RATING REPORT

Zephyr Textiles Limited

REPORT DATE:
November 17, 2023

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 Outlook	Positive		Positive	
Rating Action	*Reaffirmed*		*Reaffirmed*	
Rating Date	*November 17, 2023*		*August 30, 2022*	

COMPANY INFORMATION	
Incorporated in 1999	**External Auditors:** BDO Ebrahim & Co Chartered Accountants
Public Listed Company	**Chairperson:** Ms. Tehniyat Mussaid
Key Shareholders (with stake 10% or more):	**Chief Executive Officer:** Mr. Mussaid Hanif
Mr. Mussaid Hanif ~36.4%	
Ms. Sabah Burhan ~20.1%	
General Public (local) ~19.6%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Industrial Corporates (May 2023) *https://docs.vis.com.pk/docs/CorporateMethodology.pdf*

APPLICABLE RATING SCALE(S)
VIS Issue/Issuer Rating Scale: *https://docs.vis.com.pk/docs/VISRatingScales.pdf*

Zephyr Textiles Limited

OVERVIEW OF THE INSTITUTION

Zephyr Textiles Limited (ZTL) was incorporated in 1999 as a private limited company which later on went public in 2004. The Company is involved in the production and sale of greige and finished fabric, towels and made ups. The company is listed on Pakistan stock Exchange. Registered office of the Company is in Lahore while weaving unit is situated at Balloki Bhai Pheru Road and towel unit at district Kasur.

BDO Ebrahim & Co Chartered Accountants were appointed as the new external auditors during the review period.

Profile of the Chairperson:
Ms. Tehniyat Mussaid is the chairperson of ZTL. She graduated in Accountancy from the UK, and has worked in the UK Barclays Bank for about three years.

Profile of the CEO:
Mr. Mussaid Hanif is the CEO of ZTL. He holds an MBA from Lahore University of Management Sciences (LUMS) and has over twenty years of sales and management experience in the textile industry.

RATING RATIONALE

Corporate Profile

Zephyr Textiles Limited ('ZTL' or 'the Company') is engaged in the manufacturing of home textile products for the last two decades. Its operations include a weaving and finishing unit, complemented by a recently installed commercial dyeing segment for knitted fabric. The company is involved in manufacturing both greige and finished fabric, as well as towels.

ZTL's total power requirement is approximately 5MW, with the weaving unit demanding 4MW and the towel unit requiring roughly 1MW to operate. This requirement is mainly fulfilled by gas-fired power generation. Additionally, a 1MW solar power plant is operational to supplement the Company's energy needs.

Environmental, Social, & Governance (ESG) Initiatives

ZTL has set up an effluent treatment plant to neutralize harmful elements in the production process, and it is also compliant with the National Environment Quality Standards. In an effort to enhance its ecological footprint, the company has launched an initiative to plant 15,000 trees around its factory vicinity. Moreover, the company strives to exceed the minimum labor standards set out in the ETI Base Code.

Operational Performance

Headquartered in Lahore, ZTL operates its weaving and power plant in Bhai Pheru and towel unit at district Kasur. Over the last 12 months, due to the strategic shift planned towards knitted fabrics, production of greige fabric decreased. The production capacity for towel weaving and dyeing unit has remained consistent over the review period, whereas actual production decreased. Moving forward, production of greige fabric is anticipated to cease, with a transition toward manufacturing finished goods (stitching unit) on the horizon.

Table 1: Capacity & Production Data (Units in millions)

Capacity	FY21	FY22	FY23
Fabric Weaving Unit			
Installed Capacity (Square Meters in Millions)	84.6	84.6	81.9
Actual Production (Square Meters in Millions)	74.67	69.79	58.85
Capacity Utilization %	88.3%	82.5%	71.8%
Towel Weaving Unit			
Installed Capacity (Tons)	4,835	4,835	4,835
Actual Production (Tons)	4,614	3,953	3,992
Capacity Utilization %	95.4%	81.8%	82.6%
Towel Dyeing and Processing Unit			
Installed Capacity (Tons)	6,245	6,372	6,372
Actual Production (Tons)	4,556	4,783	4,393
Capacity Utilization %	73.0%	75.1%	68.9%

