RATING REPORT

Muhammad Shafi Tanneries (Private) Limited

REPORT DATE:
June 30, 2020

RATING ANALYSTS:
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RATING DETAILS		
Rating Category	**Latest Rating**	**Previous Rating**
Entity	**A-/A-2**	**A-/A-2**
Rating Outlook	Rating-Watch Developing	Negative
Rating Date	*June 30, '20*	*May 2, '19*
Rating Action	*Maintained*	*Maintained*

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:

Global demand for leather will be adversely impacted by coronavirus outbreak

A large proportion of Pakistan's leather exports are directed to the countries most affected by the coronavirus — UK, US, France, Italy, Spain and Germany. This naturally suggests that the implications of the pandemic on Pakistan's leather exports are likely to be significant as its major export destinations struggle to cope with the crisis. In FY19, Pakistan's tanned leather exports decreased by 19% in volume terms and 24% in value terms compared to same period last year. Leather industry remains 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. Going forward, policies towards economic revival in countries affected by coronavirus will influence the pace at which demand for Pakistani leather products reaches pre-coronavirus levels.

Around 50% of annual sales for FY21 are already booked as orders in hand while remaining orders are contingent upon global demand dynamics

Sales of the company increased by 3% to Rs. 1.8b (FY18: Rs. 1.7b) but depicted 40% growth in 1HFY20 compared to same period last year. Growth in sales were driven by export sales while local sales remained muted. With respect to exports, volumes decreased by 14% in FY19 but prices increased by 21%. However, in 1HFY20, volumes increased by 24% and prices increased by 16% compared to same period last year. Majority of sales comprise exports to China and Germany. All sales of MSTL are dove-tailed to orders. Out of total revenue, Germany represents 16.8% and China accounts for 15.3% of revenues. Client and country wise concentration in sales is moderate with top three countries generating around 30% of total revenue. 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.

From July 2019 to April 2020, revenues were reported at Rs. 1.9b. For FY20, sales are projected at Rs. 2.15b, the management expects to achieve this target. The company has orders in hand for 6 months (July-December) (at 50% of annual sales) so around Rs. 1.1b sales is at least likely to be achieved. Gross margins will not be lower than those observed over 2020 as per management due to product innovation efforts being made which allow for better pricing.

Core operating profits have improved but bottom line was affected by listed equity investments

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. MSTL was able to improve gross margins on account of strategic raw material procurement and better average selling prices. However, with losses booked on short term equity investments, bottom line of the company declined to Rs. 106m (FY18: Rs. 117m). With recovery of equity market in 1HFY20, the company was able to record significant growth in net profit to Rs. 263m (1HFY19: Rs. 6m). Going forward, profitability is expected to remain under pressure given subdued demand of leather products, and volatility in equity market. 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.

Going forward, MSTL plans to continue strategic procurement of raw material with focus on meeting clients' quality standards while minimizing costs. Management plans to reduce inventory levels to Rs. 800-900m in ongoing year. Stock-in-trade and trade debts represented 178% (FY19: 145; FY18: 121%%) of borrowings at end-1HFY20. No major capex is planned in the foreseeable horizon.

Liquidity profile has improved with higher cash flows and lower debt

Liquidity profile of the company has improved with lower quantum of debt and increase in Funds from Operations (FFO). As a result, FFO to total debt was also reported higher at 19.3% (FY18: 11.1%) in FY19. Nevertheless, aging profile of trade debts depicts room for improvement given that a large chunk of receivables lies in more than 60 days bucket. With no long term debt on its books and low gearing, capital structure of the company is considered sound. The company utilizes funding from short term borrowings only which match inventory levels. The company does not plan to extend further loans/investments to associates.

Low leveraged capital structure while equity has increased on the back of profits

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. 2.6b. At these capitalization levels, leverage indicators remain on the lower side with gearing and leverage reported lower at 0.3x (FY19: 0.4x) and 0.47x (FY19: 0.55x), respectively at end-1HFY20.

Muhammad Shafi Tanneries (Private) Limited — Appendix I

FINANCIAL SUMMARY *(amounts in PKR millions)*			
BALANCE SHEET	**FY18**	**FY19**	**1HFY20**
Fixed Assets	1,265	1,241	1,252
Long term Investments	882	855	854
Stock-in-Trade	1,015	1,199	1,164
Trade Debts	198	144	262
Cash & Bank Balances	104	126	98
Total Assets	3,632	3,714	3,907
Trade and Other Payables	250	338	358
Long Term Debt	5	1	-
Short Term Debt	1,005	926	803
Total Debt	1,010	927	803
Paid Up Capital	50.0	50.0	50.0
Total Equity	2,279	2,380	2,646
INCOME STATEMENT	**FY18**	**FY19**	**1HFY20**
Net Sales	1,753	1,813	1,270
Gross Profit	385	476	352
Operating Profit	171	245	216
Profit before Tax	137	127	274
Profit After Tax	117	106	263
RATIO ANALYSIS	**FY18**	**FY19**	**1HFY20**
Gross Margin (%)	22.0%	26.3%	27.7%
Net Margin	6.7%	5.9%	20.7%
Trade debts/Sales	11.3%	8.0%	10.3%
FFO	112.3	179.0	N/A
FFO to Total Debt (%)	11.1%	19.3%	N/A
FFO to Long Term Debt (%)	2044%	18016%	N/A
Current Ratio (x)	1.85	1.94	2.21
(Stock+ Trade Debts)/ Short term borrowing	121%	145%	178%
Debt Servicing Coverage Ratio (x)	2.73	5.75	N/A
Gearing (x)	0.42	0.38	0.29
Leverage (x)	0.59	0.55	0.47
Current Ratio	1.9	1.9	2.2
ROA (%)	3%	3%	13.80%
ROE (%)	5%	5%	21%

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	**Rating Date**	**Current Rating**	**Rating Outlook**	**Rating Action**
	RATING TYPE: ENTITY			
	6/30/2020	A-/A-2	Rating-Watch Developing	Maintained
	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
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.			
Due Diligence Meeting with	Shahid Ahmed – Manager Finance			
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