RATING REPORT

Shahkam Industries (Pvt.) Limited (SIL)

REPORT DATE:
December 27, 2018

RATING ANALYSTS:
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RATING DETAILS		
	Initial Rating	
Rating Category	Long-term	Short-term
Entity	BBB	A-2
Rating Outlook	*Stable*	
Rating Action	Initial	
Outlook Date	*December 21st, 2018*	

COMPANY INFORMATION	
Incorporated in 1992	External auditors: M. Almas & Co. Chartered Accountants
Private Limited Company	Chairman of the Board/CEO: Mr. Shahid Kamil Butt
Key Shareholders (with stake 5% or more):	
Mr. Shahid Kamil Butt – 60.5%	
Ms. Nazra Butt – 13.2%	
Ms. Sadia Kamil Butt – 13.2%	
Ms. Saiqa Kamil Butt – 13.2%	

APPLICABLE METHODOLOGY(IES)
JCR-VIS Entity Rating Criteria: Industrial Corporates (May 2016)
http://jcrvis.com.pk/docs/Corporate-Methodology-201605.pdf

Shahkam Industries (Pvt.) Limited

OVERVIEW OF THE INSTITUTION

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 Limited (SIL) was established in 1992 under the repealed Companies Ordinance, 1984 (now Companies Ordinance, 2017).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

Profile of the Chairman/CEO

Mr. Shahid Kamil has over 25 years of experience in textile industry. Mr. Shahid currently serves as the Chairman of the Board and Chief Executive Officer (CEO).

Financial Snapshot

Total Equity: end-FY18: Rs. 1.4b; end-FY17: Rs. 1.4b; end-FY16: Rs. 1.3b

Assets: end-FY18: Rs. 6.9b; end-FY17: Rs 4.5b; end-FY16: Rs. 4.5 b

Profit After Tax: FY18: Rs., 73m; FY17: Rs. 5m; FY16**:** Rs. 80m

RATING RATIONALE

Rating Rationale

Shahkam Industries (Pvt.) Limited (SIL) is an export-oriented knitwear and ready-made garment manufacturing unit located in Lahore. Shareholding of the company is vested with Mr. Shahid Kamil Butt & family who are actively involved in day to day operations. The assigned ratings take into account experience of sponsors in the textile sector and established business relations with multinational clothing companies. The up-scaling of production processes and an effective marketing strategy have played a critical role in customer retention despite increasing competition from local and regional competitors. The recent devaluation of rupee and continuation of the export package are expected to bode well for the company. However, the ratings are adversely impacted by declining trend in profit margins amidst high cost of doing business, low bargaining power against large clothing retailers, and stiff competition. The ratings are also constrained by elevated financial risk profile as depicted by high leverage indicators. The management information system and related controls deem adequate.

Key Rating Drivers

Higher exports and financial incentives provided support to the bottom-line

SIL is a mid-sized exporter of knitwear and ready-made garments, with the U.S. and Europe being the primary target markets. The business risk profile of the company is supported by long-term relations with the multinational apparel companies, including Gap Inc., American Eagle Outfitters, Zara SA, and Okaidi. The long association with clientele and financial incentives provided by the government to export sector have helped SIL exhibit notable improvement in sales. During FY18, net sales of the company increased to Rs. 9.4b (FY17: Rs. 8.7b; FY16: Rs. 8.4b) mainly on account of higher volumes and a positive impact of financial incentives, including rebates and duty drawback of worth Rs. 612m. While shirts segment remained under pressure due to further reduction in business with the financially stressed customers, the company recorded notable growth in trouser, jacket, and denim sales volume. Despite marginal increase in the selling prices, gross profits continued to decline as the company struggled to pass higher cost of doing business onto customers due to increasing competition from regional exporters. However, with notable reduction in operating costs due to the establishment of direct business ties with clothing chains in Europe, thus reducing reliance on third-party buying houses, coupled with higher other income had a positive impact on profitability. The recent rupee depreciation is expected to positively impact the overall sales and profitability of the company to a certain extent, going forward.

Improved cash flows but liquidity position remained weak

SIL exhibited notable improvement in funds from operations (FFO) during FY18, amounting to Rs. 291m (FY17: Rs. 161m; FY16: Rs. 186m) mainly on the back of higher profits. Resultantly, FFO to total debt ratio improved marginally, though remained low, at 0.08x (FY17: 0.06x; FY16: 0.08x) despite notable increase in debt financing during FY18. FFO to long-term debt ratio, however, weakened on a timeline basis to 0.28x (FY17: 0.33x; FY16: 0.48x). With higher FFO, the debt service coverage improved to 1.13x (FY17: 0.91x; FY16: 1.30x). The current ratio also improved to 0.92x (FY17: 0.75x; FY16: 0.75x), though remained lower than 1x, suggesting relatively weak liquidity position of the company. The lengthening of cash conversion cycle during FY18 was due to higher inventory levels at end-FY18, including finished goods inventory of Rs. 605m that has been sold in subsequent months of July and August of FY19. SIL has stock piled raw material inventory to meet already booked customer orders till April 2019. The cash flows position of the company is expected to improve with the conversion of outstanding customer orders into sales.

