The Pakistan Credit Rating Agency Limited

Rating Report

Khawaja Tanneries (Pvt.) Limited

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Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
30-Mar-2022	BBB	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

Khawaja Tanneries (Pvt.) Limited (hereafter referred to as ‘KTL’) is principally engaged in the manufacturing of a wide range of leathers from the rawhide to the crust and finished stages, both in Cow and Buffalo. The ratings reflect Company’s long-lived presence in tannery industry underpinned by the foundation stone for Mahmood Group – a known industrial & commercial group. Pakistan’s leather industry has seen declining trends in preceding years however slight recovery observed post-pandemic crises. The industry is ~95% export-oriented and accounts for ~3% of total country’s exports. Amongst the exports, leather apparel and gloves contribute the highest followed by tanned leather, footwear, and other products. Pakistan’s leather products enjoy duty free access to the European Union (prime consumer of leather goods globally) under the EU’s Generalized Scheme of Preferences. Lack of technological advancements, skilled labor force, presence in global fashion industry, and introduction of low-priced alternative can hamper the overall growth of this industry. Nevertheless, rising populace, increasing fashion trends, and depreciating exchange rate are likely to favor market participants. The key opportunities are generically available to the Company if investments are made in terms of offering value-added products. The Company’s export sales performance is driven by seasonal effect, volatility in global fashion trends, and local industrial developments. Margins of the Company are significantly dependent on improved topline. The Company has to build strong capital base. Ownership structure of the Company is majorly represented by family members. Going forward, the management intends to materialize the envisaged strategies by moving towards high-valued finished leather products. Financial risk profile of the Company is considered adequate with steady coverages, working capital cycle and cash flows. KTL’s capital structure is moderately leverage; encompassed STBs and low equity. Further, implementation of good governance structure is required to ensure compliance at all levels and smooth running of operations.

The ratings are dependent on the KTL’s ability to sustain its position amidst conservative leather business environment and management’s ability for successful strategy execution pertaining to manufacturing of high-fashion finished leather products. With growth in KTL’s revenue; prudent financial performance and effective liquidity profile shall remain imperative.

Disclosure

Name of Rated Entity	Khawaja Tanneries (Pvt.) Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Rating(Jun-21),Criteria | Correlation Between Long-term & Short-term Rating Scales(Jun-21),Criteria | Rating Modifiers(Jun-21)
Related Research	Sector Study | Leather(Mar-22)
Rating Analysts	Sohail Ahmed Qureshi | sohail.ahmed@pacra.com | +92-42-35869504

Profile

Legal Structure Khawaja Tanneries (Pvt.) Limited (or 'the Company') is a private limited concern. Initially, incorporated as a partnership firm in 1935. During 1961, the status was changed to a private limited company.

Background The Company is a part of Mahmood Group, originally started its operations by entering the tannery business. Founded in 1935, Mahmood Group is a conglomerate of Mr. Khawaja Muzaffar Mahmood. Ever since, the group has evolved as a diversified business empire by serving various industries in Pakistan.

Operations It is principally engaged in the manufacturing of a wide range of leathers from the rawhide to the crust and finished stages, both in Cow and Buffalo. In 2017, the Company also initiated leather shoe manufacturing division with production capacity of 2000 open pairs/day.

Ownership

Ownership Structure Mahmood Group owns absolute shareholding (100%) in the Company through family members. Mr. Muhammad Iqbal – eldest brother & chairperson for all group companies directly owns 33% stake. Mr. Muhammad Ilyas – CEO and brother of chairman owns 3% while Mr. Muhammad Younas – brother of chairman owns 33% stake. Remaining shareholding 15.5% each rest with two sons of CEO – Mr. Mehr Ali and Mr. Muhamad Qasim.

Stability Going forward, the Group is planning to establish a holding structure which is likely to result in improving the stability of Khawaja Tanneries (Pvt.) Limited. Documentation of the succession plan would bring more clarity for practical purposes.

Business Acumen The Khawaja Family has been operating for a number of decades and known to be one of the largest exporters of Pakistan. Mahmood Group expanded its presence by venturing into different industries including textile, leather, food & poultry, restaurants, power, equity investments & real estate.

Financial Strength The Group maintains a strong financial profile with substantial equity base and investments. This indicates Sponsors' ability to provide support, if needed. Furthermore, the group is planning to diversify by entering vegetable & fruit exports market.

Governance

Board Structure Board comprises four members, including Chairman – Mr. Iqbal and CEO – Mr. Ilyas. There are no independent directors on the board and it is dominated by the sponsoring-family, thus hampering effective governance. All the directors have been associated with the board for more than two decades.

Members' Profile Mr. Iqbal – Chairman has more than four decades of relevant industry experience while Mr. Ilyas – CEO also has more than four decades of experience. Both have been key position holders in various local corporate bodies of Pakistan. The board comprises vast knowledge and experience of tannery, though diversity in experiences exists as well.

