RATING REPORT

Sadaqat Limited

REPORT DATE:
October 10, 2023

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

Syed Ilyas Afridi
ilyas.afridi@vis.com.pk

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	Stable		Stable	
Rating Action	Reaffirmed		Maintained	
Rating Date	*Oct 10, 2023*		*June 22, 2022*	

COMPANY INFORMATION	
Incorporated in 1987	**External Auditors:** Kreston Hyder Bhimji & Co. 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 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

Sadaqat Limited

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Sadaqat Limited was incorporated in 1987 under the repealed Companies Ordinance, 1984 (now the Companies Act, 2017) as a private limited company.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

Corporate Profile

Sadaqat Limited (SL), initiated over half a century ago as a small spinning setup in Chiniot by a family versed in textile trade, has evolved to rank among the leading home textile and apparel exporters in Pakistan. This renowned family-owned enterprise, with sponsors actively involved in daily business affairs, operates in the value-added domain and excels in delivering home textiles, knit apparel, denim, and non-denim woven outfits. The operations cover weaving/knitting, bleaching, dyeing, printing, stitching, and finishing. Boasting various international certifications and export standards, the company has a global footprint with marketing offices, affiliate entities, and key business partnerships. Production infrastructure is based in Faisalabad, backed by a workforce of 8,200 employees. The sponsors have also invested in an associate entity, Khas, catering to the local retail market for fashion and home textiles, with 22 outlets throughout Pakistan.

SL holds ISO and various other globally recognized certifications, demonstrating its commitment to high-quality standards. The average energy demand of 18MW is primarily met by an optimal mix of three sources; 13MW national grid (FESCO), planned to be increased to 20MW, 12MW gas-powered generators, and 1.2MW solar project while 2MW diesel generators serve as a backup. In response to escalating energy costs, management has planned to increase solar capacity to 8MW in two phases over the next two years: from 1.2MW to 4.2MW in phase one, then up to 8MW in phase two. Negotiations are currently underway.

Commitment towards Environment, Social & Governance (ESG) principles

The company stands out with its commitment to quality, sustainability, and consumer safety through various certifications. It has secured a Grade "B" from SGS under the BRC Global Standard and is recognized for green textiles with a Global Organic Textile Standard (GOTS) certification, emphasizing 70% organic fibers. The company is also acknowledged for using recycled content, as seen with their Global Recycled Standard (GRS) and the Recycled Claim Standard (RCS) endorsements. It also upholds global quality with an ISO 9001:2015 certification from BUREAU VERITAS and further highlights the organic focus with Organic Content Standard. With an ISO/IEC 17025:2005 accreditation from PNAC and the STANDARD 100 by OEKO-TEX®, the company assures exceptional quality and safety across all production stages.

Management pursued backward integration with new spinning and weaving units, aiming for future cost efficiencies and improved margins.

To address value-addition constraints and align with its strategic growth plan, the company introduced new spinning and weaving units during the review period. Management highlighted that operations of both units at peak capacity would cater to about 12-15% of internal raw material needs. Moreover, cost overruns on these projects were managed through self-financing, and thus overall debt-to-equity mix was revised from 70:30 to 55:45. The debt funding majorly encompasses borrowings on concessionary rate through TERF/LTFF facility

Spinning – In July'23, the spinning unit began its commercial activities, boasting 38,200 spindles across 16 ring frames and 5 MVS machines. When fully operational, this unit is projected to produce up to 600-650 bags daily but currently outputs 400 bags. The yarn produced accommodates both knitting and weaving units. The entire project carries an investment of Rs. 5.4b, financed through a well-balanced 52:48 debt-to-equity ratio.

Weaving – The weaving unit, with 132 looms and a monthly installed capacity of 1.6m meters, was launched in Nov'22, accompanied by a yarn dyeing facility. It is currently yielding 1.5m meters of fabric per month. The entire project cost stood at Rs. 3.1b, financed by a 65:35 debt-to-equity blend.

Operating Performance

The head office along with all production facilities (except stitching) is spread out across 2-KM Sahianwala Road, Khurrianwala, Faisalabad. In the past 24 months, total capital expenditure reached over Rs. 8b. Moving forward, management prioritizes operational efficiency over new capital projects. Following the capacity increase in all operational segments, FY22 saw strong production growth. However, global textile demand dips, economic hurdles, and working capital shortfall tempered the pace, resulting in stable or slightly reduced production levels.

