# RATING REPORT

# Muhammad Shafi Tanneries (Private) Limited

**REPORT DATE:**
May 09, 2023

**RATING ANALYSTS:**
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## RATING DETAILS

| Rating Category | Latest Rating | | Previous Rating | |
|---|---|---|---|---|
| | Long-term | Short-term | Long-term | Short-term |
| **Entity** | BBB+ | A-2 | BBB+ | A-2 |
| **Rating Action** | Reaffirmed | | Downgrade | |
| **Rating Outlook** | Stable | | Stable | |
| ***Rating Date*** | *May 09, 2023* | | *May 19, 2022* | |

## 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, sheep and deer 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 with the registered office and factory situated in Karachi, and it is one of the oldest entities operating in the industry. At end-Dec'22, long term investments amounted Rs. 1.2b (FY22: Rs. 886.6m; FY21: Rs. 826.7m), increase in which is on account of addition of share of profit from associates. Long-term investment portfolio is expected to reduce with management's plan to dispose of shares in Abdal Hafeez Shah Leather (Private) Limited. Due to recovery in demand post COVID-19, ratings incorporate growing capacity utilization levels of the production unit in FY22.

| *Square feet* | FY21 | FY22 |
|---|---|---|
| Installed Capacity | 24m | 24m |
| Available Capacity | 12m | 12m |
| Actual Production | 5.528m | 6.849m |
| **Capacity Utilisation** | 46% | 57% |

**Key Rating Drivers:**

**Industry: Overview of the Leather Industry in Pakistan**

Pakistan's leather sector is predominantly export-oriented (as per Pakistan Tanners Association, ~95% export levels), accounting for ~3% of total exports and ~5% of GDP, with major export destinations including Germany, US, UK, Spain, Netherlands, and France. In terms of products, leather garments account for ~34% of total leather exports, followed by gloves (31%), leather tanned (19%), and leather footwear (13%). Market structure is competitive with more than 800 tanneries and 4 listed companies. Demand is primarily driven by the fashion industry, which includes footwear, clothing, bags, and belts, as well as the furniture and automotive industries. Given duty-free access to European Union (world's largest consumer of leather goods) under EU's Generalized Scheme of Preferences (GSP+), industry is expected to remain one of five key export-oriented sectors (along with textiles, sports goods, surgical goods, and carpets).

Business risk is supported by locally abundant raw material (animal hides and skins) and export-friendly government policies (in form of financing schemes and additional custom duty on import of leather products). However, low use of advanced technology results in higher production costs along with constrained availability of skilled labor force, low presence in global fashion market, and substitution by low-cost alternatives such as synthetic leather impact the business risk of the industry.

**Industry: Current export levels and future outlook**

Leather exports in dollar terms during FY22 have recouped to FY18 levels, following a dip during pandemic, owing to subsequent global economic recovery and resumption of international trade. Over the last two years, exports grew by ~25% driven by both increase in average unit prices and higher volumetric exports, with leather garments leading the way, followed by gloves and footwear. Demand for tanned leather remains subdued due to overall global demand contraction, availability of faux leather, and domestic industry challenges limiting product diversification.

**Figure: Leather Exports Breakup (USD in m)**

| | FY18 | FY19 | FY20 | FY21 | FY22 |
|---|---|---|---|---|---|
| Tanned leather | 330.2 | 252.2 | 184.2 | 161.9 | 208.1 |
| Leather garments | 294.4 | 256.3 | 250.9 | 286.1 | 315.2 |
| Leather gloves | 225.9 | 217.9 | 212.8 | 260.1 | 287.2 |
| Leather footwear | 95.2 | 106.4 | 107.2 | 108.4 | 124.5 |
| Others | 12.6 | 11.4 | 10.3 | 16.5 | 18.7 |
| **Total** | **948.3** | **844.3** | **765.3** | **833.2** | **953.7** |

*Source: Pakistan Bureau of Statistics (PBS)*

Going forward, sector is expected to face challenges from regional competitors, particularly India, as well as rising inflation and finance costs. However, currency depreciation, government support, changing fashion trends and resumption of trade with China after ease in pandemic restrictions is expected to keep the demand stable.