Elevated cash requirements impelled leverage indicators higher

Equity base of the company expanded at a slow pace to Rs. 1.4b by end-FY18 (FY17: Rs. 1.4b; FY16: Rs. 1.3b) with the retention of profits, representing a 3-year CAGR of 4%. The debt profile of SIL comprised a mix of short and long-term loan facilities. During FY18, SIL raised a new long-term debt of Rs. 532m to finance its CAPEX. The markup rate on the Long Term Financing Facility (LTFF) is fixed at 4%, whereas the rate on Term Finance (TF) is benchmark rate plus 1%. The loan facilities are repayable in 12 equal quarterly installments. Short-term borrowings stood higher at Rs. 2.6b by end-FY18 (FY17: Rs. 2.0b; FY16: Rs. 2.0b) as a result of increased funding requirements for working capital. With sizeable increase in debt financing, gearing and debt leverage indicators increased to 2.55x and 3.84x by end-FY18 (FY17: 1.85x and 2.31x; FY16: 1.78x and 2.34x), respectively. The sponsors currently have no plan to inject fresh equity into the business; hence, leverage indicators may remain on the higher side. However, expected profitability emanating from conversion of current pipeline of customer orders into sales may have some positive impact on capitalization indicators on account of profit retention. However, the extent of the same remain to be seen.

Stability in management and adequate IT infrastructure
The Board of Directors comprised two members. Informal Board meetings are held on ad hoc basis with no minutes being recorded. The senior management team comprises experienced resources from the textile sector and has largely depicted stability. The IT infrastructure currently in place sufficiently supports the management information system. The company is using Oracle 11g based customizable ERP platform, having modules including Human Capital Management System, Apparel Management System, and Machine Management System. The company plans to shift accounting system from SQL based ERP to Oracle.

Shahkam Industries (Pvt.) Limited **Appendix I**

FINANCIAL SUMMARY *(amounts in PKR millions)*

BALANCE SHEET	June 30, 2015	June 30, 2016	June 30, 2017	June 30, 2018
Non-Current Assets	1,739	2,285	2,357	2,492
Stores, Spares. And Loose Tools	29	43	18	161
Stock-in-Trade	638	405	367	1,711
Trade Debts	1,674	1,217	982	1,615
Cash & Bank Balances	27	28	40	27
Tax Refunds due from the Government	144	351	252	41
Advances and prepayments	75	70	67	170
Other Assets	56	84	384	657
Total Assets	4,382	4,483	4,467	6,874
Trade and Other Payables	785	729	568	1,769
Short Term Borrowings	2,000	2,000	2,000	2,600
Long-Term Borrowings *(Inc. current matur)*	302	388	495	1,027
Other Liabilities	32	23	56	57
Tier-1 Equity	1,263	1,343	1,348	1,421
Total Equity	1,263	1,343	1,348	1,421

INCOME STATEMENT	June 30, 2015	June 30, 2016	June 30, 2017	June 30, 2018
Net Sales	7,729	8,399	8,671	9,379
Gross Profit	1,471	1,387	1,191	897
Operating Profit	552	297	228	325
Profit After Tax	265	80	5	73
FFO	371	186	161	291

RATIO ANALYSIS	June 30, 2015	June 30, 2016	June 30, 2017	June 30, 2018
Gross Margin (%)	19.0%	16.5%	13.7%	9.6%
Net Working Capital	(282)	(724)	(709)	(373)
FFO to Long-Term Debt	1.23	0.48	0.33	0.28
FFO to Total Debt	0.16	0.08	0.06	0.08
Debt Servicing Coverage Ratio (x)	2.20	1.30	0.91	1.13
ROAA (%)	-	1.8%	0.1%	1.3%
ROAE (%)	-	6.1%	0.4%	5.3%
Gearing (x)	1.82	1.78	1.85	2.55
Debt Leverage (x)	2.47	2.34	2.31	3.84
Current Ratio	0.90	0.75	0.75	0.92

ISSUE/ISSUER RATING SCALE & DEFINITIONS — Appendix II

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: JCR-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.jcrvis.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.jcrvis.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.

'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.jcrvis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when JCR-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 (Pvt.) 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				
21/12/2018	BBB	A-2	Stable	Initial

Instrument Structure	N/A
Statement by the Rating Team	JCR-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	JCR-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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