The Pakistan Credit Rating Agency Limited

Rating Report

Zahir Khan & Brothers

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
31-Jan-2023	A	A2	Stable	Maintain	-
02-Feb-2022	A	A2	Stable	Maintain	-
10-Mar-2021	A	A2	Stable	Maintain	-
10-Mar-2020	A	A2	Stable	Maintain	-
30-Aug-2019	A	A2	Stable	Maintain	-
01-Mar-2019	A	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflect Zahir Khan & Brothers' (ZKB) financial & business strength. ZKB is known for undertaking large infrastructure projects on standalone basis as well as in collaboration with different JV partners. It is one of the leading contractors of Pakistan with its projects mostly financed by foreign funding agencies. ZKB is led by Zahir Khan and family - a name well known in the construction industry. The firm faced a period of low contracting activity in past few years due to muted growth in the construction industry during and post Covid-19 times and change in political landscape. However, the financial growth is expected to rebound as the firm has been awarded a number of projects in recent months including a few gigantic Public-Private Partnership (PPP) projects which shall translate into vigorous and sustainable numbers going forward. ZKB has booked net profit of PKR 314 mln in 3MFY23 (FY22 : PKR 1,334 mln; FY21: PKR 902 mln; FY20: PKR 3,996 mln). Being an integral part of business model, the firm meets its business funding needs by non-funded lines of banks and suppliers' credit mostly, however, it has also started procuring short-term borrowings recently to support its working capital requirements. The non-funded exposure is expected to increase with increasing project base, however, comfort can be drawn from rich equity base and investment property bank of the firm.

The ratings are dependent on the upcoming big projects undertaken by management for sustainability of the business and financial structure of ZKB. Governance and corporate structure is evolving to be complied with best practices and improved financial transparency as management has expressed its mandate to corporatize the firm's legal structure. Financial metrics need to be upheld as well.

Disclosure

Name of Rated Entity	Zahir Khan & Brothers
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Rating(Jun-22),Methodology | Correlation Between Long-term & Short-term Rating Scales(Jun-22),Methodology | Rating Modifiers(Jun-22)
Related Research	Sector Study | Construction(Mar-22)
Rating Analysts	Uswa Sikandar | uswa.sikandar@pacra.com | +92-42-35869504

Profile

Legal Structure Zahir Khan & Brothers (ZKB) is a Partnership Firm established in 1970. ZKB is in the process of changing the firm's legal status from Partnership to Public Limited Company in near future.

Background ZKB, as an industry leader in construction, currently nurtures projects that span across such diverse segments as transportation, power, road mapping, oil and gas pipeline constructions, irrigation and water supply, utilities, and urban infrastructure, all of which impact the nation of Pakistan. With a large number of projects, ZKB's portfolio has covered the entire spectrum of construction work in every corner of the country. The firm's head office is based in Islamabad.

Operations ZKB is registered with the Pakistan Engineering Council (PEC) and holds the 'CA' class with a 'NO LIMIT', license. It has a huge range of construction equipment such as pavers, power curber, asphalt plants, bitumen distributors, transit mixers, rotary drilling machines, gantry cranes, straddle carriers, milling machines, etc. The firm has permanent staff employees and additional labor is temporarily hired according to the requirement of projects.

Ownership

Ownership Structure ZKB is registered as a Partnership firm and owned by 4 Partners. Mr. Zahir Khan owns 51%, Mr. Mohabbat Khan owns 41%, Mr. Suleman and Mr. Samiullah hold 4% each respectively.

Stability ZKB is majority-owned by Mr. Zahir Khan but it needs to have formal succession planning in order to ensure future prospects are taken care of in the hour of need.

Business Acumen The key founder CEO of ZKB, Mr. Zahir Khan with deep hands-on knowledge has extensive construction industry experience of nearly 4 decades.

Financial Strength ZKB is entirely equity-financed and if the future need arises, the sponsors stand by to support them as they have a sound financial profile.

Governance

Board Structure The overall control of the firm vests in the 04 partners. Apart from the CEO, three partners have executive roles. The governance structure has room for improvement as currently, ZKB is still a partnership concern.

Members' Profile All the board members are experienced individuals. Three of them carry around ten years' experience of the construction industry. Mr Zahir Khan, CEO, and the founding member of ZKB, has nearly four decades of experience in construction sector. He is the person behind the success of the firm leading with his visionary leadership.

Board Effectiveness There is as such no board committee. All partners also have management positions in the company which inhabits the room for impartial oversight and strong governance.

Financial Transparency M/s. RSM Avais Hyder Liaquat Nauman Chartered Accountants, is the external auditor of the firm. The auditors have expressed an unqualified audit opinion on the financial statements of Zahir Khan & Brothers for the year ended June 30, 2022.

