RATING REPORT

Khalid Shafique Spinning Mills Limited

REPORT DATE:
June 20, 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 Outlook	Negative		Stable	
Rating Action	Maintained		Upgrade	
Rating Date	*June 20, 2023*		*Jun 29, 2022*	

COMPANY INFORMATION

Incorporated in 1992	**External auditors:** Ilyas Saeed & Co. Chartered Accountants
Public Unlisted Company	**Chairman/CEO:** Mr. Ch. Khalid Shafique
Key Shareholders (with stake 5% or more):	
Ch. Khalid Shafique ~75.5%	
Mr. Shargeel Khalid ~17.1%	

APPLICABLE METHODOLOGY(IES)

VIS Entity Rating Criteria: Industrial Corporates (May 2023)
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*

Khalid Shafique Spinning Mills Limited

OVERVIEW OF THE INSTITUTION

Khalid Shafique Spinning Mills Limited (KSSML) is a public limited unlisted company incorporated in Pakistan in April, 1992 under the repealed Companies Ordinance, 1984 (now Companies Act, 2017). The principal activity of the company is manufacturing and sale of yarn. The registered office is located at M.M. Alam Road, Gulberg II, Lahore.

Profile of CEO:

Ch. Khalid Shafique serves as the Chairman of the Board and CEO. He is a qualified Chartered Accountant from the Institute of Chartered Accountants of Pakistan. He has over 30 years of experience in the textile sector.

RATING RATIONALE

Corporate Profile

Khalid Shafique Spinning Mills Limited (KSSML) has over three decades of experience in manufacturing and sale of a wide range of blended and cotton yarn, primarily catering to the domestic market. The sponsoring family is actively involved in business affairs, and a highly qualified senior management team with extensive experience is in place. Total staff strength including labor workforce currently stands at 650+ employees. Since the last review, there has been no change in the shareholding pattern and board of directors. The average energy requirement of 3.2 MW is fulfilled through a combination of national grid line and gas generators, with a 60:40 ratio based on cost-benefit analysis.

Operational Performance

Headquartered in Lahore, the company's production facility is located at Raiwand Road, District Kasur. During the review period, the company implemented an efficiency enhancement initiative by replacing 36 outdated ring frames with new, more efficient, and higher quality ones. This resulted in a slight increase in installed capacity. The project cost of Rs. 280m was primarily financed through the TERF facility. The routine capex stood at Rs. 120m in the current year, which mainly pertained to power and back-processing machinery.

Despite the global demand slowdown, production levels have remained consistent on a timeline, as reflected in the high utilization ratios. Management stated that it was a deliberate strategy of sponsors to maintain volumes and prevent operational closure.

Table: Capacity & Production Data (Units in millions)

	FY21	FY22	9M'FY23
No. of spindles installed	33,408	33,744	33,744
No. of spindles worked	33.408	33,744	33,744
Installed Yarn Capacity (Kgs.)	12.4	12.5	12.8
Actual Yarn Production (Kgs.)	12.2	12.3	12.3
Capacity Utilization	***98%***	***98%***	***96%***

Management's plan to diversify into the socks knitting business, as a complement to their yarn manufacturing operations for hosiery and knitting companies, has been put on hold due to import restrictions and the present economic environment in the country.

<u>Key Rating Drivers</u>

Business risk profile is supported by industry wide growth in exports over the last year; however, with recent floods adversely affecting cotton crop and ongoing energy crisis in the country pose a challenge to margins sustainability and future growth.

Pakistan's export proceeds have oscillated in the range of USD 22-25b during the past decade (FY11-FY21), however, in FY22 exports finally broke the threshold, coming in at USD 32.4b. 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 around Rs. 4.0tr. In addition, textile sector has maintained an average share of about 60% in national exports.

Table: Pakistan Export Statistics (in USD millions)

	FY20	FY21	FY22		10M'FY22	10M'FY23
Pakistan Total Exports	22,536	25,639	32,450		26,858	23,211
Textile Exports	12,851	14,492	18,525		15,174	14,178
PKR/USD Average rate	158.0	160.0	177.5		174.4	245.4

Source: SBP

Export revenues from textile sector have noted sizeable growth 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.

