RATING REPORT

Muhammad Shafi Tanneries (Private) Limited

REPORT DATE:
May 7, 2019

RATING ANALYSTS:
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RATING DETAILS		
Rating Category	**Latest Rating**	**Previous Rating**
Entity	**A-/A-2**	**A-/A-2**
Rating Outlook	Negative	Stable
Rating Date	*May 2, '19*	*January 26, '18*
Rating Action	*Maintained*	*Reaffirmed*

COMPANY INFORMATION	
Incorporated in 1972	**External auditors:** RSM Avais Hyder Liaquat Nauman, Chartered Accountants
Private Limited Company	**Chairman of the Board:** Mian Muhammad Haleem
Key Shareholders (with stake 10% or more):	**Chief Executive Officer:** Mr. Muhammad Naseem
Mian Amjad Hafeez–22%	
Mian Muhammad Naseem–20%	
Mian Tahir Hanif–13%	
Mian Muhammad Haleem–12%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria for Corporates *http://www.vis.com.pk/kc-meth.aspx*

Muhammad Shafi Tanneries (Private) Limited

OVERVIEW OF THE INSTITUTION

Incorporated in 1972, Muhammad Shafi Tanneries (Private) Limited was initially established as a partnership concern. In 1998, it was converted into a private limited company. The main business activity of the company includes manufacturing and export of finished leather. The financial statements for FY17 have been audited by RSM Avais Hyder Liaquat Nauman, Chartered Accountants.

RATING RATIONALE

Muhammad Shafi Tanneries (Private) Limited (MSTL) is involved in the business of converting goat and sheep hides to finished leather. MSTL belongs to Shafi Group comprising established companies present in textile, food and footwear industries. Shareholding of the company remains unchanged and is vested solely by various family members. Current ratings of MSTL account for profile of sponsors who have extensive experience in the leather industry.

Key Rating Drivers:

High competition in the industry limits bargaining power of exporters; slowdown in European markets may impact demand outlook for leather exports. Further PKR depreciation can support revenues.

Leather industry is characterized by high competition due to presence of large number of small to medium sized players. Local firms have to compete not only with other domestic players, but also with Chinese, Indian and Bangladeshi manufacturers in the overseas market. The intense competition limits ability of companies to pass volatility of raw material prices and foreign exchange loss to customers entirely while pricing products. The domestic leather prices are dependent on availability of leather in the domestic market and are subject to significant volatility. However, as export realization is not linked to domestic leather prices, margins are susceptible to adverse price movements in export and domestic markets. In last four fiscal years, leather exports from Pakistan have declined by ~40% owing to slowdown in demand from European countries. Moreover, a shift in leather demand has been observed from Europe to Asia (the former imported US$ 753.9m and the latter imported US$ 965.7m worth of leather in FY17). Apart from deteriorating external conditions, a difficult operating environment for tanneries in southern region of the country vis-à-vis northern players has led to exits by smaller firms although large companies continue to operate given their scale and experience. Nevertheless, PKR depreciation against US$ (20%) and Euro (17%) in FY18 has provided support to revenues of Pakistani tanneries over outgoing fiscal year; further depreciation may serve as a positive driver for firms' topline.

Sales Mix

Given fall in trade volumes of leather products globally, revenue base of MSTL has weakened on a timeline basis. Topline of the company has depicted a downward trend with sales declining from Rs. 2.3b in FY16 to Rs. 1.7b in FY18. Majority of sales comprise exports to China and Germany. Total volumes exported to China decreased on account of sale of MSTL's subsidiary, Sihui Shafi Leathers China., a firm based in China from which orders were previously routed. All sales of MSTL are dove-tailed to orders. Out of total revenue, China represents almost 15.9% (FY17: 29.8%) of sales followed by Germany contributing 22.2% (FY17: 17.6%) of revenues. Both client and country wise concentration in sales is on the higher side with top three countries generating 46% of total revenue. In terms of local sales, revenues depicted growth. Going forward, management expects sales volumes to improve on the back of ongoing new product development efforts and engagement of foreign consultants for same purpose.

Profitability

Ratings factor in existence of sizeable portion of non-earning assets in the form of investments and loans to subsidiaries/associates on MSTL's balance sheet and market risk emanating from equity market exposure which are constraints on profitability. Despite decline in volumes, MSTL was able to sustain gross margins on account of strategic raw material procurement and stable average selling prices. The company's booked higher profit received from associated long-term investments due to notable improvement in earnings of Shafi Texcel Limited. Moreover, the company earned net gain of Rs. 52m on sale of long term investment in Sihui Shafi Leathers China. However, with losses booked on short term equity investments, bottom line of the company declined to Rs. 116.9m (FY17: Rs. 178.8m). Going forward, profitability is expected to remain under pressure given subdued demand of leather products. Hence, cost rationalization and achieving projected sales volumes through product modification are considered important in terms of profitability. Going forward, ratings remain dependent on improving earning profile of core operations and income from long term investments.

