RATING REPORT

Sadaqat Limited

REPORT DATE:
June 24, 2021

RATING ANALYST:
Muhammad Tabish
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RATING DETAILS				
Rating Category	**Latest Rating**		**Previous Rating**	
	Long-term	**Short-term**	**Long-term**	**Short-term**
Entity	A	A-2	A	A-2
TFC	A		A	
Rating Outlook	*Positive*		*Rating Watch-Negative*	
Rating Date	*24, June'21*		*15, Apr'21*	

COMPANY INFORMATION	
Incorporated in 1987	**External auditors:** EY Ford Rhodes Chartered Accountants
Public Unlisted Company	**Chairman:** Sheikh Mukhtar Ahmed
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Mr. Khurram Mukhtar
Mr. Hamid Mukhtar ~ 24.6%	
Mr. Awais Mukhtar ~ 24.6%	
Mr. Shoaib Mukhtar ~ 24.6%	
Mr. Khurram Mukhtar ~ 14.6%	
Mr. Hamza Mukhtar ~ 10.0%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria *Industrial Corporates (May 2019)* ***https://s3-us-west-2.amazonaws.com/backupsqlvis/docs/Corporate-Methodology-201904.pdf***

Sadaqat Limited

OVERVIEW OF THE INSTITUTION	RATING RATIONALE

OVERVIEW OF THE INSTITUTION

Sadaqat Limited was incorporated in 1987 under the repealed Companies Ordinance, 1984 (now the Companies Act, 2017) as a private limited company. It was subsequently converted into public limited company in 2008. SL is an export-oriented textile unit, involved in manufacturing and sale of home textile and woven & knitted apparels.

Profile of Chairman

Sheikh Mukhtar Ahmed is the Chairman of SL. He has almost 47 years of experience in the field of textiles.

Profile of CEO

Mr. Khurram Mukhtar holds the position of CEO and is responsible for supervision of all divisions of the company.

RATING RATIONALE

Sadaqat Limited (SL) is one of the well-known value-added textile units operating in the country's textile hub, Faisalabad for more than three decades. The company is primarily engaged in manufacturing and export of a wide range of home textile products with the market share of around ~6% in annual bed ware exports (FY20). At present, the company's operations comprise knitting, processing (dyeing & printing), stitching (cut to pack), quilting, wadding and embroidery which are carried out through two manufacturing units. Power requirement of 13.2MW is met through three sources; national grid (FESCO), 5 Gen-Sets and 2 diesel backed generators. The efficient energy mix provides a competitive edge to company.

All production facilities have been operating at high utilization levels but remained under pressure in FY20, reporting at 86% (FY19: 93%) due to pandemic induced decline in demand (specifically from Mar-June 2020). However, given subsequent economic recovery volumes along with the capacity utilization have recovered in the ongoing year.

SL's Annual Report (FY19) was declared the Best Corporate Report in textile sector while the Sustainability Report achieved 3rd position all over Pakistan by ICAP and ICMA. The Company has also secured Certificate of Merit for Integrated Reporting at South Asian Federation of Accountants (SAFA) Best Presented Annual Report Awards 2019.

Expansion of operational capacity in knitted/woven garment segment along with routine BMR supports the healthy growth in earning profile. Going forward, backward integration of operations (through setting up weaving & spinning units) is expected to lower production cost and thus improving margins in the long run.

In FY20, the management incurred capex of Rs. 2.1b which included the expansion of operational capacity in knitted/woven garment segment by more than three-fold and routine BMR activities. Consequently, resulting in overall improvement in efficiency through reduction in production bottlenecks and wastage control. Entire cost of the knitting segment expansion was funded through issuance of TFC issue of Rs. 1.5b in the ongoing year.

During the period under review, the management in order to achieve operational and managerial synergies rolled out a capex plan for backward integration of operations through setting up spinning and weaving facility with 29,664 spindles (including 29,184 ring frames & 480 MVS) and 132 Airjet looms, respectively. Total estimated cost of these project stands at Rs. 7.1b with debt to equity ratio of 70:30. Total long-term debt (TERF/LTFF) of Rs. 4.9b is planned to be undertaken at concessionary rates for the tenor of 10 years (inclusive of 2 years grace period). Remaining project's cost will be arranged through internal cash flows and additional capital issue as planned to be raised by initial public offerings (IPO). The projects are expected to come online in FY22 and would reduce the dependency of procuring raw material from outsourced suppliers by ~30%. In the long run, margins are expected to improve on account of reduced cost of production.