Management

Organizational Structure A simplified organizational structure exists in ZKB. Operations are segregated into six broad departments, (i) Bidding, (ii) Information Technology, (iii) Contract Management, (iv) Construction, (v) Admin & HR, and (vi) Finance. Clear lines of responsibility are defined for each department.

Management Team Mr Zahir Khan (CEO) is involved in key decisions of the firm specifically pertaining to bidding for the contracts from the government. Execution is being carried out by project managers under supervision of the Director (Technical Services) & COO , Mr Mohabbat Khan, who is a business man and has 15 years of experience in the construction sector. He is supported by an able core management team having ample experience.

Effectiveness With the support of a qualified and experienced team of professionals, ZKB is building up the business strengths and increasing its foot print across Pakistan. Functions of the management are clear and well-defined to effectively achieve its underlying goals and objectives.

MIS ZKB is currently using SARAP (ERP/oracle) software customized for the construction industry. The software keeps track of receivables, payables, general ledger, accounts, etc.

Control Environment ZKB follows a balanced and environment-friendly growth strategy in all their operations and has adopted sustainable growth principles that emphasize diminishing the environmental harm to a minimum & upholding social stakeholder and social values.

Business Risk

Industry Dynamics The construction sector contributed almost PKR~1,409bln to the Gross Domestic Product (GDP) of Pakistan in FY21 (FY20: PKR~1,231bln), registering a growth of ~14.4% YoY basis. Major challenges faced by the industry are increase in prices of all items related to construction, including cement, sand, crush, tiles, brick, concrete, paint as well as steel bars or rebars. Limited screening of contractors based on qualification, increasing bank regulations and limited financial leeway make it difficult to secure large amounts of bank guarantees for contractors. Bank guarantees put an undue burden on good quality contractors who may have large running projects. Construction industry has also suffered due to end of tax amnesty scheme announced by previous government. However, there is a hope on demand side which is expected to improve on account of demand generated from rehabilitation of damaged areas in recent flashfloods..

Relative Position Out of the 10,000+ firms registered with Pakistan Engineering Council as Constructors / Operators, only ~100 (1%), including ZKB, hold the prestigious CA category (no limit) license which enables them to be on the pre-qualifying list of approved constructors. ZKB is one of Pakistan's leading construction companies and biggest government contractor with over 4 decades of invaluable experience and has expertise in executing large and complex infrastructure projects.

Revenues During 1QFY23, the entity's top line was recorded at PKR 2.984 billion (FY22: PKR 9.237 billion; FY21: PKR 13.7 billion) while its net profit clocked in at PKR314mln during 1QFY23 (FY22: PKR 1,334mln; FY21: PKR 902mln). Revenues have slowed down in recent periods in response to the overall slowdown in macroeconomic indicators, however, they are expected to rebound in near future owing to a healthy projects pipeline.

Margins The gross margins of the entity were recorded at 22% (FY22: 16.2%; FY21: 17.4%), operating margins were recorded at 17.7% (FY22: 12.5%; FY21: 14.8%) while net margins were recorded at 10.5% in 1QFY23 (FY22: 14.4%; FY21: 6.6%).

Sustainability ZKB's management envisages sustainable footing in the market by planning to move to a public limited company structure instead of a partnership in the near future and will continue to work for a sustainable future with more efficient and successful projects. New projects in the pipeline stand to lift the topline as the firm's eyes geographical diversity in its business stream. 70% of the firm's projects are Asian Development Bank financed which saves it from political turmoil and instability. Construction of recently acquired sugar mill is almost complete and the firm plans to put it into production by March of this year. ZKB is also participating in bidding of Steels players and has also purchased 10% shares of a new oil refinery .

Financial Risk

Working Capital For working capital needs, which are a function of payables, inventory and receivables. ZKB's trade payable days reduced to 117 (FY22: 193 days; FY21: 181 days), inventory days reduced to 26 (FY22: 31 days; FY21: 27 days) and trade receivable days reduced to 74 (FY22: 94 days; FY21: 69 days) (average days), thus recording the networking capital days to (17) days during the 1QFY23 (Net Working Capital days; FY22: (68) days; FY21: (84) days).

Coverages In 1QFY23, ZKB's operating cash flows (FCFO) marked at PKR 730mln (FY22: 1,261mln; FY21: PKR 2034mln) on account of gross profit incurred PKR 656mln. The firm has not procured long-term debt so far and has been funding the business through its equity, so going forward if circumstances demand ZKB has enough room to procure debt to further fuel its already robust growth. However, ZKB has availed short-term borrowing to finance working capital requirements, therefore, the reported status of short-term borrowing is PKR 1,722 mln in 1QFY23 (FY22: PKR 1,722mln; FY21: PKR 724mln).