Inventory

With lower inventory days, cash conversion cycle has reduced to 263 days (FY17: 299 days) in FY18. Inventory carried on the balance sheet largely comprises raw skins in the conversion phase. Going forward, MSTL plans to continue strategic procurement of raw material with focus on meeting clients' quality standards while minimizing costs. Stock-in-trade represented 101.0% (FY17: 88.8%) of borrowings at end-FY18. No major capex is planned in the foreseeable horizon.

Liquidity

Liquidity profile of the company has improved with lower quantum of debt and increase in Funds from Operations (FFO) resulting from decrease in finance cost. As a result, FFO to total debt was also reported higher at 11.1% (FY17: 4.7%) in FY18. Nevertheless, aging profile of trade debts depicts room for improvement given that a large chunk of receivables lies in more than 60 days bucket (the same has increased in FY18). With no long term debt on its books, capital structure of the company is considered sound. The company utilizes funding from short term borrowings only which match inventory levels. In FY18, the company deployed funds amounting to Rs. 73m in Everfresh Farms (Private) Limited as advance against shares. The company does not plan to extend further loans/investments to associates.

Capitalization

Consistent profits earned by the company have resulted in strengthening of its capitalization levels. Total equity (including loan from associates) of MSTL stands at Rs. 2.3b. At these capitalization levels, leverage indicators remain on the lower side with gearing and leverage reported lower at 0.4x (FY17: 0.6x) and 0.6x (FY16: 0.8x), respectively at end-FY18.

Muhammad Shafi Tanneries (Private) Limited **Appendix I**

FINANCIAL SUMMARY			*(amounts in PKR millions)*
BALANCE SHEET	**FY17**	**FY18**	**1HFY19**
Property, Plant & Equipment	367	377	384
Long term Investments	965	882	883
Stock-in-Trade	1,280	1,015	1,005
Trade Debts	93	198	173
Short Term Loans & Advances	532	457	282
Short Term Investments	400	369	271
Cash & Bank Balances	88	104	94
Total Assets	4,015	3,632	3,344
Trade and Other Payables	302	250	175
Long Term Borrowings	10	5	-
Short Term Borrowings	1,441	1,005	806
Total Debt	1,451	1,010	806
Total Liabilities	1,847	1,354	1,057
Total Equity	2,211	2,288	2,292
INCOME STATEMENT	**FY17**	**FY18**	**1HFY19**
Net Sales	1,916	1,753	905
Gross Profit	402	385	216
Distribution Expenses	147	128	74
Administrative Expenses	70	71	33
Gain (Loss) on Short Term Equity Portfolio	102	(63)	(71)
Other Income	6	58	5
Finance Cost	72	57	19
Share of profit from associates	8	35	n/a
Profit Before Tax	205	137	15
Profit After Tax	179	117	6
RATIO ANALYSIS	**FY17**	**FY18**	**1HFY19**
Gross Margin (%)	20.98%	21.96%	23.87%
Net Margin	9.33%	6.67%	0.66%
Trade debts/Sales	5%	11%	10%
FFO	68.96	112.25	N/A
FFO to Total Debt (%)	5%	11%	N/A
FFO to Long Term Debt (%)	663%	2044%	N/A
Current Ratio (x)	1.52	1.85	2.04
Cash Conversion Cycle (days)	299	263	249
(Stock+ Trade Debts)/ Short term borrowing	95%	121%	146%
Debt Servicing Coverage Ratio (x)	2.50	2.73	N/A
Gearing (x)	0.64	0.42	0.35
Leverage (x)	0.82	0.59	0.46
ROA (%)	4%	3%	0.34%
ROE (%)	8%	5%	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	Muhammad Shafi Tanneries (Private) Limited
Sector	Tanneries and Leather Products
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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Rating History

Rating Date	Current Rating	Rating Outlook	Rating Action
RATING TYPE: ENTITY			
5/02/2019	A-/A-2	Negative	Maintained
1/26/2018	A-/A-2	Stable	Reaffirmed
6/17/2015	A-/A-2	Stable	Reaffirmed
5/20/2014	A-/A-2	Stable	Upgrade
3/18/2013	BBB+/A-3	Stable	Reaffirmed
2/1/2012	BBB+/A-3	Stable	Reaffirmed