<u>Key Rating Drivers</u>

Textile and clothing exports rebounded post ease in nation-wide lockdowns (due to Covid-19 pandemic); outlook is favorable going forward.

In FY20, export revenues from textile segment dropped by ~6% to USD 12.8b (FY19: USD 13.6b) in the wake of Covid-19 induced lockdowns both domestically and globally. Negative trend was noted in all segments. However, following the ease in pandemic restrictions after the first wave along with the implementation of smart lockdown policy and given subsequent economic recovery, textile exports (as per PBS) rose to USD 12.7b in 10M'FY21 (vis-à-vis USD 10.8b SPLY), registering a sizeable growth of ~17%. This growth was mainly was driven from the value-added sector while growth in knitwear exports (both in terms of value and volume) outpaced the other segments. Meanwhile, the commodities that witnessed negative growth in trade included raw cotton, cotton yarn and cotton cloth.

Segments	Amount in USD (millions)		(%)
	10M'FY21	10M'FY20	Change
Knitwear products	$3,126	$2,392	31%
Readymade Garments	$2,512	$2,232	13%
Bed wear	$2,292	$1,838	25%
Towels	$777	$611	27%
Made-up Articles	$628	$513	22%
Art, silk and synthetic textile	$302	$273	11%
Tents, canvas and tarpaulin	$96	$78	23%
Yarn (other than cotton yarn)	$27	$22	23%

Going forward, sector dynamics are favorable as Pakistan continues to receive export orders from global economies as competing regional countries like India and Bangladesh remains hampered by the Covid-19 outbreak. Given the surge in demand, the industry is currently operating at full capacity and going through expansion and up-gradation to cater for additional demand.

5-Year (2020-25) textile policy continues to support the business risk profile.
With the aim to double textile exports in five years, GoP through a five-year textile policy (2020-25) has provided incentives in form of preferential energy rates, low interest rates financing schemes (such as EFS, LTFF and TERF) and timely payments of DLTL which would support liquidity constraints of local players. Initiatives are also being undertaken in order to increase production and yield of cotton to support the industry. Nevertheless, downside risk, in the short-tern, remains elevated on account of third wave of Covid-19. In the long run, improvement in value addition, investment in technology and optimization of energy cost would be the key determinants of textile exports.

Healthy recovery posted in sales revenue in the ongoing year on account of volumetric growth (due to increase in production capacity in knitting segment and higher export orders) and favorable pricing. Outlook assigned to ratings has been revised to 'Positive'.
Despite posting a strong CAGR of ~16.4% over the period of last four fiscal years, topline largely remained stagnant in FY20, amounting to Rs. 20.0b (FY19: Rs. 19.6b) on account of pandemic-induced fall in demand coupled with supply chain disruptions. However, sales during 9M'FY21 depicted a healthy recovery and were reported at Rs. 25.1b, increasing by ~56% SPLY. This considerable growth in the ongoing year is attributable to favorable pricing and increase in volumes. The volumetric growth is based on two factors; spillover of previous year orders (increase in volumes due to capacity expansion in knitting segment) and surge in demand from exports. Going forward, sales revenue is targeted to reach Rs. 32b by the year-end FY21 on the back of healthy orders booked for the next five months.

Revenues of the company almost entirely emanates from direct export sales while in terms of segment-wise sales mix, home textile has constituted the major proportion on a timeline basis. Major products include bedsheets, fitted sheets, duvet set, duvet cover, quilt covers, pillow cases, comforters, cushions, curtains, kitchenware and towels. Of total exports, more than two-third is concentrated in UK followed by Australia, Spain, Belgium, USA and eastern Europe. Nonetheless, comfort is drawn from diversified client base whereas to further diversify the same, management remains focused towards exploring new international markets. In addition, the company over the years has established strong business relations with leading international retailers which ensures repeat business. Few prominent brands include Primark, B&M, Asda, Kmart, Matalan, Next, Target Australia and Zara Home.

Profitability margins have witnessed improvement in the ongoing year. Going forward, future growth in earnings will be a function of volumetric increase in sales.

