RATING REPORT

Muhammad Shafi Tanneries (Private) Limited

REPORT DATE:
May 19, 2022

RATING ANALYSTS:
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RATING DETAILS				
	Latest Rating		Previous Rating	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	BBB+	A-2	A-	A-2
Rating Action	Downgrade		Maintained	
Rating Outlook	Stable		Negative	
Rating Date	*May 19, 2022*		*July16, 2021*	

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: Industrial Corporates (August 2021)
https://docs.vis.com.pk/docs/CorporateMethodology202108.pdf

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.

RATING RATIONALE

Muhammad Shafi Tanneries (Private) Limited (MSTL) is a family owned company, engaged in the business of converting goat and sheep hides to finished leather which is used in the making of shoes, fashion articles (purses and handbags) and gloves. MSTL belongs to Shafi Group which has presence in the textile (Shafi Texcel Limited-STL), food (Everfresh Farms-EFPL, Shafi Foods- SFPL)and footwear sectors. MSTL is a family owned organization. The registered office and factory is situated in Karachi, and it is one of the oldest entities operating in the industry. At end-Dec'21, long term investments amounted Rs. 1.1b (FY21: Rs. 827m, FY20: Rs. 800m) increase in which is on account of addition of share of profit from associates. Due to relatively suppressed demand, capacity utilization of the entity has remained on the lower side.

PRODUCTION CAPACITY	24,000,000 SQF

ACTUAL PRODUCTION FOR THE YEAR 2020-21	5,528,888 SQF
ACTUAL PRODUCTION FOR HALF YEAR 2021-22	2,850,221 SQF

Key Rating Drivers:

An uptick in the performance of industry post COVID-19.

As per Pakistan Bureau of Statistics, overall exports of the leather sector grew by 9% to Rs. 833m in FY21. Of this, 20% comprised finished leather, 34% leather garments, 31% gloves, 13% footwear, and 2% leather goods. However, exports of tanned leather remained under pressure and depicted a volumetric decline of 26% in the same period, despite a slight increase in the production of hides and skins. Tanned leather demand witnessed growth in 1HFY22, with export earnings showing a 13.15% in the first seven months of FY22 as compared to the same period last year. A significant improvement in the exports of tanned leather was witnessed on the back of a volumetric growth of 48% led by diversion of orders to Pakistan on account of slowdown in business operations within regional competitors like Bangladesh, Cambodia and Vietnam due to environmental concerns. Industry competitiveness remains from other countries in the region though, with China and India accounting for more than one-third of global leather exports. In addition to the slow demand, Pakistan's 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 domestic players, but also with Chinese, Indian and Bangladeshi manufacturers. The stiff competition limits ability to extract higher margins within finished leather. Going forward, given subdued leather demand globally, industry is expected to remain under pressure. Innovations and value-additions across the sector is needed for sustainability.

Topline of the company reduced significantly during FY21 vis-à-vis FY20 due to the COVID-19 induced slowdown along with overall depressed demand for tanned leather.

Revenue of the company fell by 45% and was reported at Rs. 936m in FY21 (FY20: Rs. 2.1b, FY19: Rs. 1.8b) mainly attributable to reduction in volumes, due to restrictions imposed across the globe to combat COVID-19 which hampered economic activity along with overall depression in demand. There was some recovery observed during 1HFY22, which resulted in a revenue of Rs. 590m for the period. Prices in the export markets have also shown a gradual increase on a timeline basis. Geographic concentration has remained on the higher side, with sales in top five countries accounting for more than 73% of the total revenue. Given company sales are concentrated in Europe where markets have been more severely affected by COVID lockdown, the impact of slowdown has been more pronounced.

Going forward, the management expects the sales to remain at similar levels with the existing product offering due to shift in consumer preference towards artificial leather products. Hence, entry into new business lines, such as cow leather is being considered, as per management. Furthermore, the entity is also focusing towards bringing process innovation through which the tanned leather can be utilized for other products such as gloves and sports goods.

Going forward, profitability from core business will remain subdued, however management expects profitability to be supported through investment income from associates as well as reduced financial charges on account of de-leveraging of balance sheet.

Profitability remained under pressure, despite some improvement in 1HFY22.

Margins of the company took a hit during FY21 and fell to 13% (FY20: 19%), but reverted to around 19% in the ongoing year. Given low margins, the entity reported a loss of Rs. 62m in FY21. However, in 1HFY22 the company recorded profit after tax of Rs. 42m majorly emanating from share of profit from associates. Given declining revenue base and operating profits, overall profitability profile is considered to be under pressure. During 1HFY22, the management undertook certain cost saving measures to ease the pressure on bottom-line. In this regard, size of the workforce has been reduced to bring it to an optimal level. In addition to that, the schedule of production has also been aligned with the flow of orders, so that the factory is operational only when needed. Moreover, management's deliberate strategy towards exposure in comparatively less-riskier mutual funds has been noted. Improvement in profitability profile going forward is contingent on management's plan to diversify towards cow leather along with materialization of innovation plans.

