RATING REPORT

Shafi Texcel Limited (STL)

REPORT DATE:
December 19, 2022

RATING ANALYSTS:

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RATING DETAILS		
Rating Category	**Initial Rating**	
	Long-term	**Short-term**
Entity	BBB+	A-2
Rating Outlook	Stable	
Rating Action	Initial	
Rating Date	*December 19, 2022*	

COMPANY INFORMATION	
Incorporated in 1992	**External auditors:** RSM Avais Hyder Liaquat Nauman-Chartered Accountants
Public Unlisted Company	**Chairman:** Mr. Muhammad Naseem
Key Shareholders (with stake 5% or more):	**CEO:** Mr. Faisal Shafi
Shafi Gluco Chem Private Limited– 44%	
Shafi Tanneries Private Limited – 20%	
Mr. Amjad Hafeez – 8%	
Mr. Muhammad Naseem-5%	

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

OVERVIEW OF THE INSTITUTION	RATING RATIONALE

Shafi Texcel Limited started its operations with a weaving plant in 2004, extended its business with a yarn dying plant and processing plant in 2009 and 2014, respectively. It currently operates as a public unlisted company. STL belongs to the Shafi Group of Companies that has a diversified presence in the market. Registered office and production facilities of the entity are located in Karachi and the province of Punjab, respectively.

Profile of CEO:

Mr. Faisal Shafi has been the CEO of STL since 2004. He completed his graduation from University of Pennsylvania, USA in 1999 and MBA from LUMS in 2002. With his dedication and experience, he has been running the family business from over two decades.

Incorporated in 1992 as an unlisted public company, Shafi Texcel Limited (STL) operates as an integrated textile mill and is engaged in the manufacturing and sale of dyed yarn, yarn-dyed fabric, greige fabric, dyed fabric, and garments along with provision of yarn dyeing services.

STL started its operations with a weaving plant in 2004 encompassing, and further extended its business with a yarn dying plant in 2009 and processing plant in 2014. The Company belongs to the Shafi Group of Companies which has presence in the Textile (Shafi Texcel Limited), Food (Everfresh Farms, Shafi Foods & Shafi Gluco Chem Private Limited), Leather (Muhammad Shafi Tanneries Private Limited), and Footwear sectors. Pattern of shareholding of the company depicts 64% ownership by sister concerns (Shafi GlucoChem Private Limited and Muhammad Shafi Tanneries Private Limited) where owners have common directorship.

Product portfolio mainly consists of woven fabrics for various end uses; dealing mostly in cotton and blends with polyester, viscose, lycra and other fibers. The company has local agents in USA and Spain on a Retainership model whereby STL sends their samples and clients can review the products and place orders directly. STL follows a made-to-order model hence risk of holding excess idle inventory is on the lower side. STL's registered office is located at Shafi House, Karachi with four manufacturing facilities located in the province of Punjab (Yarn Dying-Cone Dying Plant, Weaving Unit and Fabric Processing & Dyeing Unit and Apparel/Garment Unit). Power requirement is met via mix of solar panels, internal generation through gas/diesel generators and electricity supply from the grid (WAPDA).

<u>Product Portfolio</u>

- Yarn dyed fabrics for Shirts, Jackets, Trousers, Shorts and Skirts
- Yarn dyed fabrics for Uniforms and Institutional wear such as Aprons and Chef Trousers
- Yarn Dyed Fabrics for Home Textile including Bed Linen, Quilt Covers, Table Clothes and Institutional Bedding
- PFGD Fabric (Prepared for Garment Dying) for PFGD Cotton, Cotton Lycra, Super Stretch, Cotton Poly and other blended fabrics in Poplins, Twills, Canvases, Satins and Dobby weaves
- Greige Fabric for Fashion sportswear, Work wear and Home Textiles
- Garments (shirts).