Figure: Capacity & Production Data (Units in millions)

	FY21	FY22	FY23
Knitting Conversion			
Installed Capacity – Kgs	3.6	4.0	4.0
Actual Production – Kgs	3.5	3.8	3.2
Capacity Utilization	***95%***	***95%***	***80%***
Knitting Processing			
Installed Capacity – Kgs	6.2	6.7	6.7
Actual Production – Kgs	2.5	5.6	5.7
Capacity Utilization	***40%***	***83%***	***85%***
Weaving			
Installed Capacity – Meters	-	-	18.0
Actual Production – Meters	-	-	14.4
Capacity Utilization	-	-	***80%***
Processing			
Installed Capacity – Meters	78.5	90.0	90.0
Actual Production – Meters	70.7	79.2	77.0
Capacity Utilization	***90%***	***88%***	***86%***

Key Rating Drivers

Business risk profile is constrained by current 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. All these factors pose a challenge to the sector over the medium term 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. Contributing around 8.5% to the country's 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: Pakistan Export Statistics (in USD 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, complemented by government import tax reductions and subsidized covid-related financing programs such TERF, spurred robust export growth during FY20-22. 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 ~15% year-on-year (YoY) decline in Pakistan's textile exports in FY23, totaling USD 16.5b (FY22: USD 19.3b). Knitwear, Readymade, and Bed wear segments remain key contributors, making up over 60% of the textile exports.

Table: Textile Export Details (in USD millions)

	FY20	FY21	FY22	FY23	YoY FY23
High Value-Added Segment	**9,669**	**12,427**	**15,611**	**13,576**	**-13%**
- Knitwear	2,794	3,815	5,121	4,437	-13%
- Readymade Garments	2,552	3,033	3,905	3,492	-11%
- Bed wear	2,151	2,772	3,293	2,692	-18%
- Towels	711	938	1,111	1,000	-10%
- Made-up Articles	591	756	849	693	-18%
- Art, Silk & Synthetic Textile	315	370	460	412	-10%
- Others	555	743	872	851	-2%
Low to medium Value-Added Segment	**2,858**	**2,972**	**3,719**	**2,926**	**-21%**
- Cotton Cloth	1,830	1,921	2,438	2,022	-17%
- Cotton Yarn	984	1,017	1,207	844	-30%
- Others	43	34	74	60	-20%
Total	**12,527**	**15,399**	**19,330**	**16,502**	**-15%**

Source: PBS

Flash floods in Sindh and Southern Punjab from last year's monsoon wreaked havoc on the cotton crop, washing away roughly 45% worth over USD 2.5b. This catastrophe led to a historic low yield of 4 million bales in 2022, compared to a 12 million bales annual demand. Local cotton prices subsequently reached a 12-year high of over Rs. 22,000 per 40kg during the year, and imports rose by ~20% in USD terms for FY22, vis-à-vis preceding year. This situation heightened working capital needs, adversely affecting profit margins and liquidity profile for textile entities, particularly spinners, weavers, and dyeing companies. On a positive note, the production target for the current season is set at 12.7 million bales, supported by favorable weather and timely government intervention.

Table: Cotton Prices Trend (In Rs.)

	June'19	June'20	June'21	June'22	June'23
Per Maund	8,770	8,860	13,000	17,380	17,735
YoY % Change	*26%*	*1%*	*32%*	*34%*	*2%*

The industry faces medium-term risks due to the current 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. Additionally, the potential expiration of Pakistan's GSP plus status in December 2023 could be impactful. This status, allowing duty-free access to the EU for over

6,300 tariff lines, fosters beneficial trade. Its loss could lead to reduced trade revenues and create market uncertainties.

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 led to the reduction or withdrawal of many of these supports. This along with contractionary monetary policy and political uncertainties in the country are the key present business risk factors. In the long run, improvement in value addition, investment in technology and optimization of energy cost would define the future prospects of textile exports.

Ratings continue to drive strength from strong market position as a prominent exporter.

SL, with a rich operating history spanning over three decades, stands as one of the leading manufacturers and exporters of knitted apparel and denim and non-denim woven garments and home textile products. In FY23, it secured the 14th spot among Pakistan's top 20 exporters.

Despite falling export volumes, revenue growth continues, supported by consistent rupee depreciation. Geographic and client wise sales mix feature high concentration.

Net sales crossed the Rs. 40b threshold in FY23, almost doubling in the past three fiscal years while the 6-Year CAGR hovered around 24% for the period (FY17-23). The modest ~7% YoY increase was purely due to rupee devaluation, even as volumes shrank by 15-20% and dollar-based prices dipped slightly. Home textile products contribute over 70% to revenues, trailed by knitwear and denim garments. The home textile lineup boasts items such as bed sheets, fitted sheets, duvets, pillowcases, comforters, cushions, curtains, kitchenware, and towels while the clothing segment mainly includes hoodies, fleece, and track suits.