**In line with recovery in in mid-tier products demand post-COVID19, revenue of the Company reflected a sizeable uptick during the review period.**

- In line with industry trend, sales revenue following a dip during pandemic noted strong growth in the outgoing fiscal year, amounting to Rs. 1,298.4m (FY21: Rs. 935.5m). The growth was mainly attributable to volumetric increase of around 15-20% led by sizeable uptick in export orders, increase in average prices over time in USD and PKR terms both.
- Net sales in the first half of FY23 were around Rs. 865.5m, with a full-year target of Rs. 1,600m.
- Sales mix of the Company comprises 94% of exports and remaining (6%) represent local sales. Finished leather is the most famous product in both categories. With higher demand and increase in selling rates, price 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 76% (FY21: 73%) of the total revenue. As per management, in the outgoing year, MSTL diversified its geographical spread with addition of a Korean glove manufacturer to its existing clientele.
- Going forward, the management expects client base and sales mix to further diversify by venturing into new business lines such as products made from deer leather.
- 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.

- Management expects sales growth over the rating horizon through ongoing marketing campaigns by participating in international trade fairs.

**Net profitability of the Company continue to rely on support from share of profit from associates.**

- Gross margins in the past two years have recouped to the pre- pandemic level (FY22: 19.5%; FY21: 12.6%; FY20: 19.1%), owing to better absorption of fixed cost per unit given volumetric increase in sales and improved export prices.
- Raw skin and chemicals are a major part of the raw material mix, where 31% and 36% (on an average basis), respectively, are imported. As per management, chemical represents about 28% of the total cost of production.
- Administrative overheads remained consistent with the previous year, while distribution expenses increased in line with business growth.
- The Company's profitability performance gathers support from investment income from associates amounting Rs. 61m (FY21: Rs. 28m) in FY22 and Rs. 51m in HYFY23.
- With improved gross margins attributable to better sales pricing along with support of investment income, net margins of the company have showcased increasing trend and were reported at 7.7% (FY22: 4.4%; FY21: Negative 6.6%) in HYFY23 despite exchange loss incurred during the same period.
- Management targets to gradually de-leverage its balance sheet over the rating horizon to reduce the impact of financial cost burden.
- 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 business towards high margin yielding products along with materialization of other innovation plans.

| Investment in Associates | FY22 | |
|---|---|---|
| Rs. Mlns | Investment | Profit |
| Abdal Hafeez Shafi Leather Pvt Limited | 262.0 | - |
| Shafi Texcel Limited | 597.2 | 34.3 |
| Shafi Foods Pvt Limited | 112.9 | 4.4 |
| Everfresh Farms Pvt Limited | 176.5 | 21.8 |

**Liquidity profile improved during the review period**

- Funds from Operation (FFO) of the Company increased to Rs. 27.6m (FY21: Negative Rs. 76.0m.; FY20: Rs. 175.5m) in FY22 being a function of increase in quantum of profits in absolute terms. In line with the uptick in profitability profile and manageable increase in debt level, cash flow coverages against outstanding obligations have witnessed improvement in the review period.
- FFO to Total Debt and FFO to Long-Term Debt were reported at 5% (FY21: Negative 16%; FY20: 21%) and 42% (FY21: Negative 87%; FY20: 2320%) respectively during FY22. The same furthered increased significantly to 41% and 659% respectively during 1HFY23.

- Similarly, Debt Servicing ratio (DSCR) also inclined sharply to 2.74x (FY22: 0.74x; FY21: Negative 2.15x) during 1HFY23.
- Ratings remain dependent on consistency of improvement in liquidity indicators as per the benchmarks for the assigned ratings.
- Current ratio at end-1HFY23 stood at 2.6x and short-term borrowing coverage stood at 290% at end-Dec'22; both of which are deemed adequate
- Aging profile of trade debts is considered sound with around 89% of outstanding trade receivables due within three months at end-June'22.
- The Company also holds short-term liquid investments in mutual funds amounting ~Rs 595m in mutual funds which provides additional comfort.

**The Company holds a conservative capital structure**

- Equity base of the company accumulated to Rs. 2.6b (FY22: 2.5b; FY21: Rs. 2.4b) by end-Dec'22 through profit retention.
- The debt profile comprises a mix of long-term (6%) and short-term borrowings (94%) at end-HYFY23. The outstanding balance of long-term borrowings, inclusive of current maturity, reduced to Rs. 24.7m (FY22: 65.3m, FY21: Rs. 86.9m) at end-Dec'22 on account of repayment of debt employed.
- Debt level inclined in FY22 in order to finance higher working capital needs. With growth in quantum of debt (FY22: Rs. 564.4m; FY21: Rs. 486.9m) being greater than profit retention in FY22, gearing and debt leverage ratios have depicted an uptick during FY22. In line with reduction in total debt level, the same were reported lower at 0.15x (FY22: 0.22x; FY21: 0.20x) and 0.29x (FY22: 0.35x; FY21: 0.28x) respectively, at end-1HY23.
- 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, capitalization indicators are likely to remain on the lower side.
- However, given the challenging market dynamics in inflationary and high interest rate environment maintaining financial risk profile over the rating horizon will remain critical for ratings.

