

RATING REPORT

Muhammad Shafi Tanneries (Private) Limited

REPORT DATE:

March 5, 2024

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 Outlook	Stable		Stable	
Rating Action	Reaffirmed		Reaffirmed	
Rating Date	March 5, 2024		May 09, 2023	

COMPANY INFORMATION

Incorporated in 1972	External auditors: BDO Ebrahim & Co. 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)

Applicable Rating Criteria: Corporates:

<https://docs.vis.com.pk/docs/CorporateMethodology.pdf>

APPLICABLE RATING SCALE(S)

VIS Issue/Issuer Rating Scale:

<https://docs.vis.com.pk/docs/VISRatingScales.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

Company Profile:

Muhammad Shafi Tanneries (Private) Limited ('MSTL' or 'the Company') is a family-owned company, engaged in the business of manufacturing and exporting finished leather. 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. The registered and head office of the Company is located at 35-A/3, Lalazar, Opposite Beach Luxury Hotel, Karachi.

Operational Performance:

The factory is situated at D-196/A, Haroonabad, SITE, Karachi. The installed capacity has remained unchanged while the utilization levels have shown an increasing level since FY21 despite constrained global economic conditions in FY23.

Plant Capacity and Utilization	FY21	FY22	FY23
Installed Capacity (Sq. Feet)	12.0m	12.0m	12.0m
Actual Production (Sq. Feet)	5.5m	6.8m	7.3m
Capacity Utilization	46%	57%	61%

Demerger with Mazhar Shafi Industries (Pvt) Limited (MSIPL):

On November 23, 2021, the Company's Directors approved a Scheme of Arrangements under the Companies Act, 2017, which received unanimous approval from the members in an Extraordinary General Meeting on December 27, 2021. The Court sanctioned the Scheme on February 17, 2023, making it effective from July 1, 2020. As a result, certain assets and liabilities were restructured between the Company and Mazhar Shafi Industries (Pvt) Limited (MSIPL) through a de-merger and merger process. Following the Court's order, financial transactions and balances for comparative years have been restated to reflect the Scheme's impact.

Key Rating Drivers:

Business risk profile is characterized by export-oriented nature and sensitivity to cyclicity in international economic trends.

The leather sector is ascribed a medium business risk profile, marked by its export-oriented nature which shields it from significant local economic factors such as currency depreciation and resultant inflation. In FY23, the leather sector exports saw a slight decline of ~7% to USD 887 mln (FY22: USD 953 mln) due to significant challenges in the export markets during this period. However, leather, a major raw material, is primarily sourced locally preventing the sector from exchange rate risks.

Going forward, sector performance is expected to face continuous challenges from rising gas tariffs, hike in electricity costs, and regional competition, particularly from China and India, as well as dampened demand amid high inflation in export markets such as USA and Europe.

High client concentration risks, however, long-standing relationship provides support to ratings.

MSTL's client portfolio is marked by high concentration risk with top 5 customers contributing around 63% of the Company's revenue. Nevertheless, as per the management, MSTL's has long-standing relationship with these customers, providing support to the assigned ratings.

Increased volumetric offtake coupled with upward pricing has spurred growth in topline. Gross margins improvement supported by net positive impact of currency depreciation. However, net margins are constrained by escalating finance costs.

Despite subdued economic activity in both local and international markets, the company achieved a topline growth of ~32% in FY23. This expansion is attributed to increased exports and local sales, rising by about 20% (including indirect exports) and 37%, respectively. This increase was driven by higher volumetric sales along with devaluation of the PKR/USD. MSTL's revenue structure is predominantly driven by direct exports, constituting around 83% of total revenue, while the rest is derived from indirect exports and local sales. Notably, about 35% of MSTL's input costs are imported, this results in a net positive impact on MSTL's margins from currency depreciation. Consequently, the company witnessed an improvement in gross margins, reaching 21.0% (FY22: 19.5%).

However, on the backdrop of an increase in finance costs because of a surge in the local policy rate, net margins contracted to 3.8% (FY22: 4.4%).

Coverage Profile recovers to levels commensurate with the assigned ratings.

Despite a higher quantum cash generation before working capital changes, the Company's FFO growth remained constrained primarily due to higher taxes and finance charges paid during FY23. Consequently, FFO to total debt coverage deteriorated to 2.9% (FY22: 5.1%). although, FFO to long term debt increased due to reduction in long term debt levels during the period.