Exports dominate the sales mix, with over 98% contribution on a timeline. Geographically, the UK dominates, absorbing roughly two-thirds of turnover, while the rest is spread across the United States, Australia, Spain, and Europe. Client concentration is high, with the top ten clients making up over two-thirds of sales revenue. However, longstanding relationships with these major clients provide a sense of stability and confidence. Key revenue contributors include Asda stores, Primark, Target, Carrefour Global Sourcing, B&M retail, Kmart, and Next among others. Management anticipates future growth, banking on global demand recovery, further rupee depreciation, and revision in sales contracts to accommodate rising financial costs. Based on 10% growth in volumes, projected top-line revenue for FY24 stands at over Rs. 52b, with a 5% targeted net margin.

Gross margins rebounded in FY23, but significant jump in financial charges squeezed net margins. Strategic move towards backward integration with new spinning and weaving units would improve margins, going forward.

Following a slight dip, gross margins recovered in FY23, largely driven by the benefits of backward integration and rupee devaluation. Presently, all produced yarn and fabric meet about 15% of overall raw material needs internally. The rest is procured locally: direct greige fabric acquisitions for quicker order fulfillment (requiring less working capital) and yarn conversions, which typically span six months. Yarn is also sourced from the local market for the weaving facility.

Facing economic hurdles, management curtailed operating overheads by eliminating overtime and instituting a five-day workweek. Distribution expenses were trimmed due to global freight charges returning to normal levels and lowered sales commissions. The rise in administrative costs mirrors inflation and sales growth patterns, while financial charges grew significantly due to expansion-led elevated debt levels. This has led to thinner net margins over time yet still remained on par with the industry median. Moving forward, profitability is projected to benefit from backward integration and price adjustments in sales contracts.

Debt service coverage ratio trails industry peers, and prolonged inventory holding has extended the cash conversion cycle. Combined with high financing costs, these factors have heightened liquidity concerns. The same will be addressed with expected improvement in profitability profile in the future.
Funds flow from operations (FFO) has stayed consistent, exceeding Rs. 3b over time. However, rising debt levels adversely impacted cash-flow coverages, while the debt service coverage ratio (DSCR) fell below 2.0x, trailing behind industry counterparts. The current ratio of 1.0x is satisfactory, but capital expenditure is prioritized over working capital. While short-term borrowings are adequately covered by trade debts and inventory, room for improvement exists. Going forward, management plans to release Islamic commercial paper or initiate an IPO to ease liquidity pressures.

The cash conversion cycle has stretched to 96 days in FY23, up by 24 days in two years, driven by higher inventory holding and receivable days. This trend is anticipated to continue with the onset of cotton procurement, intensifying reliance on short-term financing. At present, yarn is offered on 15-20 day credit terms, while fabric extends to 60 days. Notably, only ~8% of trade debts were outstanding past 180 days, with no reported bad debts.

Retained profits and sizeable equity injection kept leverage metrics in line with peers.
Equity base (excluding revaluation surplus) grew by ~38% in the last 24 months, hitting Rs. 13.0b at end-FY23, primarily driven by the issuance of bonus shares of Rs. 2.5b and increase in director's loan of Rs. 420m along with all-out profit retention. Debt profile is a blend of short-term and long-term debt, with total interest-bearing liabilities increasing to Rs. 21.6b (FY22: Rs. 21.4b; FY21: Rs. 15.2b) at end-FY23, ~64% constituted short-term debt while aggregated running finance lines currently stand at Rs. 15.1b, with roughly half of it being ERF/EFS facility. Leverage ratios have improved to mirror FY21 levels, aligning with industry peers.

Governance framework is adequate.
Sponsors have over five decades of experience in the textile sector and the senior management team comprises seasoned professionals. The organizational structure is well-designed under assigned heads, directors, and sales teams for carrying out business operations. The 7-member board includes two independent directors. Dedicated committees for Audit, HR and remuneration, headed by independent members, along with internal audit function, ensure effective oversight.

<u>Term Finance Certificates (TFCs) Issue</u>
In July'20, SL secured Rs. 1.5b via a private TFC issue to fund expansion in the knitted/woven garment sector with new equipment. The instrument's tenor is 5 years, including a one-year grace period, starting repayments in Jan'22 with 8 semiannual installments. The interest rate is 3-month KIBOR plus 225 bps, paid quarterly. The current and fixed assets worth Rs. 2b collectively back this with a joint pari passu charge.