<u>Capacity Utilization and Operations</u>

Capacity utilization witnessed an uptick across all the segments as actual production increased over the period given high demand post COVID-19 and enhanced operational efficiencies. During FY22, STL has incurred cumulative capital expenditure to the tune of Rs. 1.0b which was financed through a mix of debt financing and internal cash generation. The same was utilized in replacement of looms, procurement of new gas generators, addition of garments machines and for solar investment. To achieve operational and cost efficiency, management is in the process of setting up an additional apparel unit over the rating horizon. Building is under construction with costs (Rs. 450m) pertaining to the same already financed through internal cash generation. Post expansion, installed capacity of the garments unit is expected to increase to 900,000 units as compared to 780,000 units currently. The unit is expected to come online by Dec'22. As per management, apart from financing for routine expenditure, no additional debt is expected to be withdrawn over the rating horizon.

Sector Update

Table 1: Pakistan Export Statistics

	FY20	FY21	FY22	Q1'FY22	Q1'FY23
PAKISTAN EXPORTS (IN USD' MILLIONS)	22,536	25,639	32,450	7,201	7,594
TEXTILE (IN USD' MILLIONS)	12,851	14,492	18,525	4,241	4,777
PKR/USD RATE (AVERAGE)	158.0	160.0	177.5	164.4	229.1
SOURCE: SBP					

- Pakistan's export growth came in at 14% and 27% in FY21 and FY22 respectively. Pakistan's export proceeds have oscillated in the range of USD 22-25b during the past decade (FY11-FY21), however, in FY22 exports finally grew beyond USD 32.4b.
- In FY22, textile exports were up 28%. Growth in textile exports played a significant role in this uptick, contributing 59% of the overall growth in export base. Share of textile exports in total exports has oscillated in the range of 54-59%, coming in at 57% during the past 3-years (FY20-22).
- As illustrated in the table below, the composition of textile exports has depicted improvement in the last 3-year period, with contribution from higher value added segment increasing from 77.2% in FY20 to 80.8% in FY22 of aggregate textile exports

.Table 2: Segment-wise textile Exports (All Figures in USD' Millions, except for percentages)

	FY20	FY21	FY22	1Q'FY22	1Q'FY23	FY20	FY21	FY22	1Q'FY22	1Q'FY23
High Value-Added Segment	**9,669**	**12,427**	**15,605**	**3,561**	**3,749**	**77.2%**	**80.7%**	**80.8%**	**80.6%**	**81.8%**
- Knitwear	2,794	3,815	5,118	1,145	1,321	22.3%	24.8%	26.5%	25.9%	28.8%
- Readymade Garments	2,552	3,033	3,905	861	912	20.4%	19.7%	20.2%	19.5%	19.9%
- Bed Wear	2,151	2,772	3,291	803	780	17.2%	18.0%	17.0%	18.2%	17.0%
- Towels	711	938	1,110	241	237	5.7%	6.1%	5.7%	5.5%	5.2%
- Made-Up Articles (Excl. Towels & Bed Wear)	591	756	848	197	180	4.7%	4.9%	4.4%	4.5%	3.9%
- Art, Silk & Synthetic Textile	315	370	460	108	108	2.5%	2.4%	2.4%	2.4%	2.4%
- Others	555	743	872	206	211	4.4%	4.8%	4.5%	4.7%	4.6%
Low To Medium Value-Added Segment	**2,858**	**2,972**	**3,717**	**860**	**835**	**22.8%**	**19.3%**	**19.2%**	**19.4%**	**18.2%**
- Cotton Cloth	1,830	1,921	2,332	557	581	14.6%	12.5%	12.1%	12.6%	12.7%
- Cotton Yarn	984	1,017	1,311	289	236	7.9%	6.6%	6.8%	6.5%	5.2%
- Others	43	34	74	14	18	0.3%	0.2%	0.4%	0.3%	0.4%
Total	**12,527**	**15,399**	**19,332**	**4,421**	**4,584**					
SOURCE: PBS										

- Cotton production in Pakistan, was at its lowest level in decades for FY21, albeit the same posted 18% uptick in FY22. Actual production at 8.33m bales still missed the targeted production of 10.5m bales. Cotton prices rose to a new 12-year high of ~Rs. 21,600/maund as of March'22, as a result of the shortage and higher input costs of fertilizer and energy. Cotton imports were also up 19.8%, in USD terms, for FY22 vis-à-vis preceding year.

- According to United States Department of Agriculture (USDA), the 2022/23 harvested area has declined notably following devastation caused by recent flood in Sindh and Southern Punjab. Hence, the projected production has been brought down to 5m bales. To counter the shortage, import of 5.8m bales is expected during FY23, which is 29% higher than preceding year.

