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
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 the strength of the Zahir Khan & Brothers' (ZKB) business model. ZKB embarks upon large infrastructure projects in collaboration with different JV partners, which in their own right are established institutions, hailing from different countries. Over the years, ZKB has undertaken huge projects, of which the completion spanned a number of years. Some of the projects are in the process - providing projected revenues in the coming years as well. After witnessing phenomenal growth in FY18, there has been a downward trend in the aggregate new orders of the infrastructural construction. Therefore, the pipeline is getting dry though ZKB is hopeful of getting some new projects. The company booked high profits in FY18; the recent profitability, on a comparative scale, is on the lower side, yet remains healthy. ZKB is led by Zahir Khan and family - a name well known in the construction industry. They have built expertise in the business and worked out oversight mechanism to manage various risks prevalent in this business. The business has funding needs. This is primarily met by non-funded lines of banks and supplier credit. The equity base is strong and is mostly represented by a portfolio of investment property.

The ratings are dependent on the sustainability of the business and financial structure of ZKB. Governance and corporate structure requires upgradation and improvement and so does the financial transparency. Financial metrics need to be upheld as well. Any prolonged downturn in subdued business volume can have a detrimental effect on the rating. The management has an express mandate to corporatise its structure while improving the reporting of its financial performance on a quarterly and annual basis.

Disclosure

Name of Rated Entity	Zahir Khan & Brothers
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-19),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-19),Criteria | Rating Modifier(Jun-19)
Related Research	Sector Study | Construction(Mar-19)
Rating Analysts	Muhammad Noor ul Haq | muhammad.noorulhaq@pacra.com | +92-42-35869504

Profile

Legal Structure Zahir Khan & Brothers (hereinafter referred to as''ZKB'') is a Partnership Firm established in 1970.

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 over 152 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 Quetta Cantt.

Operations ZKB is registered with the Pakistan Engineering Council (PEC) and holds the 'CA' class with NO LIMIT, license. It has a huge range of construction equipment such as pavers, power curber, asphalt plants, bitumen distributor, transit mixers, rotary drilling machines, gantry cranes, straddle carrier, milling machines, etc. The firm has permanent staff employees and additional labour 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 a formal succession planning in order to ensure that 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 over 36 years.

Financial Strength ZKB is entirely equity financed and if in the future need arises, the sponsors stand by to support as they have never applied for any funded facility from the banks. 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 of the partners are experienced individuals. Three of them carry six years' experience in the construction industry. Mr Zahir Khan, CEO, and the founding member of ZKB has over three decades of experience in the 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 Presence of an independent director is important to ensure effective, transparent and independent oversight. The company has its own internal audit function as well. M/s. RSM Avais Hyder Liaquat Nauman Chartered Accountants is the external auditor of the firm.

Management

Organizational Structure A simplified organizational structure exists in ZKB. Operations are segregated into six broad departments, (i) Mechanical Engineering, (ii) Information Technology, (iii) Contract Management, (iv) Project Management, (v) Business Development, 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 the supervision of the Director (Technical Services), Mr Mohabbat Khan, who is a businessman and has 10 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 in all the relevant facts of the construction industry. Functions of the management are clear and well-defined to effectively achieve its underlying goals and objectives. The system of internal control is in place and has been effectively implemented.

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 follow a balanced and environment-friendly growth strategy in all their operations has adopted sustainable growth principles that emphasize diminishing the environmental harms to a minimum and creating social stakeholder values and social values.

Business Risk

Industry Dynamics The construction sector comprises construction of bridges, dams, roads and urban infrastructure development which also forms the base and supporting factor for other services sectors. Mostly CPEC related projects remained slow and there was a muted growth during the period under review. For FY19 the Federal Government has allocated PKR ~800bln under PSDP spending, and considering 70% utilization history, there is a major cut in the expected construction activity which doesn't bode very well for the sector. Although if / when PMs' ambitious plan to build 5 million houses goes through it would provide a major impetus to the debilitating construction industry.

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.

Revenues During FY19, the entity's revenues witnessed a significant dip of 43.4% in comparison to the prior year's magnificent growth of 45.9% (FY19: PKR 22.9bln FY18: PKR 40.3bln). This was mainly in response to the overall slowdown in economic activity in the wake of macro adjustment policies and sector-specific issues. The underwhelming industrial performance was primarily attributed to cuts in PSDP spending.

Margins Despite the sharp contraction in revenues during FY19, with a slight improvement; the gross margins of the entity stood at 22.3% (FY18: 20.8%; FY17: 19.9%). Since there were no borrowings from banks, a static finance cost of PKR 73mln (FY18: PKR 50mln; FY17: PKR 109mln) and slight support from operating margins 13.1% (FY18: 12.5%; FY17: 11.8%) positively supported the bottom line. Hence, the firm's net profit clocked at PKR 2.9bln during FY19 (FY18: PKR 5.0bln).

Sustainability ZKB's management envisage sustainable footing in the market by planning to move to a private limited company structure instead of partnership in near future and will continue to work for a sustainable future with more efficient and successful projects with technical competency, experience, quality, speed, high technology, creativity and corporate responsibility. New projects in pipeline stand to lift the topline as the firm's eyes geographical diversity in its business stream.

Financial Risk

Working Capital The firm is totally equity based. For working capital needs, which is a function of inventory and receivables, ZKB relies on internal cash flows. ZKB's trade payable days increased to 260 (average days), therefore net working capital days showed negative value during the FY19, however, it may be misleading as average inventory held days are not accounted for in these ratios. Furthermore, ZKB does not have short term borrowings, which provides a sizable cushion for future borrowings.

