The Pakistan Credit Rating Agency Limited

Rating Report

KTM Leather (Pvt.) Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
21-Mar-2024	BBB+	A2	Stable	Maintain	Yes
30-Mar-2023	BBB+	A2	Stable	Upgrade	-
30-Mar-2022	BBB	A2	Stable	Initial	-

Rating Rationale and Key Rating Drivers

KTM leather (Pvt.) Ltd ('KTM' or 'the Company') formerly known as Khawaja Tanneries (Pvt.) Limited is principally engaged in the manufacturing of a wide range of leathers from the rawhide to the crust and finished stages, both in Cow & 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 comprised five different segments i.e. Leather Gloves (31.8%), followed by Leather Apparel & Clothing (31.7%), Tanned Leather (18.9%), Leather footwear (16%), and other leather goods & accessories (1.7%). The tanned leather industry in Pakistan has experienced a downward trend for the past couple of years, with export volumes plummeting from 26 million sqm in FY18 to just 11 million sqm in FY23. This worrisome trend poses a significant business risk for the industry players. However, value-added leather export segments such as apparel & clothing, and footwear registered volumetric growth only. Total leather exports of the country also posted a decline of ~7% and recorded at $887mln as compared to $954mln SPLY due to shrinking in global demand caused by high inflation and geographical tensions i.e. Russia-Ukraine war, etc. The major potential export markets of industry are Italy, Vietnam, China, Hong Kong, Bangladesh, and Indonesia. Lack of technological advancements, skilled labor force, and introduction of low-priced alternatives can potentially hamper the overall growth of this industry. Nevertheless, a rising populace, increasing fashion trends, and depreciating exchange rates (for export-oriented sectors) 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 effects, volatility in global fashion trends, and local industrial developments. Margins of the Company are significantly dependent on improved topline. Further, the Company must build a strong capital base. The ownership structure is majorly represented by sponsoring family members. During the review period, the Company managed to sustain its topline mainly due to PKR depreciation, but volumes remained under pressure in line with the industry. Gross margins improved to 24.8% from 21.4% SPLY, but net profit margin reduced to 0.5% (FY22: 3.4%) due to an increase in borrowing cost. The financial risk profile of the Company is considered modest with dwindling coverages, cashflows, and working capital cycle. KTM's capital structure is leverage; encompassing STBs & humble equity.

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

Disclosure	
Name of Rated Entity	KTM Leather (Pvt.) Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Rating(Jul-23),Methodology | Correlation Between Long-term & Short-term Rating Scales(Jul-23),Methodology | Rating Modifiers(Apr-23)
Related Research	Sector Study | Leather(Mar-23)
Rating Analysts	Kanwal Ejaz | kanwal.ejaz@pacra.com | +92-42-35869504

Profile

Legal Structure KTM leather (Pvt.) Ltd ('KTM' or 'the Company') formerly known as Khawaja Tanneries (Pvt.) Limited 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 2,000 open and close pairs/day.

Ownership

Ownership Structure Mahmood Group owns absolute shareholding (100%) in the Company through family members. Mr. Muhammad Iqbal – eldest brother & previous chairperson for all group companies (Late) has died recently and all his stake has been transferred to his family members (28%). Mr. Muhammad Ilyas – Chairman and brother of Mr. Muhammad Iqbal owns 2.8% while Mr. Muhammad Younas – brother of Mr. Muhammad Iqbal owns 28%% stake. Remaining shareholding 12.61% each rest with two sons of Chairman – Mr. Mehr Ali and Mr. Muhamad Qasim. Masood Model Ginning Factories (Pvt) Ltd an associated Company holds 16%.

Stability Going forward, the Group is planning to establish a holding structure which is likely to result in improving the stability of KTM leather (Pvt.) Ltd . 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. Muhammad 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. Ilyas – Chairman has more than four decades of relevant industry experience while Mr. Muhammad Mehr Ali – CEO also has 16 years 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 M/S. 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 30th, 2023.