Board Effectiveness Board of Directors meet on quarterly basis as per regulatory framework. Meetings have full attendance, boding well for the board effectiveness. Meanwhile, minutes are recorded properly. Still, there is still some room for improvement.

Financial Transparency EY Ford Rhodes, the 'Big 4' accounting firm, is the external auditor of the Company. The auditors have expressed an unqualified audit opinion on the financial statements for the year ended June 30, 2021.

Management

Organizational Structure Well-designed organizational structure exists in the Company. In the first tier, operations are segregated into 7 broad departments: (i) KTM Leather Wing, (ii) Accounts & Taxation, (iii) HR, (iv) MIS & IT, (v) Internal Audit, (vi) Administration, and (vii) KTM Footwear Wing. Clear lines of responsibility are defined for each department.

Management Team Overall management control is in the hands of Mr. Ilyas (CEO) and his son Mr. Mehr Ali, who is also holding position of director in the Company. Mr. Muhammad Waseem is the CFO of the company who is an FCA with 11+ years of experience.

Effectiveness With the support of qualified and experienced team of professionals, the Company is successfully building up its strengths and increasing foot print within and outside Pakistan. Functions of the management are clear and well-defined to achieve its underlying goals and objectives.

MIS Currently, the Company is using Oracle based ERP solution with version R-12.2.9. The management has entered into a contract with "System Haus" – a Brazilian vendor to acquire bespoke leather production software "Antara." It is expected to go-live by May, 2022.

Control Environment The Company follows a balanced & environment-friendly growth strategy in all their operations and adopted sustainable growth principles that emphasize diminishing the environmental harm to a minimum and upholding social stakeholder. The Company installed state-of-the-art Waste Water Treatment Plant by Italprogetti Spa. The Company has also been awarded with various ISO certifications to ensure overall quality.

Business Risk

Industry Dynamics Pakistan's leather industry is segregated into 5 major divisions including: i). Tanned Leather, ii). Apparel & clothing, iii). Gloves, iv). Footwear and v). other products. In 2021, industry performed slightly better on back of resumption in economic activities post Global Pandemic Crises. Leather industry earned a revenue of PKR 133bln (USD 833mln). Leather industry exports account for almost ~3% of total country's exports. In terms of sector share, apparel & clothing contributes highest (~34%) of total export market, followed by leather gloves (~31%), tanned leather (~20%), footwear (~13%), and other leather products (~2%).

Relative Position The Company cruised its export by ~29% and became the largest Leather Exporter in Pakistan. In quantity terms, it performed well when compared with other market players, thus increased its share from 3.85% of total Pakistan's leather exports to 11.15% in last 5 years. The Company's selling price is 33% better than average selling price of Pakistan.

Revenues During FY21, topline clocked at PKR 3,190mln (FY20: PKR 2,262mln; FY19: PKR 2,653) registering growth of 41.0% (FY20: -14.7%). Export sales made up 87.6% (FY20: 86.2%) of total revenue. In 1HFY22, the Company recorded revenue of PKR 1,951mln out of which sales of PKR 1,710 contributed through export channel. As at end Dec-21, growth was registered at 22.3%.

Margins The Company's gross margin decreased to 19.5% in FY21 (FY20: 23.1%; FY19: 21.2%) on back of proportionate increase in the prices of materials consumed. Operating profit margin also reduced to 6.7% in FY21 (FY20: 8.2%; FY19: 6.0%). Net profit margin witnessed an improvement in FY21 and stood at 3.6% (FY20: 3.0%, FY19: 1.9%). As at end Dec-21, the Company's gross margin and net margin recorded at 17.8% and 2.1%, respectively.

Sustainability Khawaja Tanneries (Pvt.) Limited's management envisage sustainable footing in the local and international markets by investing in new technology and machines to enhance and facilitate its production lines. In 2021, the Company invested PKR 188mln to support different projects that includes installing Lime Split Machine and new Toggle Machine.

Financial Risk

Working Capital The Company's capital needs emanate from financing inventories & trade receivables for which it relies on STBs and internal cash flows. During FY21, gross working capital days reduced to ~146 (FY20: ~197 days; FY19: ~119 days). Average inventory days reduced to ~121 days (FY20: ~156 days; FY19: ~77 days). Whereas, average receivable days reduced to ~26 days (FY20: ~42 days; FY19: ~43 days). Resultantly, net working cycle reduced to ~44 days (FY20: ~ 73 days, FY19: ~23 days). As at end Dec-21, gross working capital cycle of the Company stood at ~151 days, however net working capital cycle stood at ~41 days.

Coverages In FY21, the Company's free cash flows from operations (FCFO) marked at PKR 223mln (FY20: PKR 217mln; FY19: PKR 180mln) on account of gross profit incurred of PKR 623mln in FY21 (FY20: PKR 522mln; FY19: PKR 563mln). As at end Dec-21, FCFO clocked at PKR 124mln. Interest coverage ratio improved to 3.6x in FY21 (FY20: 2.7x; FY19: 2.5) whereas core-debt coverage ratio stood at 1.7x (FY20: 2.5x; FY19: 1.4x). The Company has procured short-term debt to fund its working capital requirements.

