RATING REPORT

Shahkam Industries (Private) Limited

REPORT DATE:
August 18, 2022

RATING ANALYST:
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RATING DETAILS		
Rating Category	**Initial Rating**	
	Long-term	**Short-term**
Entity	BBB+	A-2
Rating Outlook	Stable	
Rating Date	*Aug 18, 2022*	

COMPANY INFORMATION	
Incorporated in 1992	**External Auditors:** M. Almas & Co. Chartered Accountants
Private Limited Company	**Chairman/CEO:** Mr. Shahid Kamil Butt
Key Shareholding (more than 5%)	**Managing Director (MD):** Mrs. Saiqa Kamil Butt
Mr. Shahid Kamil Butt ~73.6%	
Mrs. Sadia Kamil Butt ~13.2%	
Mrs. Saiqa Kamil Butt ~13.2%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Industrial Corporates (August 2021) *https://docs.vis.com.pk/docs/CorporateMethodology202108.pdf*

Shahkam Industries (Private) Limited

OVERVIEW OF THE INSTITUTION

Shahkam Industries (Private) Limited (SIPL) was established in 1992 under the repealed Companies Ordinance, 1984 (now Companies Ordinance, 2017). Principal business activity of the company is manufacturing and export of knitwear and ready-made garments.

Profile of Chairman/CEO:
With over 28 years of experience in textile industry, Mr. Shahid Kamil Butt has been serving as Chairman & CEO since 1996. He holds a bachelor's degree from University of California, USA.

Profile of MD:
Mrs. Saiqa Kamil Butt is serving as Managing Director (MD) of the company since inception. She holds MBA degree from Lahore School of Management Sciences (LUMS), Lahore and has 30+ years of experience in the textile industry.

RATING RATIONALE

Corporate Profile

Headquartered in Lahore, Shahkam Industries (Private) Limited (SIPL) is an export-oriented knitwear and ready-made garment (from basic to high-end fashion) manufacturing unit with an established operating track record of nearly three decades. Operations are carried out through knitting (no. of machines: 135), dyeing/washing, printing/embroidery and garment finishing divisions. Product portfolio mainly comprises pullover hoodies, shirts, trousers, jackets and denim. The sponsoring family is actively involved in business affairs while entire shareholding is held among three individuals.

Under-utilization of capacity during FY20 was mainly due to pandemic and normal maintenance shutdown. The same has noted a strong recovery on account of sizeable jump in export orders. Moreover, the capacity reduction in garment and dyeing/washing segments is mainly the result of change in product mix.

Figure: Capacity & Production Data

	FY19	FY20	FY21	9M'FY22
Average Production Capacity Per Day				
Knitting – KGs	22,500	22,500	22,500	26,500
Dyeing/Washing – KGs	40,000	40,000	31,832	30,000
Garments – Pcs	62,307	62,307	62,307	48,000
Actual Production Per Day				
Knitting - KGs	18,675	12,840	20,983	26,500
Dyeing/Washing – KGs	32,856	15,686	29,462	26,500
Garments – Pcs	56,986	33,415	59,656	45,000
Capacity Utilization Per Day				
Knitting - KGs	83%	57%	93%	100%
Dyeing/Washing – KGs	82%	39%	93%	88%
Garments – Pcs	91%	54%	96%	94%

Capacity is locked until FY23; some knitting machines will be replaced with latest models, which will be funded through LTFF while balance BMR is to be financed via internal capital generation.

<u>Key Rating Drivers</u>

Textile and clothing exports registered a sizeable growth given the surge in demand on account of rerouting of orders to Pakistan. The ongoing energy crisis in the country poses a challenge to industrywide margin sustainability and future growth.

Textile sector contributes nearly one-fourth to industrial value-added segment and 8.5% to the country's GDP, with an estimated market size of Rs. 3.8tr (FY20: Rs. 3.3tr) in FY21. Barring seasonal and cyclical fluctuations, textiles products have maintained an average share of about 60% in national exports. Export revenues from textile sector have increased significantly over the years (FY22: $19.3b FY21: $15.4b; FY20: $12.5b; FY19: $13.6b). Knitwear, Readymade and Bed wear segments continue to contribute higher than other segments, with a cumulative contribution of more than 60% in textile exports. While the growth was primarily driven by volume (excluding knitwear and cotton yarn), higher prices also boosted exports.