Gross margins, after registering a decline in FY19, have exhibited an increasing trend on a timeline basis (9M'FY21: 18.6%; FY20: 16.5%; FY19: 14.1%) on the back of better absorption of fixed overheads and overall cost reduction measures. Meanwhile, overall operating expenses have also trended upwards in the ongoing year due to higher staff salaries and depreciation charge (due to sizable capex). Rising debt levels have led to an increase in financial charges while the same is projected to increase further in the following years given the planned debt drawdown. Other income has remained on the lower side due to absence of exchange gains.

Owing to improved gross margins and higher operating profit, bottom-line profitability has improved in 9M'FY21 with net margins reporting higher at 4.0% (FY20: 2.6%; FY19: 6.8%). Going forward, margins are projected to stay stagnant in the medium term due to accelerated depreciation of new additions in plant and machinery while future growth in profitability will be a function of volumetric increase in sales.

Liquidity profile continues to gain support from adequate cash flows and sound debt servicing ability.

In absolute terms, Funds from Operations (FFO) decreased to Rs. 1.1b (FY19: Rs. 1.5b) in FY20 due to higher finance cost paid. This along with increased debt levels resulted in weakening of cash flow coverages in FY20; FFO to total debt and FFO to long-term debt were reported at 10.2% (FY19: 16.9%) and 41.6% (FY19: 94.9%), respectively. Nevertheless, cash flow generation in relation to debt obligations remains adequate as evident from Debt Service Coverage Ratio (DSCR) which stood at 2.18x (FY19: 2.09x). Cash conversion cycle has improved on a timeline basis to 77 days (FY20: 99 days; FY19: 86 days). Current ratio of the company stands above 1.0x, while trade debts and stock in trade are sufficient to cover short term borrowings. Overall liquidity profile has improved in the ongoing year on account of improved profitability.

Leverage indicators have increased on a timeline basis and will remain elevated given the debt drawdown planned for the capital-intensive investment projects. The capitalization will be supported through additional capital issue (planned to be raised through IPO).

Equity base (excluding revaluation surplus) has more than doubled over the past five fiscal years, reporting at Rs. 8.6b at end-9M'FY21. In FY20, the management carried out the revaluation of fixed assets; adding surplus of Rs. 4.7b while the accumulated revaluation surplus amounted to Rs. 6.6b (FY20: Rs. 1.9b) at end-9M'FY21. Dividend payout policy has remained at conservative levels at 11.7% (FY19: 9%) in FY20.

At present, debt profile comprises a mix of short term and long term debt with total interest bearing liabilities increasing to Rs. 13.8b (FY20: Rs. 10.6b; FY19: Rs. 8.8b) at end-9M'FY21; short-term debt (ERF) constituted more than around three-fifth of total debt. The increase in debt levels is attributable to the TFC issue. Leverage indicators have increased on a timeline basis and will continue to remain elevated given the debt drawdown of Rs. 4.9 planned for the capital-intensive investment projects.

Satisfactory governance structure while IT infrastructure has been upgraded.
Board of Directors (BoD) includes seven members (including the CEO) with extensive experience in textile sector. Composition of the BoD is line with best governance practices as one-third of the Board is represented by independent directors while the same chairing Audit Committee and HR&R Committee. Moreover, the Board meets fortnightly and the minutes are adequately documented. Four committees, namely Audit Committee (AC), Human Resource and Remuneration Committee (HR&RC), Risk Management Committee (RMC) and Nomination Committee (NC), are present in order to ensure effective governance.

Given the management's plan to change the legal status of the company from 'Public Unlisted Company' to 'Public listed Company', addition of non-executive directors on the board is underway. The company has recently deployed SAP HANA which is a fully integrated business management software and includes modules for administration, financials, sales, marketing, production planning and etc.

Term Finance Certificates (TFCs) Issue

In July'20, SL raised Rs. 1.5b through a privately placed TFC issue in order to fund the expansion in knitted/woven garment segment by addition of new machinery. Tenor of the instrument is 5 years (including one year of grace period) with 8 equal semiannual principal installments commencing from Jan'2022. In addition, the instrument carries an interest rate of 3-month KIBOR plus a spread of 225 bps. Interest is payable quarterly in arrears. Security structure entails joint pari passu charge over current and fixed assets of Rs. 2b collectively.