Management

Organizational Structure A 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. Mehr Ali, (CEO) son of Mr. Muhammad Ilyas. Mr. Mehmood Ahmad is the CFO of the company who is CA Finalist 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 entered into a contract with "System Haus" – a Brazilian vendor to acquire bespoke leather production software "Antara." It went Go-Live w.e.f. July 1st, 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 terms of sector share, apparel & clothing of leather contributed (32%) in total export market, accompanied by leather gloves (32%), tanned leather (19%), leather footwear (16%), & other leather products (2%). Pakistan's tanned leather industry shows devastating picture as it lost its exports by 55% in previous years, also declined by ~7% in FY23 . In FY23, Pakistan leather's average selling price per SQFT has increased to USD $ 1.41/SQFT from USD $ 1.20/SQFT.

Relative Position Company maintained its export market share of ~87% in FY23 and maintained its position as one of the largest Leather Exporters in Pakistan. It has sustained growth in its revenue at a consistently increasing pace. The Company's average selling price is 23% better than average selling price of Pakistan.

Revenues During FY23, it's topline clocked at ~PKR 4,004mln (FY22: ~PKR 3,950mln) registering growth of ~1.4% (FY22: ~23.8%). Export sales made up ~87.08% (FY22: ~87.6%) of total figure.

Margins During FY23, the Company's gross margin increased to ~24.8% (FY22: ~21.4%) on back of proportionate increase in the prices of finished leather sold. Operating profit margin also increased to ~9.5% in FY23 (FY22: ~8.1%) due to higher operating profits year-on-year. Net profit margin witnessed a slight decline in FY23 and stood at ~0.5% (FY22: ~3.4%).

Sustainability KTM leather (Pvt.) Ltd' management envisage sustainable footing in the local and international markets by investing in new technology and machines to enhance and facilitate its production lines. During the year, the Company has made investments to support different projects that includes installing Lime Split Machine and new Toggle Machine.

Financial Risk

Working Capital During FY23, the Company's gross working capital days has been increased to ~173 days (FY22: ~139 days, FY21: ~146 days). Average inventory days reduced to ~126 days (FY22: ~108 days, FY21: ~121 days). Whereas, average receivable days increased to ~46 days (FY22: ~31 days, FY21: ~26 days). However, the net working capital cycle also increased to ~61 days (FY22: ~41 days, FY21: ~44 days).

Coverages During FY23, the Company's free cash flows from operations (FCFO) marked at PKR ~323mln (FY22: PKR 340mln). Interest coverage ratio of the Company stood to 1.1x in FY23 (FY22: 3.3x) whereas core-debt coverage ratio remained at 0.8x (FY22: 1.7x, FY21: 1.7x).

Capitalization In FY23, the Company had a leveraged capital structure with a leveraging ratio of ~65% (FY22: ~61.3%, FY20: ~55.2%). Leveraging ratio increased year-on-year basis as the Company's borrowings ramped up to PKR 2,939mln in FY23 (FY22: PKR 2,077mln, FY21: PKR 1,303mln) mainly due to rise in STBs. Majority portion of the Company's debt is comprised of short-term borrowings FY23: ~80.5% (FY22: ~75.5%, FY21: ~77.3%) from various commercial banks.