Business plans to move towards sale of finished products

The Company's management has indicated a strategic transition towards the exclusive production of knitted fabric and finished products (stitching unit), with plans to discontinue greige fabric production in the upcoming period. This shift is attributable to the higher margin sale of finished products compared to recent greige fabric margins. Efforts to facilitate this transition are already in progress, evidenced by the sale of weaving looms. As of September 2023, approximately half of all looms have been sold, with the remaining 100 looms left for sale in the coming months. Moving forward the proceeds from the sale of spindles of fabric-weaving unit would be used to install stitching machines that would cater the market for sportswear, t-shirts, hoodies and other made-ups.

Key Rating Drivers

Business risk remain elevated amid weak macroeconomic environment, high-interest rates, inflationary pressures, rising raw material costs, ongoing energy crisis in the country, and a global slump in demand. All these factors pose a challenge to the sector in terms of margins sustainability and future growth.

Pakistan's export proceeds have oscillated in the range of USD 22-25b during the past decade (FY11-FY21), however, in FY22 exports broke the threshold, clocking in at USD 32.4b. Textile sector contributes nearly one-fourth to industrial value-added segment and provides employment to about 40% of the industrial labor force[1]. Contributing around 8.5% to the country's gross domestic product (GDP), with an estimated market size of around Rs. 4.0tr, textile sector has maintained an average share of about 60% in national exports over the years.

Table 2: Pakistan Export Statistics (USD in Millions)

	FY20	FY21	FY22	FY23
PAKISTAN TOTAL EXPORTS	22,536	25,639	32,450	27,911
TEXTILE EXPORTS	12,851	14,492	18,525	16,710
PKR/USD AVERAGE RATE	158.0	160.0	177.5	248.0

Source: SBP

The lingering effects of Covid-19 pandemic continue to shape the Pakistan's textile industry. Initially, as lockdowns lifted, the industry capitalized on opportunities, securing production contracts with western countries. This redirection of substantial volumes to Pakistan, was complemented by government import tax reductions and subsidized covid-related financing programs such Temporary Economic Refinance Facility (TERF), spurred robust export growth during FY22. However, a subsequent phase presented new challenges. Global interest rate hikes aimed at curbing post-pandemic inflation, coupled with geopolitical unrest such as the Ukraine conflict, led to supply chain disruptions and energy crisis. These factors led to a global demand slowdown in major textile economies, reflected in a 10% year-on-year decline in Pakistan's textile exports in FY23, totaling USD 16.7b (FY22: USD 18.5b). As per the data from Pakistan Bureau of Statistics (PBS), High Value-Added Segments made up over 82.2% (FY22: 80.7%) of the total textile exports in FY23.

Flash floods in Sindh and Southern Punjab monsoon wreaked havoc on the cotton crop last year. This catastrophe led to a historic low production level of 4 million bales of cotton in 2022, compared to a 12 million bales annual demand. Consequently, local cotton prices reached 12-year high of over Rs. 22,000 per 40kg during the year as well as import of raw cotton rose by ~20% in USD terms during FY22, as compare to the preceding year. This situation led to higher working capital requirements, adversely affecting profit margins and liquidity profile of textile entities, particularly spinners, weavers, and dyeing companies. Supported by favorable weather and timely government intervention, cotton production in the country is estimated to increase to 12.7 million bales during the current season (FY24).

[1] https://www.brecorder.com/news/40179021

4.0 million bales have already been produced during Q1FY24, marking an impressive 80.0% increase compared to the same period last year.

The industry is facing business risk due to weak macroeconomic environment both globally and locally, high-interest rates, inflationary pressures, rising raw material costs, ongoing energy crisis in the country, and a global slump in demand, primarily from North America and Europe.

Previously, the sector also enjoyed incentives provided by the government through a five-year textile policy (2020-25), including preferential energy rates, low-interest financing schemes, and timely payments of various refunds, easing liquidity constraints for local players. However, the prevailing economic instability along with advisory from the IMF led to the reduction or withdrawal of many of these fiscal supports. This along with contractionary monetary policy and political uncertainties in the country are the key business risk factors facing by the industry. In the long run, improvement in value addition, investment in technology and optimization of energy cost would define the future prospects of textile exports.

