The Pakistan Credit Rating Agency Limited

Rating Report

Khaadi Pakistan (SMC-Pvt) Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
14-Dec-2020	A-	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

Khaadi is a distinct player in the retail fashion industry. With over two decades of history, reflecting growth and expansion, Khaadi has built strong brand equity. It has become synonymous with innovation and quality while ensuring affordability for its target customer base. The basket of the products offered and the topline size and growth supplement this assertion. The business model of Khaadi, as envisioned by its founder and CEO, has been the self-propelling force for the expansion of the entity. The retail network has reached half a million square foot physical presence. The brand has outreached outside Pakistan as well. Khaadi designs its outlets in a way to give more than shopping experience to walk-in customers. The management is focusing on further expansion. Potential induction of an equity partner will be of further help. The entity has a strong management structure in place, with professionals leading their respective roles. COVID-19 has impacted the retail sector severely; though revival is underway, it will take some time for a full recovery to take place. The reported number for the recent period reflects dilution. While debt metrics accordingly depict a weak position, they are expected to improve post equity injection and recovery in the business.

The ratings are dependent on the recovery in the business performance and relative position of the entity. The financial profile is also expected to improve as anticipated. Governance of the Company is expected to take positive support from the initiatives undertaken by the sponsor shareholder.

Disclosure	
Name of Rated Entity	Khaadi Pakistan (SMC-Pvt) Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-20),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria | Rating Modifier(Jun-20)
Related Research	Sector Study | Composite(Nov-19)
Rating Analysts	Muhammad Fahad Iqbal | fahad.iqbal@pacra.com | +92-42-35869504

Profile

Legal Structure Khaadi SMC (Pvt.) Ltd (Khaadi), a single member company, commenced operations in 1998.

Background Khaadi is one of Pakistan's leading fashion retail brand which offers home and clothing, shoes and accessories, fragrances, and skin care for women and kids. The Company has a history of 22 years.

Operations Khaadi has an exceptional retail network with over 61 stores in Pakistan, 14 in UK, UAE, Qatar, and Bahrain. The Company has a market share of 6.3% in the retail segment within the country. The Company has laid its foundation on the back of brand strength, retail market, fashion design, marketing, supply chain, strategy, and finance. In the apparel and footwear retail market Khaadi has retained its #1 market position in terms of revenue among leading apparel retail brands. Khaadi's compounded growth over the past 5 years has been 28% vs 12% for the industry.

Ownership

Ownership Structure The ownership of the Company is with Mr. Shamoon Sultan.

Stability The ownership structure of the Company is seen as stable in the foreseeable future where the majority stake will rest with existing sponsor. The existence of formal succession planning will add to the strength of the stable structure.

Business Acumen Extensive growth has been seen in the business where expansion into different segments multiplied growth volumes. Hence, the business acumen of sponsor is considered strong.

Financial Strength Over the years, Khaadi has grown into a big retail brand with total assets of ~PKR 17bln, equity of ~PKR 1.1bln. Total leveraging for the Group remains fairly aggressive with total annual revenues of ~PKR 16bln.

Governance

Board Structure Currently, the company has an SMC status where it has a one-member board. However, the company is planning to formulate properly governed board over the years.

Members' Profile Mr. Shamoon Sultan is the sole owner, founder, and director of Khaadi. He is the man at the last mile and the driving force behind the success and growth of Khaadi. Khaadi has established itself as a leading women's fashion brand in 4 countries based on his vision.

Board Effectiveness After the formation of the board, the company will have board committees to assist the board. Currently, an experienced management team is assisting the CEO in any capacity needed.

Financial Transparency AF Ferguson & Co Company (PwC) is the external auditor of the Company. The auditors have expressed an unqualified opinion on the financial reports for the periods ended 30th June 2020. The Company does not have an in-house audit function but engages Ernst & Young (EY) from time to time to carry out audit assignments.

Management

Organizational Structure The Company's overall operations are segregated into six broad divisions, namely: (i) Designing, (ii) Commercial operations, (iii) Branding and Marketing, (iv) Human Resource, (v) Finance, and (vi) Product strategy (vii) Supply Chain, (viii) Strategy and E-Commerce. Each of the department is led by an experienced individual ensuring smooth operations in the Company. A large number of senior executives report directly to the CEO.