Table 3: Cotton Prices

	FY19	FY20	FY21	FY22
Per Maund (Rs.)	8,770	8,860	13,000	17,380
% Change	26%	1%	32%	34%

- After posting windfall margins in FY21 and H1'FY22, margins of textile operators came under pressure in H2'FY22, mainly on account of higher input costs and recessionary trend in export markets.

Growth in topline attributable to a blend of higher average selling prices and rise in volumetric sales in line with capacity enhancements. Meeting projected growth targets amidst depressed global and local demand scenario will be important.

STL's revenue have grown at a CAGR of 28% over the past three years (FY19-FY22). Growth has been attributable to a blend of higher average selling price and a rise in the quantity of pieces sold in line with consistent capacity enhancements. During FY22, revenue growth of 63% largely emanated from dollar appreciation in exports sales and higher prices in the local market. Exports to local sales mix is in the ratio of around 78:22 over the past two years with management's plans to increase the proportion of sales going forward by focusing on growing sales in the US market. In line with the revenue trend, net sales were reported at Rs. 2.5b in 1Q23.

Increasing revenue base is contributed by an organic growth from local and international clients. Moreover, continuous emphasis on extending clientele, maximizing production and uplifting efficiency related measures help to strengthen the entity's competitive position. Furthermore, ability to fulfill small orders is one of the key competitive advantages of the Company. In terms of geographic sales distribution, around 70% of export revenue is provided by Europe followed by Asia, and USA. With higher installed capacity, management plans to target volume-based market-USA going forward consequently increasing proportion of exports in the sales mix.

Client concentration in sales is at a moderate level, as top fifteen customers account for around 55% of total sales during FY22 with 45% emanating from local clients. Going forward, management plans to focus towards value-added products particularly in yarn-dyed fabric and garments. Meeting projected growth targets amidst depressed global and local demand scenario will be important.

Profitability indicators of the Company have remained stable on a timeline basis. Net margins supported by lower tax expensed due to lower quantum of deferred taxation

Gross margins of the company have averaged at 11% over the last four years with a decline noted in FY22 to 10.7% (FY21: 11.3%, FY20: 11.5%) being a result of higher direct expenses (FY22: Rs. 7.5b;

FY21: Rs. 4.6b) largely comprising elevated raw material and energy costs. Management expects further uptick in energy costs due to expected removal of subsidies provided by the GoP. As per management, Company's inability to completely pass the rising input costs to final customers also suppressed margins. However, ratings incorporate efficient procurement strategy of the company with lower lead times evident from purchasing fabric from local vendors.

Gross margins picked up pace in 1Q23 on account of higher revenue generated. Distribution costs (FY22: Rs. 195.7m; FY21: Rs. 154.9m) and administrative expenses (FY22: Rs. 158.2m; FY21: Rs. 118.3m) went up in line with higher revenue in FY22. Other income also depicted a noticeable increase in FY22 mainly attributable to exchange gain earned during the year. Despite significant rise in finance costs, overall net profitability profile of the company indicated an upward movement in FY22 given lower tax expense. Going forward, projected improvement in profitability profile is contingent on improvement in the macro-economic dynamics.

Sufficient cash flow coverages depicts sound liquidity profile

Despite increasing quantum of debt on a timeline basis, funds from operations (FFO) provide sound coverage against outstanding obligations. In 1Q23, FFO to Total Debt and FFO to Long Term Debt were reported at 22.1% (FY22: 24.7%; FY21: 21.9%, FY20: 12.7%) and 46.0% (FY22: 45.2%; FY21: 34.4%, FY20: 23.3%), respectively. Debt Servicing Coverage ratio declined to 1.50x (FY22: 1.92x; FY21: 4.23x; FY20: 1.14x) in 1Q23 on account of higher current portion of long-term debt due. Current ratio remained at an adequate level of 1.4x at end-Sept'22. Quantum of trade debts in relation to sales revenue has seen to increase to 11.3% (FY22: 9.1%; FY21: 7.9%, FY20: 8.3%) at end-1Q23 largely emanating from foreign, secured debtors. Foreign LCs are secured and generally for a term of 30-120 days while local debtors also comprise similar credit terms along with advance payments and post-dated cheques. With major local customers bearing sound financial health, there were no defaulting parties at end-June'22. With higher stock of finished goods inventory at end-June'22, cash conversion cycle of the company increased to 64 days (FY21: 59 days, FY20: 57 days) which depicts modest liquidity profile of the Company. In addition, stock in trade and trade debts provided sufficient coverage against short-term debt. Maintaining liquidity profile is considered important from a ratings perspective.

