographic concentration is considered to be high with top two markets (namely Germany and Austria) contributing sizeable proportion. Client concentration also remains high with top 10 customers accounting for ~93% of sales; however, this is partly mitigated by long-term association with most clients. As per management, collection issues in the local market have restrained them from targeting local market.

Gross margins were supported by topline growth and cost-cutting initiatives; however, net margins remained thin in the absence of one-time gains.
Gross margins swiftly bounced back from the pandemic slump (FY22: 14.0%; FY21: 16.3%; FY20: 1.9%), owing to better absorption of fixed cost per unit given volumetric increase in sales, improved export prices and certain energy cost-saving initiatives implemented. Entire raw material is sourced locally and average cowhides prices have more than doubled over the review period, reaching to Rs. 100 (FY21: Rs. 58; FY20: Rs. 60) per sq. ft.

Administrative overheads remained consistent with the previous year, while distribution expenses increased in line with business growth. Financial charges noted a declining trend given lower utilization of running finance facility. Moreover, one-off other income (gain on sale of fixed assets) contributed to overall profitability profile. However, in absence of the same, net margins remain thin and require improvement. Going forward, management expects it to improve, as topline grows further.

Cash flow generation remains limited; elevated inventory-holding days have stretched working capital cycle.
Cash flow coverage has remained constrained, with Funds from Operations (FFO) reported consistently on the lower side. Despite higher bottom-line, FFO decreased to Rs. 13.5m (FY21: 27.3m) in FY22 owing to considerable increase in depreciation along with gain on fixed asset sale. Current ratio remains near to 1.0x over time while coverage of short-term debt in relation to inventory and receivables is considered satisfactory. Aging profile of trade debts remain sound with entire receivables outstanding for less than 90 days.

Working capital days have been stretched due to elevated inventory days, necessitating the use of running finance. Management aims to reduce the average inventory days holding, going forward. Hence, efficient management of working capital cycle is considered important.

Low equity base constraints capitalization; leveraged balance sheet.
Equity base has increased over the last two years as profitability improved, reaching to Rs. 237.0m (FY21: Rs. 208.0m) at end-FY22. There is no fixed dividend payout policy in place, and no dividend has been paid in the past few years for all-out profit retention.

At present, entire debt profile is short term in nature, with total interest bearing liabilities declining to Rs. 166.0m (FY21: Rs. 241.6m) at end-FY22. Management aims to further reduce borrowing levels going forward. In addition, sponsors have also provided interest-free loan of Rs. 78.7m (FY21: Rs. 111.5m), repayable on demand therefore not accounted in equity. Owing to growth in equity base, gearing and leverage indicators have improved over time although remaining higher given the cyclicality in the industry.

Universal Leather Private Limited — Appendix I

FINANCIAL SUMMARY					*(amounts in PKR millions)*
BALANCE SHEET	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**
Fixed Assets	67.2	70.0	71.0	76.9	127.7
LT Investments	122.2	122.2	122.2	122.2	122.2
Stock-in-Trade	498.7	497.9	468.4	373.6	236.5
Trade Debts	60.8	112.1	37.5	58.1	60.0
Cash & Bank Balances	23.9	7.6	1.8	2.3	28.4
Total Assets	**888.9**	**940.3**	**827.0**	**747.8**	**721.6**
Trade and Other Payables	280.2	291.2	257.2	168.8	215.9
Short Term Debt	301.8	286.5	268.5	241.6	166.0
Long Term Debt	-	-	-	-	-
Loan from Directors	65.1	88.5	94.5	111.5	78.7
Total Liabilities	**655.5**	**676.1**	**627.9**	**529.2**	**470.8**
Paid up Capital	34.0	34.0	34.0	34.0	34.0
Total Equity *(without surplus revaluation)*	**198.3**	**231.3**	**182.4**	**208.0**	**237.0**
INCOME STATEMENT					
Net Sales	564.2	495.1	386.9	420.0	749.7
Gross Profit	20.4	102.4	7.5	68.5	104.6
Profit Before Tax	(32.1)	37.7	(43.7)	30.0	36.9
Profit After Tax	(37.7)	33.0	(48.7)	25.6	29.1
RATIO ANALYSIS					
Gross Margin (%)	3.6%	20.7%	1.9%	16.3%	14.0%
Net Margin	-6.7%	6.7%	-12.6%	6.1%	3.9%
FFO	-40.7	40.7	-60.7	27.3	13.5
FFO to Total Debt (%)	-13.5%	14.2%	-22.6%	11.3%	8.1%
Current Ratio (x)	1.07	1.11	1.01	1.04	1.00
(Stock+ Trade Debts)/ Short-term Debt	1.85	2.13	1.88	1.79	1.79
Gearing (x)	1.52	1.24	1.47	1.16	0.70
Leverage (x)	3.48	3.06	3.53	2.60	2.04
ROAA (%)	-4.1%	3.6%	-5.5%	3.3%	4.0%
ROAE (%)	-17.4%	15.4%	-23.5%	13.1%	13.1%

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	Universal Leather (Private) Limited
Sector	Tanneries & Leather Products
Type of Relationship	Solicited
Purpose of Rating	Entity Rating

Rating History

Rating Date	Medium to Long Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY			
01/30/2023	BBB/A-3	Stable	Upgrade
11/18/2021	BBB-/A-3	Positive	Maintained
10/01/2020	BBB-/A-3	Negative	Maintained
05/09/2019	BBB-/A-3	Stable	Downgrade
10/16/2017	BBB/A-3	Negative	Downgrade
05/20/2016	BBB+/A-3	Stable	Reaffirmed
05/04/2015	BBB+/A-3	Stable	Reaffirmed
04/09/2014	BBB+/A-3	Stable	Reaffirmed
04/08/2013	BBB+/A-3	Stable	Reaffirmed
02/13/2012	BBB+/A-3	Stable	Reaffirmed

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 Meeting Conducted

Name	Designation	Date
Mr. Waqas Shakil	Chief Financial Officer	Jan 18, 2023