Capitalization During1QFY23, the leverage structure of the firm is 3.1% (FY22: 3.1%; FY21: 1.4%). Historically, ZKB has had no reliance. Historically, ZKB has had no reliance on long term debt for its business requirement, however, management has incorporated short-term borrowing into the capital mix. The firm has non funded credit facility mainly in the form of bank guarantees given to project owners. These borrowings are secured against tangible collateral in the form of a mortgage over residential/commercial properties in the name of sponsors

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Financial Summary

PKR mln

Zahir Khan & Brothers Construction	Sep-22 3M	Jun-22 12M	Jun-21 12M	Jun-20 12M
A BALANCE SHEET				
1 Non-Current Assets	16,455	17,595	18,582	19,217
2 Investments	32,693	32,037	33,107	32,795
3 Related Party Exposure	2,252	972	962	769
4 Current Assets	16,166	20,006	16,061	17,725
a Inventories	*944*	*744*	*845*	*1,205*
b Trade Receivables	*2,506*	*2,356*	*2,385*	*2,824*
5 Total Assets	67,566	70,611	68,712	70,507
6 Current Liabilities	8,288	10,898	11,175	13,757
a Trade Payables	*3,039*	*4,622*	*5,132*	*8,434*
7 Borrowings	1,722	1,722	724	115
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	5,031	5,031	4,606	4,643
10 Net Assets	52,525	52,960	52,207	51,993
11 Shareholders' Equity	52,525	52,960	52,207	51,993
B INCOME STATEMENT				
1 Sales	2,984	9,237	13,702	12,221
a Cost of Good Sold	*(2,328)*	*(7,743)*	*(11,315)*	*(10,135)*
2 Gross Profit	656	1,494	2,387	2,086
a Operating Expenses	(128)	(338)	(357)	(291)
3 Operating Profit	528	1,156	2,030	1,795
a Non Operating Income or (Expense)	*15*	*54*	*117*	*4,993*
4 Profit or (Loss) before Interest and Tax	543	1,210	2,147	6,788
a Total Finance Cost	*(20)*	*(535)*	*(240)*	*(121)*
b Taxation	*(209)*	*660*	*(1,005)*	*(2,671)*
6 Net Income Or (Loss)	314	1,334	902	3,996
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*730*	*1,261*	*2,034*	*1,630*
b Net Cash from Operating Activities before Working Capital Changes	*730*	*1,261*	*2,034*	*1,630*
c Changes in Working Capital	*(5,512)*	*(2,124)*	*(1,521)*	*(342)*
1 Net Cash provided by Operating Activities	(4,782)	(863)	513	1,288
2 Net Cash (Used in) or Available From Investing Activities	1,939	1,002	(845)	(161)
3 Net Cash (Used in) or Available From Financing Activities	175	1,405	1,157	(1,652)
4 Net Cash generated or (Used) during the period	(2,668)	1,544	826	(525)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	29.2%	-32.6%	12.1%	-46.5%
b Gross Profit Margin	22.0%	16.2%	17.4%	17.1%
c Net Profit Margin	10.5%	14.4%	6.6%	32.7%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	-160.3%	-9.3%	3.7%	10.5%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Sl*	2.4%	2.5%	1.7%	8.2%
2 Working Capital Management				
a Gross Working Capital (Average Days)	100	125	97	202
b Net Working Capital (Average Days)	-17	-68	-84	-119
c Current Ratio (Current Assets / Current Liabilities)	2.0	1.8	1.4	1.3
3 Coverages				
a EBITDA / Finance Cost	53.3	13.5	16.2	22.5
b FCFO / Finance Cost+CMLTB+Excess STB	53.3	8.1	10.7	15.1
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	0.0	0.0	0.0	0.0
4 Capital Structure				
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	3.2%	3.1%	1.4%	0.2%
b Interest or Markup Payable (Days)	0.0	0.0	0.0	0.0
c Entity Average Borrowing Rate	4.9%	16.8%	52.2%	93.6%

Credit Rating

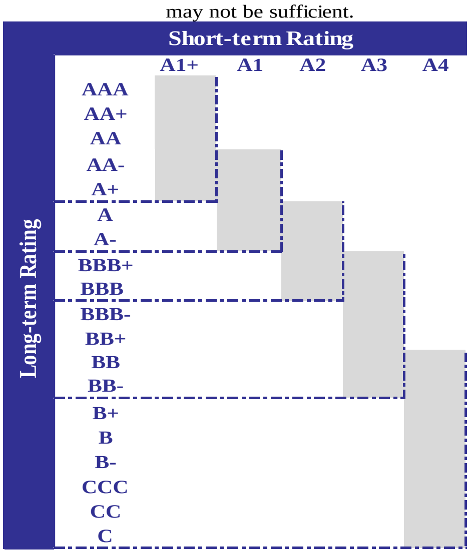
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long-term Rating

Scale	Definition
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating

Scale	Definition
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Companies Rating

Regulatory and Supplementary Disclosure
(Credit Rating Companies Regulations,2016)

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report | Clause 11-(A)(p).
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
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