Figure: Textile Exports (as per PBS)

Segments	Value (US$ millions)		
	FY20	FY21	FY22
Knitwear products	2,785	3,816	5,121
Readymade Garments	2,549	3,033	3,905
Bed wear	2,149	2,772	3,293
Cotton Cloth	1,830	1,921	2,438
Cotton Yarn	987	1,017	1,207
Towels	711	938	1,111
Made-up Articles	591	756	849
Art, silk and synthetic textile	314	370	461
Tents, canvas and tarpaulin	98	110	110
Others	487	667	835

Going forward, the country's ongoing energy crisis, rising production costs as a result of inflation, and expected slowdown in demand given looming global recession and monetary tightening in major world economies are key business risk factors, posing a challenge to industrywide margin sustainability and future growth.

5-Year (2020-25) textile policy continues to support the industry.
With an aim to double textile exports in five years, GoP through a five-year textile policy (2020-25) has provided incentives in form of preferential energy rates, low interest rates financing schemes (such as EFS, LTFF and TERF) and timely payments of DLTL, Income tax & Sales tax refund which support liquidity constraints of local players. Initiatives have also been undertaken to increase production and yield of cotton to support the industry. However, imposition of 10% super tax would have a negative effect on profitability profile of textile players. In addition, contractionary monetary policy and political uncertainties in the country are the present major business risk factors. In the long run, improvement in value addition, investment in technology and optimization of energy cost would define the future of textile exports.

Growth in export orders has led to healthy recovery of sales revenue. The same is projected to cross Rs. 10b mark by end-FY22.
Sales revenue has posted a recovery trend and amounted to Rs. 7.7b (FY21: Rs. 6.8b; FY20: Rs. 5.6b; FY19: Rs. 9.4b) during 9M'FY22. The recovery was mainly attributable to higher volumetric demand on export front. In addition, financial incentives provided to labour workforce also enabled the company to achieve higher operational efficiency and sale targets. Going forward, the management is projecting sales revenue to cross Rs. 10b mark in FY22 on the back of continued demand growth and sound revenue visibility. The targeted sales for next year FY23 is Rs. 13b.

Revenues of the company almost entirely emanates from export sales. Major exports are directed towards USA and European markets, which mainly includes Spain, Germany & Poland. In terms of products, revenue contribution from denim and jackets has remained subdued whereas trousers and shirts registered strong volumetric growth coupled with additional sales of pullover hoodies. Client-wise sale concentration risk is moderate while additional comfort is drawn from long-term association of SIPL with multinational apparel companies and brands such as GAP, US Polo, Zara, Pull & Bear, Springfield, Next, Jack & Jones etc., which ensures repeated business.

Profitability profile is constrained by thin net margins. Improvement in the same is considered important.
Gross margins have recouped in the ongoing year from the pandemic slump (9M'FY22: 10.1%; FY21: 9.8%; FY20: 11.6%; FY19: 11.6%) mainly due to increase in topline, which has facilitated in better absorption of fixed cost. Moreover, efficient yarn procurement, operational efficiencies and rupee devaluation impact also contributed towards improving gross margins. On the cost front, financial charges have witnessed a declining trend post FY19 on account of long-term debt repayments whereas operating overheads continue to remain on the higher side, resulting in thin net margins. Going forward, projected growth in revenues along with improvement in margins is considered important from a ratings perspective.

Liquidity profile is sound; recovery in earnings has led to improvement in cash flow coverages.
Liquidity profile is considered sound with sufficient cash flow generation in relation to debt obligations. In absolute terms, Funds from Operations (FFO) increased considerably to Rs. 329m (FY20: Rs. 241m; FY19: Rs. 198m) at end-FY21. As a result, FFO to total debt and FFO to long-term debt improved to 0.11x (FY21: 0.09x) and 1.88x (FY21: 1.49x), respectively as at end-9M'FY22. Given higher current portion of long-term debt, Debt Service Coverage Ratio (DSCR) decreased to 1.67x (FY21: 2.39x; FY20: 0.81x). Going forward, maintenance of liquidity indicators will remain crucial.