Management Team Mr. Shamoon Sultan – the CEO – primarily manages the Company's affairs, supported by a team of seasoned professionals. After Mr. Shamoon, his wife Miss. Saira Shamoon is the Chief Design Officer of the Company. Mr. Adnan Samdani is the CFO of the Company. He joined the Company as CFO in 2016 and over the years also served as Chief Commercial Officer MESA & NA and Chief Commercial Officer E-commerce. Before Khaadi, Mr. Adnan also has experience in Lotte Chemicals as a Finance Director and served as a board member of Lotte Kolson. He has a Bachelor's degree from the University of Rochester, NY.

Effectiveness Management has formed six committees, namely, i) Steering Committee ii) Board and Product Committee iii) Commercial committee iv) CAPEX committee v) Management committee vi) Marketing committee headed by the CEO and other committee members.

MIS MIS primarily includes Microsoft, Adobe, Tubatech, and Oracle HRM Cloud. The MIS reports are updated on a real-time basis to be available to senior management all the time. The reports are shared and discussed with the CEO regularly so that the information is conveyed promptly to the CEO and higher management.

Control Environment Since Khaadi is not a manufacturing company, ISO certification does not apply. However, the Company maintains criteria for strong internal controls within the Company and follows the SOP's required for effective operations within the organization.

Business Risk

Industry Dynamics Pakistan's textile and clothing exports declined by over 1% year-on-year in August 2020, from ~PKR 2.3bln in Aug last year to ~PKR 2.28bln. Exports in the textile sector have dipped in the second month of the current fiscal year after posting growth in the first month. The Covid-19 has severely hampered the demand for the country's textile exports during the last five months. The demand for textile products internationally deteriorated on account of lockdowns in major export destinations, the export market had under-performed in 2MFY21. Furthermore, economies around the world have been gradually reopening as businesses recommenced in the past month. Hence, the exports in 2MFY21 experienced an upward trend despite prior lockdown imposed. The markets gradually opened in some parts of the world towards the end of 1QFY21. Going forward, second wave of the pandemic has begun its course and lockdowns may be a cause of concern. However, business community is expected to continue operations under strict SOPs, both; locally and in most of the export destinations of the Company.

Relative Position Khaadi enjoys a strong position among its competitors. Some of the competitors of Khaadi are Ideas by Gul Ahmed, Outfitters, J., and Bareeze. Among these competitors, Khaadi enjoys a robust market share of 6.3% in the apparel division. It is followed by Ideas (5.2%), Outfitters (4.2%), J. (3.5%), and Bareeze (2.8%). The compound growth rate for Khaadi in the industry is 28% as compared to 12% of the retail industry.

Revenues The revenue of Khaadi declined to ~PKR 15.6bln in FY20 as compared to (PKR 19.5bln in FY19) primarily due to the negative impact of COVID-19 pandemic and resultant lock-downs imposed by the government. The revenue is primarily derived from local sales ~93.6% and the rest is from the export sales. Product-wise analysis reveals that unstitched cloth category generates the maximum revenue for Khaadi ~PKR 8.8bln.

Margins The Company's gross margin dropped slightly (FY20: 31.4%, FY19: 35%) due to a decrease in sales primarily due to the negative impact of the COVID-19 outbreak and resultant lockdown imposed. Similarly, due to higher operating costs, operating margin declined (FY20: -6.3%, FY19: 4.9%). The finance cost of the Company increased to ~PKR 1.3bln as compared to ~PKR 192mln in the previous years as the Company took a long-term loan of ~PKR 8bln for the first time: As a result, the Company posted a net loss of PKR -1.6bln in FY20 as compared to net profit in FY19 (~PKR 564mln).

Sustainability Khaadi plans to further penetrate the audience of Lahore, Islamabad, and Karachi using the digital platform; already the second most visited website in the country. To ensure the sustainability of growth that Khaadi is expecting, the Company plans to attract new customers in Tier-II cities by creating awareness among mass media. An external investor is expected, over the few months course, who along with the current sponsor will assist further organic growth.

Financial Risk

Working Capital Receivables and inventory days increased due to the impact of COVID-19 and payables remained stagnant led to an increase in net working capital days (FY20: 60days, FY19: 43days). Additionally, Khaadi borrowed short-term loans for fulfilling its working capital needs. The low-cost borrowing benefits in keeping the overall group's finance cost low.

Coverages During FY20, Khaadi's cashflows (FCFO) drops slightly (FY20: PKR 809mln, FY19: PKR 1.1bln). Consequently, Interest coverage declined (FY20: 0.7, FY19: 14.1x) due to the high long-term loan being taken. Similarly, debt coverages declined (FY20: 0.3x, FY19: 5x) because of CMLTD as the Company has opted for a long-term loan. The Company's TCF debt coverage also significantly declined (FY20: 0.3x; FY19: 5.1x).