Investments in Associates	Investment	Profit from Inv
in rs. Mn	Dec'21	1HFY22
Abdal Hafeez Shafi Leather Pvt	262	-
Shafi Texcel	593	30
Shafi Foods Pvt Ltd	117	9
Everfresh Farms Pvt Ltd	155	0.3

Liquidity profile shows room for improvement.

Due to fall in profitability, cash flow coverages of the entity were negatively affected. FFO to Total Debt ratio was reported at 7.7% for HYFY22 (FY21: -15.8%, FY20: 20.7%). Debt servicing coverage also fell below the adequate level, and was reported at 0.83 at end-Dec’21 (FY21: -2.17, FY20: 6.05). However, stock and trade debt do provide sufficient coverage for short term debt, while current ratio also remained at a reasonable level. In order to improve the overall working capital management, the management has decided to be prudent in its procurement strategy. Instead of bulk buying raw skins are purchased in accordance with the flow of orders, helping to free up funds that were previously tied up in inventory. Company also holds short term liquid investments of ~Rs 545m in mutual funds which provides additional comfort.

A conservative capital structure.

Even though the equity base of the company declined over the last 18-month period due to losses incurred in the outgoing year; having small quantum of long term- debt on the books has helped to keep the leverage indicators at low levels. Short term debt at end-Dec’21 was reported on the higher side comprising SBP’s refinance salary support scheme At end-1HFY22, gearing and leverage ratios were reported at 0.19x (FY21: 0.2, FY20: 0.34) and 0.28x (FY21: 0.28x, FY20: 0.44x). Going forward, the entity is expected to pay off the remaining portion of its long –term debt, whereas short-term debt is expected to remain at similar levels to finance the working capital needs. Hence, leverage is likely to remain on the lower side.

Muhammad Shafi Tanneries (Private) Limited Appendix I

FINANCIAL SUMMARY *(amounts in PKR millions)*					
BALANCE SHEET	**FY18**	**FY19**	**FY20**	**FY21**	**1HFY22**
Fixed Assets	377.2	384.2	347.0	350.3	372.4
Long term Investments	882.0	855.4	799.7	826.7	1,127.8
Short term invetments	369.4	239.2	637.4	630.3	545.0
Stock-in-Trade	1,015.0	1,199.3	1,074.1	840.1	676.4
Trade Debts	197.5	144.4	199.9	120.7	190.1
Cash & Bank Balances	103.6	125.8	130.4	72.5	43.8
Total Assets	3,632.1	3,714.0	3,631.5	3,140.2	3,201.5
Trade and Other Payables	249.6	338.2	194.5	122.5	141.1
Long Term Debt	5.5	1.0	7.6	84.3	21.6
Short Term Debt	1,005.0	926.0	840.0	400.0	451.7
Total Debt	1,010.5	927.0	847.6	484.3	473.3
Paid-Up Capital	50.0	50.0	50.0	50.0	50.0
Total Equity	2,278.5	2,379.8	2,513.3	2,454.6	2,496.8
INCOME STATEMENT	**FY18**	**FY19**	**FY20**	**FY21**	**1HFY22**
Net Sales	1,753.0	1,813.1	2,081.6	935.5	590.5
Gross Profit	385.0	476.3	397.3	117.4	110.4
Profit Before Tax	148.3	351.7	157.6	(45.1)	46.3
Profit After Tax	128.3	330.8	134.4	(61.7)	42.3
RATIO ANALYSIS	**FY18**	**FY19**	**FY20**	**FY21**	**1HFY22**
Gross Margin (%)	22.0%	26.3%	19.1%	12.6%	18.7%
Net Margin	7.3%	18.2%	6.5%	-6.6%	7.2%
FFO (Annualized)	157.3	236.0	175.5	(76.5)	36.5
FFO to Total Debt (%)	15.6%	25.5%	20.7%	-15.8%	7.7%
FFO to Long Term Debt (%)	2863%	23752%	2320%	-91%	NA
Current Ratio (x)	1.85	1.94	2.38	3.33	2.77
(Stock+ Trade Debts)/ Short term borrowing	121%	145%	152%	240%	192%
Debt Servicing Coverage Ratio (x)		5.51	6.05	(2.17)	0.83
Gearing (x)	0.44	0.39	0.34	0.20	0.19
Leverage (x)	0.59	0.56	0.44	0.28	0.28
ROA (%) (Annualized)		9.0%	3.7%	-1.8%	2.7%
ROE (%)(Annualized)		14.2%	5.5%	-2.5%	3.4%

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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Due Diligence Meetings Conducted	(see table below)

Rating History

Rating Date	Current Rating	Rating Outlook	Rating Action
RATING TYPE: ENTITY			
05/19/2022	BBB+/A-2	Stable	Downgrade
07/26/2021	A-/A-2	Negative	Maintained
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

Due Diligence Meetings Conducted

Name	Designation	Date
Mr. Shahid Ahmed	Manager Financial Reporting and Risk	15 March, 2022