Table: Textile Export Details (in USD millions)

	FY20	FY21	FY22		10M'FY22	10M'FY23
High Value-Added Segment	**9,669**	**12,427**	**15,605**		**12,908**	**11,337**
- Knitwear	2,794	3,815	5,121		4,218	3,712
- Readymade Garments	2,552	3,033	3,905		3,214	2,905
- Bed wear	2,151	2,772	3,293		2,727	2,250
- Towels	711	938	1,111		928	825
- Made-up Articles	591	756	849		710	585
- Art, Silk & Synthetic Textile	315	370	460		385	343
- Others	555	743	866		725	718
Low to medium Value-Added Segment	**2,858**	**2,972**	**3,717**		**3,074**	**2,372**
- Cotton Cloth	1,830	1,921	2,438		2,006	1,685
- Cotton Yarn	984	1,017	1,207		1,006	637
- Others	43	34	72		62	51
Total	**12,527**	**15,399**	**19,332**		**15,982**	**13,709**

Source: PBS

Cotton prices rose to a new 12-year high of ~Rs. 22,935/maund as of Sept'22 driven by a scarcity of cotton resulting from the recent floods that impacted the local cotton production. Cotton imports were also up 19.8%, in USD terms, for FY22 vis-à-vis preceding year.

Table: Cotton Prices Trend (In Rs.)

	FY19	FY20	FY21	FY22	10M'FY23
Per Maund	8,770	8,860	13,000	17,380	20,235
YoY % Change	26%	1%	32%	34%	*n/a*

Floods in Sindh and Southern Punjab during recent monsoon season have caused significant damage to the cotton crop. According to industry estimates, ~45% of the crop has been washed, worth more than $2.5b, resulting in significant price increases. The government has announced facilitation for raw materials imports to compensate for domestic shortages. Nonetheless, in addition to affecting profit margins, higher raw material pricing is expected to increase the working capital requirements, which is likely to have a negative impact on the liquidity profile of textile operators, particularly spinners, weavers and dying companies.

Global and domestic challenges, such as slowdown in export demand (primarily from North America and the EU, which has begun to materialize in Pakistan's monthly export proceeds) due to recessionary trend, industrial gas load shedding expected in the country, and rising production costs due to inflation, will weigh on the business risk profile going forward. These factors may result in competitive market pricing for exporters.

High cyclicality and competitiveness in the spinning sector translate into high business risk profile.
Movement in cotton prices and cotton crop levels drives performance of spinning players in Pakistan. Given sizeable deficit in local cotton production compared to demand in recent years, cotton prices remained high. However, availability of imported yarn kept yarn prices competitive in the current fiscal year and thus resulting in weakening of profitability profile for spinning players.

FY22 revenue growth was driven by higher prices, but the current fiscal year was affected by demand slowdown, impacting growth.
Net sales have posted strong double-digit annual growth for two consecutive years in a row, reaching Rs. 5.1b in FY22. The YoY uptick of ~34% was primarily driven by higher average prices with a slight increase in volumes. However, the recent demand slowdown impacted the growth in the current fiscal year, with revenues sustaining to Rs. 3.9b in 9M'FY23. Management anticipates FY23 revenue to match the previous year's level, as the dip in volumes was offset by a strategic shift in the sales mix towards higher quality fine count yarn.

The revenues are solely sourced from domestic sales, with nearly half originating from cotton yarn sales and the remainder from polyester yarn sales. Client concentration remains high, with the top ten clients consistently generating over one-half of total sales. However, the majority of clients are brokers and distributors, resulting in a varying client base each year depending on the product mix.

Profitability margins contracted significantly in the current fiscal year due to sluggish sales, increased costs for raw materials and power, and higher financial charges.
Profitability margins, both gross and net, took a hit in the current fiscal year following their peak in FY22. Factors contributing to this decline include sluggish sales, rising cotton prices, higher salary, and power expenses, and elevated financial charges due to increased benchmark rates. The sizeable dip in margins adversely affected the bottom line in absolute terms. Previously, the company relied solely on the local market for cotton sourcing. However, due to the scarcity of high-quality cotton caused by recent floods and accommodate the shift towards fine count yarn production, around one-fourth of cotton was imported this year. Inventory levels have over 10 months of buffer due to seasonal procurement.