Sound Capitalization indictors

Equity base of the company reported a CAGR of 16.6% over the past three years (FY19-FY22) due to profit retention. The growth has been subdued due to effect of re-measurement of staff retirement gratuity. The company recorded equity to the tune of Rs. 3.0b (FY22: Rs. 2.8b; FY21: Rs. 2.1b; FY20: Rs. 1.9b) at end-Sept'22 attributable to profit retention and loan from sponsors (Rs. 450m) provided during FY22. Debt levels increased over time to finance BMR plans and to fulfill higher working capital needs with the same reported at Rs. 2.8b (FY22: Rs. 2.6b; FY21: Rs. 1.8b, FY20: Rs. 1.7b) at quarter end Sept'22. BMR financing was required to employ gas generators, to equip solar panels and to replace looms with latest technology as discussed in the capex plan above. Debt portfolio constitutes 52% of short-term borrowing while remaining (48%) is long-term in nature. The company enjoys the benefit of concessionary rate financing with majority (71%) of the total debt portfolio comprising ERF and LTFF at end-June'22.

With adequate profit retention, leverage and gearing ratios were reported at 1.44x (FY22: 1.46x; FY21:1.34x, FY20: 1.25x) and 0.93x (FY22: 0.91x; FY21: 0.87x, FY20: 0.84x), respectively at end-September'22. As per management, the company plans to continue its retention policy and therefore, no dividend payout is envisaged over the rating horizon. Despite management's plans to continue BMR expansion and routine capital expenditure annually for which minimal debt will be drawn, capitalization indicators are expected to remain within manageable levels over the medium term. Maintenance of the same in accordance with the benchmarks for the assigned ratings is considered important.

Sound internal control and IT framework; however room for improvement exists in governance structure given family members (owners) being the directors of the company.

The company has a Board of Directors comprising five members with no independent director employed. The Company's ownership and Board composition is vested with family members. Discussions at the Board and management level are convened on a quarterly basis with formal documentation for the minutes of the same. Room for improvement exists through induction of external members in accordance to corporate governance best practices. RSM Avais Hyder Liaquat Nauman, Chartered Accountants are the external auditors of the company who classify in Category A on the SBL Panel of Auditors.

Corporate governance framework draws support from sound internal audit, compliance and IT functions. Shafi Texcel Limited has an independent internal audit department that conducts compliance of internal policies, timely preparation of reliable financial information, performs reliable financial reporting and emphasizes prevention and detection of fraud/error. The scope of the internal audit function includes inventory audits, procurement and payable management audits, risk based financial audits, and policy reviews and development. The company conducts function-wise audits on a quarterly basis. The internal audit (IA) department follows a risk based audit approach with observations classified into 'high', 'medium' and 'low' risk categories. A rating scale is used to assist the audit function and audit reports are discussed with Board of Directors.

On the IT front, the company uses Oracle E-Business Suite (EBS) R12 as the integrated ERP system and an in-house developed HRMS software. Oracle EBS R12 system consists of four modules; Oracle Financial Module, Order Management System Module, Production Module & Supply Chain Module. As for data, the company possesses a RMAN backup server for security purposes, however, does not have a disaster recovery site in place. As per management, R&D and Management Information Systems teams continue to upgrade the IT function of the Company time to time as per requirement.

RATING SCALE & DEFINITION Appendix I

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: JCR-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.jcrvis.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.jcrvis.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.

'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.jcrvis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when JCR-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 II**
Name of Rated Entity	Shafi Texcel Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	see table below
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 Meetings Conducted	see table below

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
19-12-2022	BBB+	A-2	Stable	Initial

Due Diligence Meetings Conducted

Name	Designation	Date
Yasir Mehmood	Chief Financial Officer	6th October, 2022
Usman Cheema	Manager Finance	6th October, 2022