Coverages In FY19, ZKB's operating cash flows (FCFO) marked at PKR 4.9bln (FY18: 7.3bln; FY17: PKR 2.6bln) on account of gross profit incurred PKR PKR 5.1bln. 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.

Capitalization During FY19, the firm had an unlevered capital structure, with a gearing ratio of 0% (FY18: 0%). Historically, ZKB has had no reliance on long term debt for its business requirement. 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.

The Pakistan Credit Rating Agency Limited

Financial Summary

PKR mln

Zahir Khan & Brothers	Jun-19	Jun-18	Jun-17	Jun-16
Construction	12M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	39,702	48,224	43,770	8,213
2 Investments	-	-	-	-
3 Related Party Exposure	553	476	4,070	-
4 Current Assets	20,887	27,833	28,160	13,951
a Inventories	*2,066*	*3,141*	*3,343*	*374*
b Trade Receivables	*7,416*	*11,151*	*4,352*	*6,243*
5 Total Assets	61,142	76,533	76,000	22,164
6 Current Liabilities	15,646	23,409	26,338	10,833
a Trade Payables	*13,029*	*19,443*	*21,631*	*9,684*
7 Borrowings	-	-	-	-
8 Related Party Exposure	-	3,254	-	-
9 Non-Current Liabilities	486	2,528	4,089	402
10 Net Assets	45,010	47,342	45,572	10,930
11 Shareholders' Equity	45,010	47,342	45,572	10,930
B INCOME STATEMENT				
1 Sales	22,827	40,298	27,623	17,727
a Cost of Good Sold	*(17,736)*	*(31,912)*	*(22,128)*	*(14,867)*
2 Gross Profit	5,091	8,386	5,496	2,860
a Operating Expenses	(405)	(445)	(543)	(157)
3 Operating Profit	4,686	7,941	4,953	2,703
a Non Operating Income or (Expense)	*92*	*88*	*89*	*39*
4 Profit or (Loss) before Interest and Tax	4,777	8,029	5,042	2,742
a Total Finance Cost	*(73)*	*(50)*	*(109)*	*(26)*
b Taxation	*(1,712)*	*(2,955)*	*(1,670)*	*(1,359)*
6 Net Income Or (Loss)	2,992	5,024	3,262	1,357
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*4,857*	*7,250*	*2,557*	*1,072*
b Net Cash from Operating Activities before Working Capital Changes	*4,784*	*7,200*	*2,448*	*1,047*
c Changes in Working Capital	*(2,300)*	*(3,262)*	*2,077*	*1,155*
1 Net Cash provided by Operating Activities	2,485	3,938	4,525	2,202
2 Net Cash (Used in) or Available From Investing Activities	7,720	(5,427)	(4,249)	(4,489)
3 Net Cash (Used in) or Available From Financing Activities	(10,620)	(1,561)	3,479	3,365
4 Net Cash generated or (Used) during the period	(415)	(3,051)	3,754	1,078
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-43.4%	45.9%	55.8%	0.7%
b Gross Profit Margin	22.3%	20.8%	19.9%	16.1%
c Net Profit Margin	13.1%	12.5%	11.8%	7.7%
d Cash Conversion Efficiency (EBITDA/Sales)	24.4%	22.3%	20.7%	17.2%
e Return on Equity (ROE)	6.5%	10.8%	11.5%	15.8%
2 Working Capital Management				
a Gross Working Capital (Average Days)	190	100	95	89
b Net Working Capital (Average Days)	-70	-86	-112	-61
c Current Ratio (Total Current Assets/Total Current Liabilities)	1.3	1.2	1.1	1.3
3 Coverages				
a EBITDA / Finance Cost	76.3	178.7	52.5	117.7
b FCFO / Finance Cost+CMLTB+Excess STB	66.4	143.9	23.4	41.5
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	0.0	0.0	0.0	0.0
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	0.0%	0.0%	0.0%	0.0%
b Interest or Markup Payable (Days)	0.0	0.0	0.0	0.0
c Average Borrowing Rate	N/A	N/A	N/A	N/A

Rating Scale | Corporate

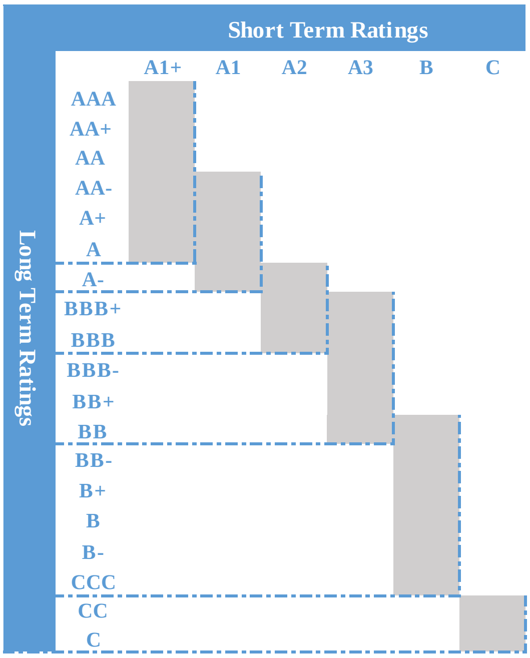
2019

Credit Rating Scale & Definitions

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 Ratings	
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 Ratings	
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 conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



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, a) some material identifiable event and/or b) deviation from expected trend. 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 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) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) 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.

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

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(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)

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