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Financial Summary
PKR mln

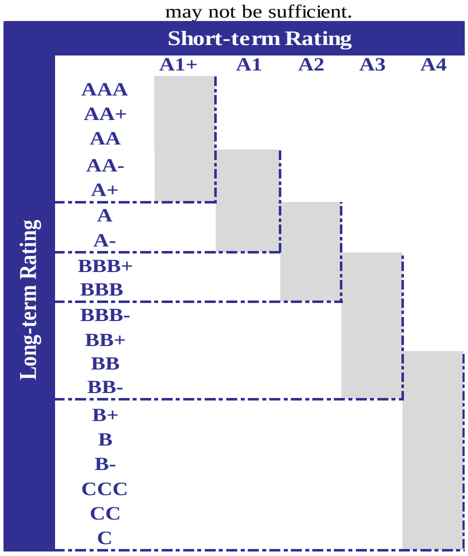
KTM Leather (Private) Limited Tanneries / Leather	Jun-23 12M	Jun-22 12M	Jun-21 12M	Jun-20 12M
A BALANCE SHEET				
1 Non-Current Assets	1,730	1,550	1,162	1,107
2 Investments	129	-	-	-
3 Related Party Exposure	-	-	114	-
4 Current Assets	4,199	3,230	2,099	1,860
a Inventories	*1,526*	*1,243*	*1,087*	*1,020*
b Trade Receivables	*588*	*429*	*246*	*208*
5 Total Assets	6,059	4,779	3,376	2,967
6 Current Liabilities	1,521	1,388	1,029	905
a Trade Payables	*1,283*	*1,174*	*946*	*842*
7 Borrowings	2,939	2,077	1,303	1,136
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	15	1	7	6
10 Net Assets	1,584	1,314	1,037	921
11 Shareholders' Equity	1,584	1,314	1,037	921
B INCOME STATEMENT				
1 Sales	4,004	3,950	3,190	2,262
a Cost of Good Sold	*(3,012)*	*(3,103)*	*(2,567)*	*(1,740)*
2 Gross Profit	992	847	623	522
a Operating Expenses	(610)	(528)	(410)	(338)
3 Operating Profit	382	319	213	184
a Non Operating Income or (Expense)	*(3)*	*(28)*	*17*	*(8)*
4 Profit or (Loss) before Interest and Tax	378	291	230	176
a Total Finance Cost	*(325)*	*(125)*	*(84)*	*(93)*
b Taxation	*(33)*	*(31)*	*(30)*	*(15)*
6 Net Income Or (Loss)	20	135	116	68
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*323*	*340*	*223*	*217*
b Net Cash from Operating Activities before Working Capital Changes	*82*	*261*	*162*	*118*
c Changes in Working Capital	*(665)*	*(667)*	*(293)*	*41*
1 Net Cash provided by Operating Activities	(584)	(406)	(131)	158
2 Net Cash (Used in) or Available From Investing Activities	(296)	(323)	(55)	(102)
3 Net Cash (Used in) or Available From Financing Activities	864	774	168	(70)
4 Net Cash generated or (Used) during the period	(16)	44	(18)	(14)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	1.4%	23.8%	41.0%	-14.7%
b Gross Profit Margin	24.8%	21.4%	19.5%	23.1%
c Net Profit Margin	0.5%	3.4%	3.6%	3.0%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	-8.6%	-8.3%	-2.2%	11.4%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Shareholders' Equity)]*	1.4%	11.5%	11.8%	8.5%
2 Working Capital Management				
a Gross Working Capital (Average Days)	173	139	146	197
b Net Working Capital (Average Days)	61	41	44	73
c Current Ratio (Current Assets / Current Liabilities)	2.8	2.3	2.0	2.1
3 Coverages				
a EBITDA / Finance Cost	1.2	4.0	4.2	3.1
b FCFO / Finance Cost+CMLTB+Excess STB	0.8	1.7	1.7	2.5
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	27.1	2.2	1.8	1.5
4 Capital Structure				
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	65.0%	61.3%	55.7%	55.2%
b Interest or Markup Payable (Days)	117.6	128.6	70.5	37.3
c Entity Average Borrowing Rate	12.1%	6.2%	5.1%	6.8%

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

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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(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)

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(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 | 17-(a)
(19) PACRA reviews all the outstanding ratings periodically, on annual basis; Provided that public dissemination of annual review and, in an instance of change in rating will be made; | Chapter III | 17-(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 | 17-(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 | 17-(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 | 14-3(f)(vii)
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