Moreover, issuer has an option to prepay the issue amount after the expiry of the grace period with thirty days prior written irrevocable notice to the trustee/issue agent. Prepayment option will be subject to a) in multiples of Rs. 250m b) to be allowed on scheduled principal/profit payment dates and c) shall not attract any prepayment penalty.

FINANCIAL SUMMARY					*(amounts in PKR millions)*
BALANCE SHEET	**FY17**	**FY18**	**FY19**	**FY20**	**9M'FY21**
Property, Plant and Equipment	8,379	8,548	9,540	16,280	17,035
Stock-in-Trade	2,879	3,060	4,088	4,677	5,504
Trade Debts	1,600	2,557	4,933	2,992	4,707
Balances With Statutory Authorities	446	1,094	1,235	606	932
Tax Refund Due From Government	606	402	423	1,321	2,071
Total Assets	**14,810**	**16,995**	**21,521**	**27,862**	**34,517**
Trade and Other Payables	1,758	2,166	3,440	2,890	5,266
Short-Term Borrowings	4,638	5,678	7,264	8,003	9,529
Long-Term Borrowings *(Inc. current maturity)*	1,561	1,223	1,574	2,567	4,273
Total Liabilities	**8,096**	**9,200**	**12,513**	**13,705**	**19,350**
Paid-up Capital	1,200	1,200	2,400	2,400	2,400
Equity (*Excl. revaluation surplus*)	**4,571**	**5,732**	**7,015**	**7,538**	**8,601**
Revaluation Surplus	**2,143**	**2,063**	**1,992**	**6,619**	**6,566**
INCOME STATEMENT					
Net Sales	10,893	15,023	19,618	20,035	25,070
Gross Profit	1,683	2,735	2,769	3,307	4,667
Profit Before Tax	518	1,226	1,501	718	1,275
Profit After Tax	469	1,081	1,333	512	1,010
RATIO ANALYSIS					
Gross Margin (%)	15.5	18.2	14.1	16.5%	18.6%
Net Margin (%)	4.3	7.2	6.8	2.6%	4.0%
Net Working Capital	(547)	(69)	351	(121)	1,648
FFO	1,076	1,489	1,493	1,084	-
FFO to Long-Term Debt	0.69	1.22	0.95	0.42	-
FFO to Total Debt	0.17	0.22	0.17	0.10	-
Debt Servicing Coverage Ratio (x)	1.79	2.18	2.09	2.18	-
Gearing (x)	1.36	1.20	1.26	1.41	1.60
Debt Leverage (x)	1.77	1.61	1.78	1.82	2.25
Current Ratio	0.92	0.99	1.03	0.99	1.11
Inventory + Receivable/Short-term Borrowings (x)	0.97	0.99	1.24	0.96	1.07

ISSUE/ISSUER RATING SCALE & DEFINITION Annexure 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	Annexure III
Name of Rated Entity	Sadaqat Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity & Instrument Rating

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
06/24/2021	A	A-2	Positive	Maintained
04/15/2020	A	A-2	Rating Watch - Negative	Maintained
07/18/2019	A	A-2	Stable	Reaffirmed
02/23/2018	A	A-2	Stable	Reaffirmed
12/27/2016	A	A-2	Stable	Upgrade
12/31/2015	A-	A-2	Stable	Reaffirmed
01/01/2015	A-	A-2	Stable	Reaffirmed
04/23/2013	A-	A-2	Stable	Reaffirmed
03/16/2012	A-	A-2	Stable	Reaffirmed
RATING TYPE: Term Finance Certificates (TFC)				
06/14/2021	A	A-2	Positive	Maintained
04/15/2020	A	A-2	Rating Watch - Negative	Maintained
12/13/2019	A		Stable	Preliminary

Instrument Structure	SL raised Rs. 1.5b through a privately placed TFC issue. Tenor of the instrument is 5 years (including one year of grace period) with 8 equal semiannual principal installments commencing from Jan'2022. The instrument carries an interest rate of 3-month KIBOR plus a spread of 225 bps. Interest is payable quarterly in arrears. Security structure entails joint pari passu charge over current and fixed assets of Rs. 2b collectively. The issuer would have an option to prepay the issue amount after the expiry of the grace period with thirty days prior written irrevocable notice to the trustee/issue agent.
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. Hummayun Shahzad	CFO	June 07, 2021
Mr. Asim Ali	Manager Finance	