Significant cash flow decline due to dip in margins weakened the debt coverage metrics over the review period.
Improved earnings in the last two years significantly increased funds flow from operations (FFO) to Rs. 532.7m (FY21: Rs. 288.1m; FY20: Rs. 107.0m) at end-FY22. However, a contrasting cash flow trend in the current fiscal year, due to a significant drop in margins and net profitability, led to a notable deterioration in debt coverage metrics.

Current ratio is consistently reported above 2x, and coverage of short-term borrowings in relation to trade debts and inventory remains sufficient, indicating a satisfactory liquidity position. Cash conversion cycle has noted an improvement on a timeline on the back of lower inventory holding days. The aging profile of trade debts is sound as no receivables are outstanding beyond 60 days; no instances of bad debt were reported.

Improved leverage ratios due to declining debt levels compare favorably vis-à-vis peer median.
Supported by all-out retention, the equity base continues to grow and reached Rs. 1.4b at end-9M'FY23. However, it remains comparatively smaller than its peers. Debt profile comprises a mix of short-term and long-term debt, with total interest-bearing liabilities decreasing to Rs. 379.3m (FY22: Rs. 579.8m) at end-9M'FY23. About ~31% of the debt represents short-term obligations, and total running finance lines stand at Rs. 1b, mobilized at non-concessionary rates. Improved leverage ratios due to declining debt levels, consistently outperforming the peer median.

Khalid Shafique Spinning Mills Limited Appendix I

FINANCIAL SUMMARY				*(amounts in PKR millions)*
BALANCE SHEET	**FY20**	**FY21**	**FY22**	**9M'FY23**
PPE	542.2	487.3	712.3	742.2
Stores, Spares. And Loose Tools	45.3	25.5	20.9	22.5
Stock-in-Trade	865.6	712.0	1,047.5	1,341.7
Trade Debts	130.3	226.7	428.1	419.1
Advances, Deposits and Prepayment	37.9	50.8	75.8	50.9
Cash and Bank Balance	35.1	35.6	158.2	35.8
Total Assets	**1,664.4**	**1,599.7**	**2,450.3**	**2,669.8**
Trade and Other Payables	181.9	238.4	313.9	723.6
Long-Term Borrowings *(Incl. current maturity)*	110.3	146.7	260.6	262.2
Short-Term Borrowings	541.7	124.9	319.2	117.1
Total Liabilities	**896.6**	**582.7**	**1,055.6**	**1,230.3**
Paid-up Capital	159.9	159.9	159.9	159.9
Total Equity *(Incl. loan from directors)*	**767.8**	**1,017.1**	**1,394.7**	**1,439.5**
INCOME STATEMENT				
Net Sales	2,774.4	3,784.0	5,089.1	3,978.4
Gross Profit	190.4	491.3	738.9	205.7
Operating Profit	137.7	428.4	662.0	145.0
Profit Before Tax	**44.3**	**349.2**	**557.4**	**94.9**
Profit After Tax	**12.2**	**251.8**	**382.3**	**44.8**
RATIO ANALYSIS				
Gross Margin (%)	6.9%	13.0%	14.5%	5.2%
Net Margin (%)	0.4%	6.7%	7.5%	1.1%
Net Working Capital	323.5	633.1	1,026.1	1,010.7
Current Ratio	1.41	2.44	2.46	2.11
FFO	107.0	288.1	532.7	62.3
FFO to Long-Term Debt	0.97	1.96	2.04	0.32*
FFO to Total Debt	0.16	1.06	0.92	0.22*
DSCR (x)	1.56	3.22	4.74	1.41*
Gearing (x)	0.85	0.27	0.42	0.26
Debt Leverage (x)	1.17	0.57	0.76	0.85
Inventory + Receivable/Short-term Borrowings (x)	1.84	7.51	4.62	15.04

** Annualized*

REGULATORY DISCLOSURES — Appendix II

Name of Rated Entity	Khalid Shafique Spinning Mills Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity Ratings

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
Rating Type: Entity				
20-06-2023	BBB+	A-2	Negative	Maintained
29-06-2022	BBB+	A-2	Stable	Upgrade
11-06-2021	BBB	A-2	Stable	Maintained
14-04-2020	BBB	A-2	Rating Watch-Negative	Maintained
18-02-2019	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.
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Due Diligence Meeting Conducted

Name	Designation	Date
Mr. Muhammad Ashraf	GM Finance	May 26, 2023