## Muhammad Shafi Tanneries (Private) Limited Appendix I

| FINANCIAL SUMMARY *(amounts in PKR millions)* | | | | | |
|---|---|---|---|---|---|
| **BALANCE SHEET** | **FY19** | **FY20** | **FY21** | **FY22** | **1HFY23** |
| Fixed Assets | 384 | 347 | 341.7 | 361.9 | 380.3 |
| Long term Investments | 855 | 800 | 826.7 | 886.6 | 1,204.2 |
| Short term invetments | 239 | 637 | 368.3 | 594.9 | 355.6 |
| Stock-in-Trade | 1,199 | 1,074 | 840.1 | 734.5 | 868.8 |
| Trade Debts | 144 | 200 | 120.7 | 174.7 | 210.0 |
| Cash & Bank Balances | 126 | 130 | 72.5 | 73.9 | 20.4 |
| Total Assets | 3,714 | 3,631 | 3,140.2 | 3,389.5 | 3,317.6 |
| Trade and Other Payables | 338 | 194 | 122.5 | 236.0 | 269.6 |
| Long Term Debt | 1 | 8 | 86.9 | 65.3 | 24.7 |
| Short Term Debt | 926 | 840 | 400.0 | 499.1 | 369.6 |
| Total Debt | 927 | 848 | 486.9 | 564.4 | 394.3 |
| Paid-Up Capital | 50 | 50 | 50.0 | 50.0 | 50.0 |
| Total Equity | 2,380 | 2,513 | 2,454.6 | 2,514.1 | 2,580.9 |
| Total Liabilities | 1,334 | 1,116 | 686 | 875 | 737 |
| | | | | | |
| **INCOME STATEMENT** | **FY19** | **FY20** | **FY21** | **FY22** | **1HFY23** |
| Net Sales | 1,813 | 2,082 | 935.5 | 1,298.4 | 865.5 |
| Gross Profit | 476 | 397 | 117.4 | 253.0 | 236.8 |
| Profit Before Tax | 352 | 158 | (45.1) | 74.8 | 76.9 |
| Profit After Tax | 331 | 134 | (61.7) | 57.0 | 66.7 |
| | | | | | |
| **RATIO ANALYSIS** | **FY19** | **FY20** | **FY21** | **FY22** | **1HFY23** |
| Gross Margin (%) | 26.3% | 19.1% | 12.6% | 19.5% | 27.4% |
| Net Margin | 18.2% | 6.5% | -6.6% | 4.4% | 7.7% |
| FFO (Annualized) | 236 | 175.5 | (76.0) | 27.6 | 81.5 |
| FFO to Total Debt (%) | 25.5% | 20.7% | -15.6% | 4.9% | 41.3% |
| FFO to Long Term Debt (%) | 23752.4% | 2320.2% | -87.4% | 42.2% | 658.9% |
| Current Ratio (x) | 1.94 | 2.38 | 3.37 | 2.69 | 2.60 |
| (Stock+ Trade Debts)/ Short term borrowin | 145% | 152% | 240% | 182% | 292% |
| Debt Servicing Coverage Ratio (x) | 5.51 | 6.05 | (2.15) | 0.74 | 2.74 |
| Gearing (x) | 0.39 | 0.34 | 0.20 | 0.22 | 0.15 |
| Leverage (x) | 0.56 | 0.44 | 0.28 | 0.35 | 0.29 |
| ROA (%) (Annualized) | 9.0% | 3.7% | -1.8% | 1.7% | 4.0% |
| ROE (%)(Annualized) | 14.2% | 5.5% | -2.5% | 2.3% | 5.2% |

# 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.

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**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. |
| **Disclaimer** | Information herein was obtained from sources believed to be accurate and reliable; however, VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information.  |

**Rating History**

| Rating Date | Current Rating | Rating Outlook | Rating Action |
|---|---|---|---|
| **RATING TYPE: ENTITY** | | | |
| **05/09/2023** | BBB+/A-2 | Stable | Reaffirmed |
| 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 | March 30th, 2023 |
| **Mr. Mustafa** | CFO | March 30th, 2023 |