Capitalization As at end Jun-21, the Company had a moderately leveraged capital structure with a ratio of ~55.7% (FY20: ~55.2%; FY19: ~64%). Leveraging ratio increased year-on-year basis as borrowings increased to PKR 1,303mln in FY21 (FY20: PKR 1,136mln; FY19: 1,206mln). Majority portion of the debt is comprised of short-term borrowings (FY21: ~77.28%; FY20: ~82.39%; FY19: ~81.59%) from various banks. Leveraging ratio recorded at ~59.7% in 1HFY22 mainly on back of increased STBs (PKR 1,252mln).

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Financial Summary
PKR mln

Khawaja Tanneries (Pvt.) Limited	Dec-21	Jun-21	Jun-20	Jun-19
Tanneries /Finished Leather	6M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	1,304	1,162	1,107	908
2 Investments	-	-	-	5
3 Related Party Exposure	110	114	-	-
4 Current Assets	2,842	2,099	1,860	1,748
a Inventories	*1,613*	*1,087*	*1,020*	*910*
b Trade Receivables	*290*	*246*	*208*	*309*
5 Total Assets	4,257	3,376	2,967	2,661
6 Current Liabilities	1,575	1,029	905	774
a Trade Payables	*1,415*	*946*	*842*	*702*
7 Borrowings	1,595	1,303	1,136	1,206
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	8	7	6	4
10 Net Assets	1,079	1,037	921	677
11 Shareholders' Equity	1,079	1,037	921	677
B INCOME STATEMENT				
1 Sales	1,951	3,190	2,262	2,653
a Cost of Good Sold	*(1,603)*	*(2,567)*	*(1,740)*	*(2,090)*
2 Gross Profit	348	623	522	563
a Operating Expenses	(230)	(410)	(338)	(404)
3 Operating Profit	118	213	184	159
a Non Operating Income or (Expense)	-	*17*	*(8)*	*(6)*
4 Profit or (Loss) before Interest and Tax	118	230	176	153
a Total Finance Cost	*(57)*	*(84)*	*(93)*	*(82)*
b Taxation	*(20)*	*(30)*	*(15)*	*(21)*
6 Net Income Or (Loss)	42	116	68	50
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*124*	*223*	*217*	*180*
b Net Cash from Operating Activities before Working Capital Changes	*73*	*162*	*118*	*103*
c Changes in Working Capital	*(124)*	*(293)*	*41*	*(204)*
1 Net Cash provided by Operating Activities	(51)	(131)	158	(101)
2 Net Cash (Used in) or Available From Investing Activities	(177)	(55)	(102)	(184)
3 Net Cash (Used in) or Available From Financing Activities	293	168	(70)	325
4 Net Cash generated or (Used) during the period	65	(18)	(14)	40
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	22.3%	41.0%	-14.7%	--
b Gross Profit Margin	17.8%	19.5%	23.1%	21.2%
c Net Profit Margin	2.1%	3.6%	3.0%	1.9%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	0.0%	-2.2%	11.4%	-0.9%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Sh*	7.9%	11.8%	8.5%	7.4%
2 Working Capital Management				
a Gross Working Capital (Average Days)	151	146	197	119
b Net Working Capital (Average Days)	41	44	73	23
c Current Ratio (Current Assets / Current Liabilities)	1.8	2.0	2.1	2.3
3 Coverages				
a EBITDA / Finance Cost	3.7	4.2	3.1	2.9
b FCFO / Finance Cost+CMLTB+Excess STB	1.5	1.7	2.5	1.4
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	2.1	1.8	1.5	2.1
4 Capital Structure				
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	59.7%	55.7%	55.2%	64.0%
b Interest or Markup Payable (Days)	76.1	70.5	37.3	73.4
c Entity Average Borrowing Rate	5.8%	5.1%	6.8%	5.9%

Credit Rating

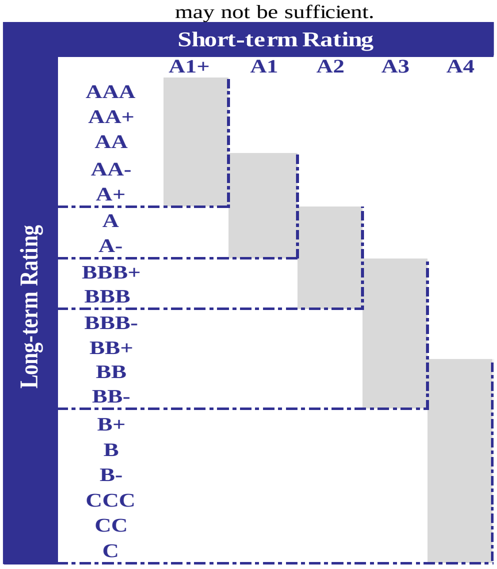
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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):

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

Instruments
a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk 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.
(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)

Proprietary Information