Topline witnessed a subdued growth supported by rupee depreciation
Over the last 5-year span, the Company's topline registered a CAGR of 11%. After a 22% increase in FY22, net revenue displayed an increase of 7% Y/Y, reaching to Rs. 7.9b in FY23. This increase is primarily attributable to rising prices despite falling volumetric sales. Historically, the ratio between local sales and exports has been roughly at 50:50. However, in FY23, exports saw a notable increase, shifting the balance to 65:35. Management anticipates this trend to further increase as they strategize to target the export market for finished goods in the near future.

Geographical sales mix remains diversified with Europe continuing to be the primary export destination. Popular regions in FY23 remained France (~24.6%), Italy (~19.5%) and Germany (~9.6%), other regions include USA, Sri Lanka and New Zealand. Customer concentration remains high as top 10 clients contributed nearly ~59% of total revenue while almost all individual clients remained under ~10%. In terms of product sales, towels contributed more than half of the total revenue.

Gross margins inched up in FY23 while remained in line with historical trend.
After experiencing a slight decline in FY22, gross margins rebounded to 13.2% during FY23. The improvement in gross margins last year was primarily driven by an uptick in high sales of value added products and impact of rupee devaluation.

Currently, major portion of yarn used is locally procured and a small portion of nearly ~5% is imported while chemicals used in dyeing are entirely imported. On the cost front, increase in admin and general expenses remained in line with the inflation, however, distribution expenses registered a drop with lower offtake. Other operating expenses have increased mainly due to a one time provisioning for sales tax refund. Other income has increased mainly due to higher exchange gain. Whereas, finance expenses have almost doubled in the last year amid higher interest rates. Consequently, net margins of the company came in at 3.0% (FY22: 2.5%) in FY23.

Table 3: P&L (Extract)

Rs. in Mn.	FY21	FY22	FY23
Sales	6,129	7,384	7,926
Gross Profit	**808**	**739**	**1,044**
Gross Margin (%)	***13.2%***	***10.0%***	***13.2%***
Operating Expenses	300	433	378
Other Expenses	48	46	270
Other Income	14	99	164
EBIT	**474**	**359**	**560**
Finance Cost	112	98	190
Profit before Tax	**361**	**261**	**371**
Profit after Tax	**302**	**182**	**238**
Net Margin	***4.9%***	***2.5%***	***3.0%***

Increase in profitability and provisioning reversals led the FFO to increase notably resulted in better cash flow coverages in FY23. Liquidity profile remained manageable.

FFO of the Company increased to Rs. 648.1 (FY22: 278.3m) in FY23 due to increase in profitability while one time provisioning reversals of sales tax refund, expected credit loss and obsolete stock of Rs. 139.4m also played its part. Resultantly, Debt Service Coverage Ratio (DSCR) improved to 2.5x (FY22: 1.1x) in FY23. With the increase in FFO and a minor decrease in total debt, FFO to total debt has also improved to 0.45x (FY22: 0.17x) in FY23. Going forward, sustainable improvement in cash flow coverage indicators will remain important from the ratings perspective.

Liquidity profile of ZTL remained at manageable levels wherein current ratio and ST debt coverage from trade debts and inventory remained intact at 1.07x and 1.53x (Jun'22: 1.07x and 1.55x) as at Jun'23, respectively. During the review period, Cash Conversion Cycle (CCC) witnessed an improvement as the Company reduced the days receivable while increased the days payable.