While the Company's debt service coverage ratio (DSCR) has historically remained healthy at a 5-Year average of 2.0x. In recent years it has come under pressure on account of operational losses incurred by the Company. The DSCR after a low of -0.8x in FY21 has recovered to adequate levels in FY23 at 1.2x (FY22: 0.8x). However, it is still significantly below its historic levels. Meanwhile, short-term debt coverage remains strong at 2.6x in FY22 (FY23: 1.8x).

Conservative capitalization profile, with low quantum of debt.

The company adheres to a conservative debt management strategy, reflecting minimal debt levels in its financial statements. In FY23, the gearing and leverage ratios remained stable at 0.2x (FY22: 0.2x) and 0.4x (FY22: 0.4x).

Healthy liquidity profile

Historically, the Company has maintained an average current ratio of 2.9x from FY21 to FY22 and has remained healthy in FY23 at 2.3x albeit a slight deterioration. In FY23, because of the buildup in inventories, MSTL liquidated its short-term investments to bridge the resultant working capital gap.

Key Considerations for the Ratings:

Going forward, the MSTL's ability to maintain its profitability profile, capitalization profile, liquidity profile as well as improvement in the coverage profile will remain the key rating considerations.

Muhammad Shafi Tanneries (Private) Limited
Appendix I

FINANCIAL SUMMARY				
<i>(PKR Millions)</i>				
<u>BALANCE SHEET</u>	FY20	FY21	FY22	FY23
Property, plant and equipment	347.0	341.7	361.9	393.0
Stock In Trade	1,074.1	840.1	734.5	1,027.3
Trade debts	199.9	120.7	174.7	222.3
Cash & Bank Balances	130.4	72.5	73.9	75.1
Total Assets	3,631.5	2,878.2	3,127.5	3,154.7
Trade & Other payables	194.5	122.5	236.0	257.7
Long-term Debt (incl. current portion and lease liability)	0.2	74.9	55.9	16.8
Short Term Borrowing	840.0	400.0	499.1	474.8
Total Debt	840.2	474.9	555.0	491.6
Total Liabilities	1,115.8	685.6	875.3	844.0
Paid up Capital	50.0	44.6	44.6	44.6
Equity (excl. Revaluation Surplus)	2,513.3	2,192.6	2,252.1	2,310.7
<u>INCOME STATEMENT</u>				
Net Sales	2,081.6	935.5	1,298.4	1,713.0
Gross Profit	397.3	117.4	253.0	359.4
Operating Profit	131.5	-76.9	36.5	110.6
Finance Costs	33.8	24.5	19.4	42.3
Profit Before Tax	157.6	-45.1	74.8	89.2
Profit After Tax	134.4	-61.7	57.0	64.6
<u>RATIO ANALYSIS</u>				
Gross Margin (%)	19.1%	12.6%	19.5%	21.0%
Net Margin (%)	6.5%	-6.6%	4.4%	3.8%
Funds from Operation (FFO)	71.3	-75.2	28.2	14.4
FFO to Total Debt* (%)	8.5%	-15.8%	5.1%	2.9%
FFO to Long Term Debt* (%)	39617.1%	-100.4%	50.5%	85.8%
Gearing (x)	0.3	0.2	0.2	0.2
Leverage (x)	0.4	0.3	0.4	0.4
Debt Servicing Coverage Ratio* (x)	3.1	-0.7	0.8	1.2
Current Ratio	2.4	2.9	2.4	2.3
(Stock in trade + trade debts) / STD (x)	1.5	2.4	1.8	2.6
Return on Average Assets* (%)	3.7%	-1.9%	1.9%	2.1%
Return on Average Equity* (%)	5.5%	-2.6%	2.6%	2.8%

**Annualized, if required*

REGULATORY DISCLOSURES		Appendix II			
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				
	03/05/2024	BBB+	A-2	Stable	Reaffirmed
	05/09/2023	BBB+	A-2	Stable	Reaffirmed
	05/19/2022	BBB+	A-2	Stable	Downgrade
	07/26/2021	A-	A-2	Negative	Maintained
	06/30/2020	A-	A-2	Rating-Watch Developing	Maintained
	05/02/2019	A-	A-2	Negative	Maintained
	01/26/2018	A-	A-2	Stable	Reaffirmed
	06/17/2015	A-	A-2	Stable	Reaffirmed
	05/20/2014	A-	A-2	Stable	Upgrade
	03/18/2013	BBB+	A-3	Stable	Reaffirmed
02/01/2012	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.				
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Due Diligence Meetings Conducted	Name		Designation	Date	
	Mr. Shahid Ahmed		Manager Financial Reporting and Risk	02/21/2024	