Additionally, the issuer can opt for early repayment now, provided they give a 30-day irrevocable written notice to the trustee/issue agent. Prepayment conditions include: a) in multiples of Rs. 250m, b) to be allowed on scheduled payment dates for principal/profit, and c) without attracting any prepayment penalty.

Sadaqat Limited **Appendix I**

FINANCIAL SUMMARY				*(amounts in PKR millions)*
BALANCE SHEET	**FY20**	**FY21**	**FY22**	**FY23***
Fixed Asset	16,279.8	18,223.7	30,448.1	31,837.6
Stock-in-Trade	4,676.6	6,610.3	8,327.2	9,584.9
Trade Debts	2,991.7	5,613.9	7,391.1	6,900.1
Cash and Bank Balance	409.5	103.2	484.8	189.7
Total Assets	**27,862.5**	**36,143.6**	**52,398.2**	**54,239.1**
Trade and Other Payables	2,890.2	4,860.3	6,035.1	6,272.2
Long-Term Borrowings *(Incl. current maturity)*	2,603.5	4,649.4	7,502.1	7,689.6
Short-Term Borrowings	8,003.2	10,532.1	13,948.9	13,895.0
Total Borrowing	**10,606.7**	**15,181.5**	**21,451.0**	**21,584.6**
Total Liabilities	**13,705.2**	**20,556.0**	**28,299.1**	**28,609.4**
Paid-up Capital	2,400.0	2,460.0	4,920.0	4,920.0
Total Equity *(Incl. loan from directors)*	**7,538.1**	**9,386.5**	**10,915.2**	**12,963.3**
INCOME STATEMENT				
Net Sales	20,375.2	32,969.0	37,635.0	40,338.0
Gross Profit	3,647.2	6,585.4	6,602.0	8,069.4
Operating Profit	1,843.0	2,545.5	2,883.9	4,663.3
Profit Before Tax	**1,058.2**	**1,762.2**	**1,580.6**	**1,552.7**
Profit After Tax	**851.3**	**1,432.9**	**1,145.4**	**1,110.5**
RATIO ANALYSIS				
Gross Margin (%)	17.9%	20.0%	17.5%	20.0%
Net Margin (%)	4.2%	4.3%	3.0%	2.8%
Net Working Capital	(121.1)	846.2	(440.9)	(19.5)
Current Ratio (x)	0.99	1.05	0.98	1.00
FFO	1,084.2	3,141.7	3,025.5	3,204.0
FFO to Long-Term Debt (%)	10.2%	20.7%	14.1%	14.8%
FFO to Total Debt (%)	41.6%	67.6%	40.3%	41.7%
DSCR (x)	1.43	3.13	2.06	1.49
Gearing (x)	1.41	1.62	1.97	1.67
Debt Leverage (x)	1.82	2.19	2.59	2.21
Inventory + Receivable/Short-term Borrowings (x)	95.8%	116.1%	112.7%	118.6%
ROAA (%)	3.4%	4.5%	2.6%	2.1%
ROAE (%)	11.7%	16.9%	11.3%	9.3%

**Unaudited financial statements*

REGULATORY DISCLOSURES — Appendix II

Name of Rated Entity	Sadaqat Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
Rating Type: Entity				
10/10/2023	A	A-2	Stable	Reaffirmed
22/06/2022	A	A-2	Stable	Maintained
24/06/2021	A	A-2	Positive	Maintained
15/04/2020	A	A-2	Rating Watch – Negative	Maintained
18/07/2019	A	A-2	Stable	Reaffirmed
23/02/2018	A	A-2	Stable	Reaffirmed
27/12/2016	A	A-2	Stable	Upgrade
31/12/2015	A-	A-2	Stable	Reaffirmed
01/01/2015	A-	A-2	Stable	Reaffirmed
23/04/2013	A-	A-2	Stable	Reaffirmed
16/03/2012	A-	A-2	Stable	Reaffirmed
Rating Type: Term Finance Certificate (TFC)				
10/10/2023	A	A-2	Stable	Reaffirmed
22/06/2022	A	A-2	Stable	Maintained
14/06/2021	A	A-2	Positive	Maintained
15/04/2020	A	A-2	Rating Watch – Negative	Maintained
13/12/2019	A	A-2	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 now has an option to prepay the issue amount 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.
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Due Diligence Meeting Conducted

Name	Designation	Date
Mr. Hummayun Shahzad	CFO	July 04, 2023