Table 4: Cash flow and Liquidity

	FY21	FY22	FY23
FFO	485.4	278.3	648.1
FFO/Total Debt (x)	0.27	0.18	0.47
FFO/LT Debt (x)	0.97	0.98	8.67
FFO/ST Debt (x)	0.38	0.21	0.49
DSCR (x)	2.78	1.06	2.52
Current Ratio	1.11	1.07	1.07
Inv.+Rec./ST Debt (x)	1.76	1.55	1.53
DIO	86	76	74
DSO	46	37	28
DPO	69	66	74
CCC	**63**	**47**	**28**

Moderately leveraged Capital Structure

With the absence of any dividend announcement for FY23, equity (exc. Reval. of PPE) of the Company grew to Rs. 2.0b as at Jun'23 from Rs. 1.73b in the previous year. The Company did not mobilize any new long term debt on its balance sheet during the period under review, resulted in a decline in LT debt to Rs. 119m (Jun'21: 330m) as at Jun'22. On the other hand, short term borrowing remained intact at Rs. 1.31b (Jun'22: 1.30b) as at Jun'22. Consequently, total debt stood at Rs. 1.43b (Jun'22: 1.63b) as at Jun'23. As discussed, decrease in total debt and increase in equity resulted in the gearing ratio to drop at 0.7x (Jun'22: 0.9x) as at Jun'23. Leverage ratio of the Company came in at 1.7x (Jun'22: 1.8x) as at Jun'23. As per the management, there is no plan to mobilize any new long term debt on balance sheet during the rating horizon. Incorporating the same, capitalization ratios are expected to inch down further during in FY24.

Zephyr Textiles Limied Appendix I

Financial Summary (amounts in PKR millions)					Appendix I
BALANCE SHEET	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**
Property Plant and Equipment	1,910	1,903	2,032	2,050	2,421
Stock-in-Trade	915	1,104	1,411	1,342	1,457
Trade Debts	712	709	824	661	557
Cash & Bank Balances	56	72	79	65	156
Total Assets	4,157	4,480	5,201	5,177	5,875
Trade and Other Payables	559	818	1,196	1,196	1,603
Long Term Debt ***(including current maturity)***	472	416	501	330	119
Short Term Debt	1,250	1,320	1,269	1,295	1,313
Total Debt	1,722	1,736	1,769	1,625	1,432
Total Liabilities	2,570	2,866	3,239	3,074	3,345
Paid Up Capital	594	594	594	594	594
Total Equity ***(excluding surplus revaluation)***	1,261	1,311	1,573	1,735	1,956
INCOME STATEMENT	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**
Net Sales	5,091	4,326	6,129	7,384	7,926
Gross Profit	524	402	808	739	1,044
Profit Before Tax	149	76	361	261	371
Profit After Tax	118	55	302	182	238
RATIO ANALYSIS	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**
Gross Margin (%)	10.3%	9.3%	13.2%	10.0%	13.2%
Net Margin (%)	2.3%	1.3%	4.9%	2.5%	3.0%
Current Ratio	1.08	1.10	1.11	1.07	1.07
Net Working Capital	170	228.4	307.1	202.8	211.4
FFO	310	253.1	485.4	278.3	648.1
FFO to Total Debt (%)	0.18	0.15	0.27	0.17	0.45
FFO to Long Term Debt (%)	0.66	0.61	0.97	0.84	5.43
Debt Servicing Coverage Ratio (x)	1.57	1.6	2.8	1.1	2.5
Short-term Debt Coverage (%)	1.30	1.4	1.8	1.5	1.5
ROAA (%)	2.8%	1.3%	6.2%	3.5%	4.3%
ROAE (%)	7.6%	3.4%	17.1%	9.1%	10.3%
Gearing (x)	1.37	1.3	1.1	0.9	0.7
Leverage (x)	2.04	2.2	2.0	1.8	1.7

REGULATORY DISCLOSURES — Appendix II

Name of Rated Entity	Zephyr Textiles Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings
Instrument Structure	N/A

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
17-11-2023	BBB+	A-2	Positive	Reaffirmed
30-08-2022	BBB+	A-2	Positive	Reaffirmed
30-06-2021	BBB+	A-2	Positive	Maintained
23-04-2020	BBB+	A-2	Rating Watch – Negative	Maintained
12-04-2019	BBB+	A-2	Stable	Reaffirmed
10-11-2018	BBB+	A-2	Stable	Initial

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. Naveed Aleem	CFO	October 11, 2023