Working capital cycle necessitates utilization of short-term borrowings mainly to fund inventory levels. Average payments terms to suppliers extend up to 55 days while receivable days generally remain around 60-90 days. Current ratio stands at over 1.0x while room for improvement exists with respect to coverage of short-term borrowings vis-à-vis stock in trade and trade debts. Aging profile of trade debts is considered satisfactory.

Limited size of equity base is a constraint on capitalization levels. However, leverage ratios have improved marginally in the ongoing year.
Equity base grew by ~15% over the past 20 months; however, the same has remained limited in terms of size. The company has not paid any dividends for the last five years. Debt profile of the company comprises a mix of short term and long term debt with total interest bearing liabilities amounting to Rs. 3.4b (FY21: Rs. 3.5b; FY20: Rs. 3.9b) at end-9M'FY22; short-term debt (ERF) constituted ~95% of total debt. Given limited equity base, leverage indicators are reported on the higher side. As per management, there are no plans to mobilize any additional long-term borrowings.

Sound IT infrastructure & senior management team.
Board of Directors comprises two members. Informal board meetings are held on ad-hoc basis with no formal documentation of minutes. SIPL has in place a qualified senior management team with extensive experience while at present, total staff strength including labor workforce stands at 5.7K+ employees. IT infrastructure currently in place sufficiently supports the scale of operations while oracle-based ERP system has several integrated modules. Moreover, presence of internal audit function adds to governance levels.

Shahkam Industries (Private) Limited **Appendix I**

FINANCIAL SUMMARY					*(amounts in PKR millions)*
BALANCE SHEET	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**
Non-Current Assets	2,481	2,689	6,181	5,965	5,756
Stores, Spares. And Loose Tools	20	18	10	10	15
Stock-in-Trade	1,256	1,427	1,609	990	1,353
Trade Debts	1,883	1,667	1,318	1,669	1,712
Advances, Deposits and Other Receivables	105	114	39	62	93
Cash and Bank Balance	2	12	30	37	205
Total Assets	**6,270**	**6,332**	**10,520**	**10,323**	**11,043**
Trade and Other Payables	1,149	985	748	559	771
Long-Term Borrowings *(Inc. current maturity)*	1,068	961	266	221	160
Short-Term Borrowings	2,633	2,950	3,317	3,243	3,243
Total Liabilities	**4,883**	**4,942**	**4,358**	**4,096**	**4,291**
Paid-up Capital	173	173	173	173	173
Tier-1 Equity	**1,387**	**1,389**	**1,390**	**1,454**	**1,981**
Total Equity	1,387	1,389	6,162	6,226	6,752
INCOME STATEMENT					
Net Sales	9,320	9,400	5,590	6,821	11,694
Gross Profit	1,159	1,090	651	666	1,410
Operating Profit	289	380	249	296	832
Profit Before Tax	120	99	58	131	643
Profit After Tax	39	3	1	64	526
RATIO ANALYSIS					
Gross Margin (%)	12.4%	11.6%	11.6%	9.8%	12.1%
Net Margin (%)	0.4%	0.0%	0.0%	0.9%	4.5%
Net Working Capital	(374)	(685)	205	376	1,143
Current Ratio	0.91	0.84	1.05	1.09	1.28
FFO to Long-Term Debt	0.29	0.21	0.91	1.49	4.47
FFO to Total Debt	0.08	0.05	0.07	0.09	0.21
DSCR (x)	1.20	0.76	0.81	2.39	2.77
Gearing (x)	2.67	2.82	2.58	2.38	1.72
Debt Leverage (x)	3.52	3.56	3.14	2.82	2.17
Inventory + Receivable/Short-term Borrowings (x)	119%	105%	88%	82%	95%

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	Shahkam Industries (Private) Limited				
Sector	Textile				
Type of Relationship	Solicited				
Purpose of Rating	Entity Rating				
Rating History	Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
	RATING TYPE: ENTITY				
	18/08/2022	BBB+	A-2	Stable	Initial
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 Meeting Conducted	Name	Designation	Date		
	Mr. Khawaja Naveed Javed	Chief Financial Officer	May 23, 2022		