Capitalization Khaadi has a highly leveraged capital structure of ~90% in FY20 (FY19: ~23%). The primary reason for that is that the Company opted for the long-term loan facility of ~PKR 8bln in FY20. Out of total debt of ~PKR 4.1bln in FY20, short-term borrowings debt comprises ~20% whereas the long-term loan consists of ~80%. The Company's non-current lease liabilities are ~PKR 5.7bln due to a change in the accounting policy. Going forward, leveraging is expected to remain range bound.

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Khaadi SMC	Jun-20	Jun-19	Jun-18
Retail	12M	12M	12M
A BALANCE SHEET			
1 Non-Current Assets	11,476	4,322	3,164
2 Investments	85	96	140
3 Related Party Exposure	88	-	712
4 Current Assets	5,341	3,346	3,625
a Inventories	*2,650*	*1,031*	*2,374*
b Trade Receivables	*1,312*	*1,298*	*522*
5 Total Assets	16,990	7,763	7,640
6 Current Liabilities	5,688	4,080	3,583
a Trade Payables	*5,264*	*3,623*	*3,168*
7 Borrowings	3,954	854	321
8 Related Party Exposure	-	-	-
9 Non-Current Liabilities	6,060	-	-
10 Net Assets	1,288	2,829	3,735
11 Shareholders' Equity	1,288	2,829	3,735
B INCOME STATEMENT			
1 Sales	15,678	19,502	16,824
a Cost of Good Sold	*(10,751)*	*(12,674)*	*(10,195)*
2 Gross Profit	4,927	6,828	6,629
a Operating Expenses	(5,803)	(5,875)	(5,306)
3 Operating Profit	(876)	953	1,322
a Non Operating Income or (Expense)	*177*	*8*	*(525)*
4 Profit or (Loss) before Interest and Tax	(699)	961	797
a Total Finance Cost	*(1,438)*	*(192)*	*(150)*
b Taxation	*595*	*(205)*	*(193)*
6 Net Income Or (Loss)	(1,541)	564	454
C CASH FLOW STATEMENT			
a Free Cash Flows from Operations (FCFO)	*913*	*1,114*	*780*
b Net Cash from Operating Activities before Working Capital Changes	*(494)*	*974*	*609*
c Changes in Working Capital	*(885)*	*1,644*	*490*
1 Net Cash provided by Operating Activities	(1,379)	2,618	1,099
2 Net Cash (Used in) or Available From Investing Activities	(1,135)	(1,608)	(150)
3 Net Cash (Used in) or Available From Financing Activities	2,242	(616)	(974)
4 Net Cash generated or (Used) during the period	(272)	394	(25)
D RATIO ANALYSIS			
1 Performance			
a Sales Growth (for the period)	-19.6%	15.9%	--
b Gross Profit Margin	31.4%	35.0%	39.4%
c Net Profit Margin	-9.8%	2.9%	2.7%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	0.2%	14.1%	7.5%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Sh*	-164.3%	20.1%	12.2%
2 Working Capital Management			
a Gross Working Capital (Average Days)	73	49	11
b Net Working Capital (Average Days)	-30	-15	-57
c Current Ratio (Current Assets / Current Liabilities)	0.9	0.8	1.0
3 Coverages			
a EBITDA / Finance Cost	0.7	18.8	34.0
b FCFO / Finance Cost+CMLTB+Excess STB	0.3	0.7	2.4
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	-11.0	1.5	0.4
4 Capital Structure			
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	75.4%	23.2%	7.9%
b Interest or Markup Payable (Days)	17.5	166.4	41.7
c Entity Average Borrowing Rate	54.3%	13.5%	14.5%

Credit Rating

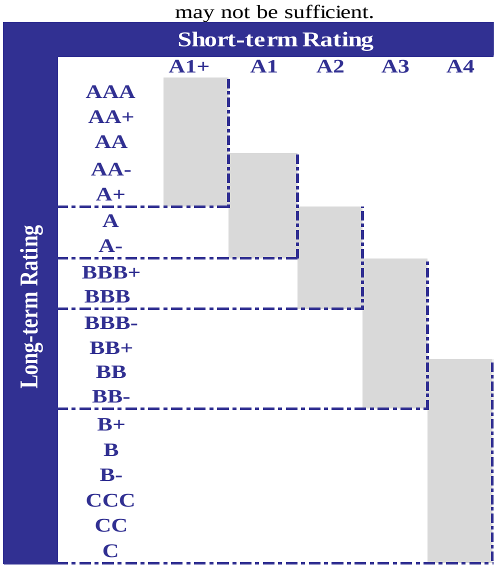
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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