



Leather

Sector Study

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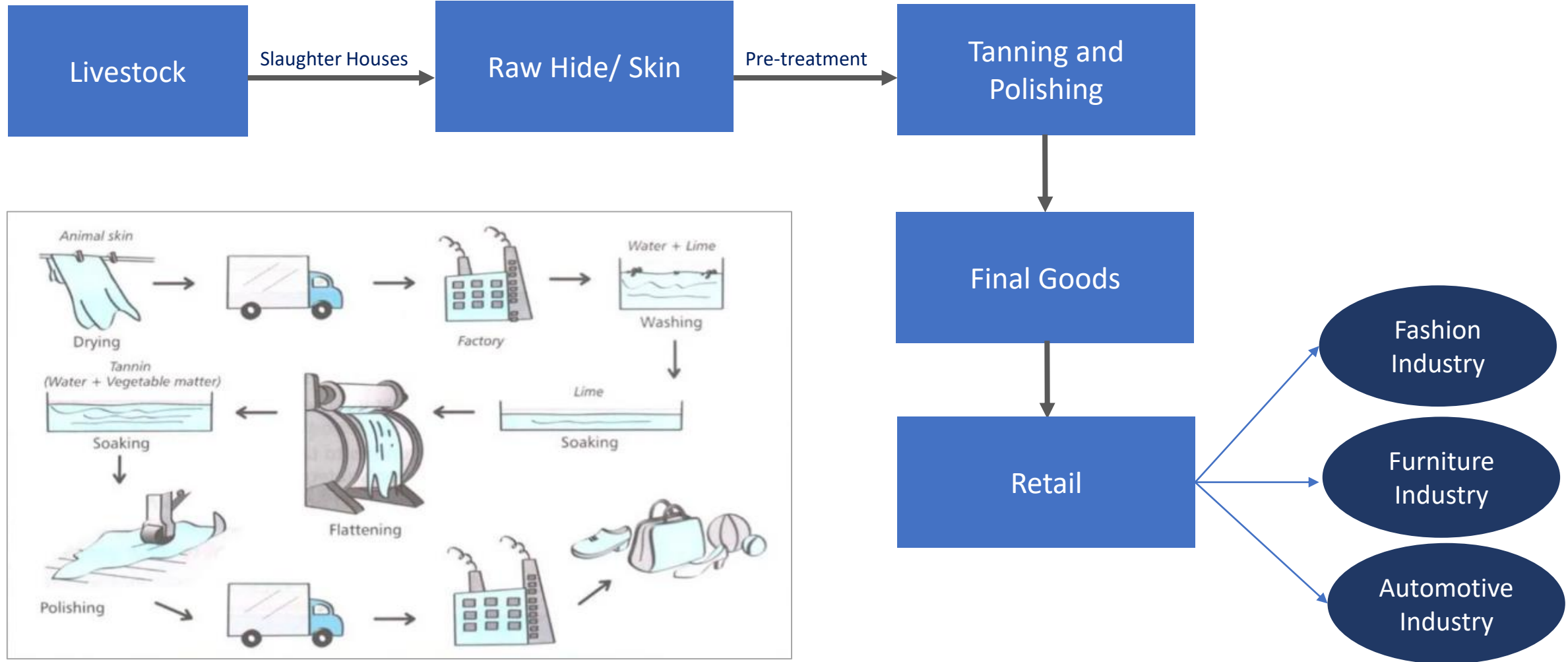
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Introduction

- Leather is one of the most widely traded commodities globally. The popularity of leather in various industries comes from its high tensile strength, good heat insulation, flexibility and durability.
- The primary raw material for leather industry is derived from slaughter houses and waste from the meat industry. This raw material is processed and converted into usable leather in tanneries. Hence, tanning industry is considered as one of the primary leather processing units in the entire leather industry.
- The demand in leather industry is driven by the fashion industry that includes footwear, garments, bags and belts. Apart from this, furniture and automotive industry also demand leather. The broad categories of leather industry include:
 - **Tanned leather:** Leather produced from treating skins and hides of animals.
 - **Garments:** includes leather jackets, long Coats, waist coats, pants, and accessories such as gloves.
 - **Footwear:** includes formal footwear, boots, sandals and clogs with leather uppers for both men and women.
 - **Bags and Belts:** includes wallets, handbags, backpacks, cosmetic cases, laptop bags and leather belts.
 - **Furniture:** majorly used for furniture covers.
 - **Automotive:** majorly used for car interior, especially seat covers.



Production Process



Global | Overview

- The global leather industry consisting of tanned leather, leather garments, gloves, bags & belts and footwear grew by ~20% YoY and reached a value of USD~441bln in CY22 (USD~370bln in CY21).
- Approximately USD~4.4bln of leather and leather products were traded globally in CY22. Leather Apparel was the highest traded category making up ~63% of exports followed by footwear (~30%) and tanned leather (~6%).
- In CY22, slowdown in global economic growth precipitated a decline in demand for leather exports. As indicated in the next slide, all three product segments experienced a significant decline in export revenues.
- Factors such as high cost of leather products and absence of developed supply chain in many major exporting countries is expected to hamper the growth of global leather market. However, increasing investment by well-known luxury brands and approach towards rising trends development, such as bio-leather products, are factors that are expected to create a whole new world of opportunities in the global leather industry.
- The leather production process from animal skins and hides is currently linked to various sustainability issues including deforestation, water wastage, gas emissions, and others. Multiple chemicals and gases are produced due to the tanning process and strict regulations have caused closure of some tanneries in Europe and U.S in the recent past. In the US, all tanneries must meet the Environmental Protection Agency waste standards which apply to disposal of liquid wastes into public waste treatment facilities. In Europe, there are several EU environmental regulations which have implications for tanneries.

Global Overview	CY21	CY22
Market Size (USD bln)	370.0	440.6
Leather Exports - CY21 (USD mln)		
Leather Apparel	7,395	
Leather Footwear	3,457	
Tanned Leather	802	
Total	11,654	

Global | Exports

- Based on available data, the top exporters in CY22 were Germany for leather apparel (market share: ~18%); Italy for tanned leather (market share: ~21%); and USA for leather footwear (market share: ~18%).
- Top importer of tanned leather in CY22 is Portugal with a share of ~17%. The top importer of leather apparel and leather footwear in CY22 is USA with a share of ~34% each in global imports.

Top Exporters - CY21 (USD mln)					
Leather Apparel CY21		Tanned Leather CY21		Leather Footwear CY21	
Poland	113	Egypt	18	Greece	7
UK	126	Hong Kong	24	Sweden	21
Türkiye	142	Spain	25	UK	28
USA	146	South Africa	31	Portugal	58
Hong Kong	198	China	44	Netherlands	76
Spain	205	Pakistan	53	Türkiye	80
Netherlands	256	Nigeria	70	Germany	84
Germany	405	Singapore	71	Spain	94
China	1,031	India	72	Poland	97
Italy	1,442	Italy	168	USA	136
Others	3,330	Others	226	Others	1,935
Total	7,395	Total	802	Total	3,457

Local | Overview

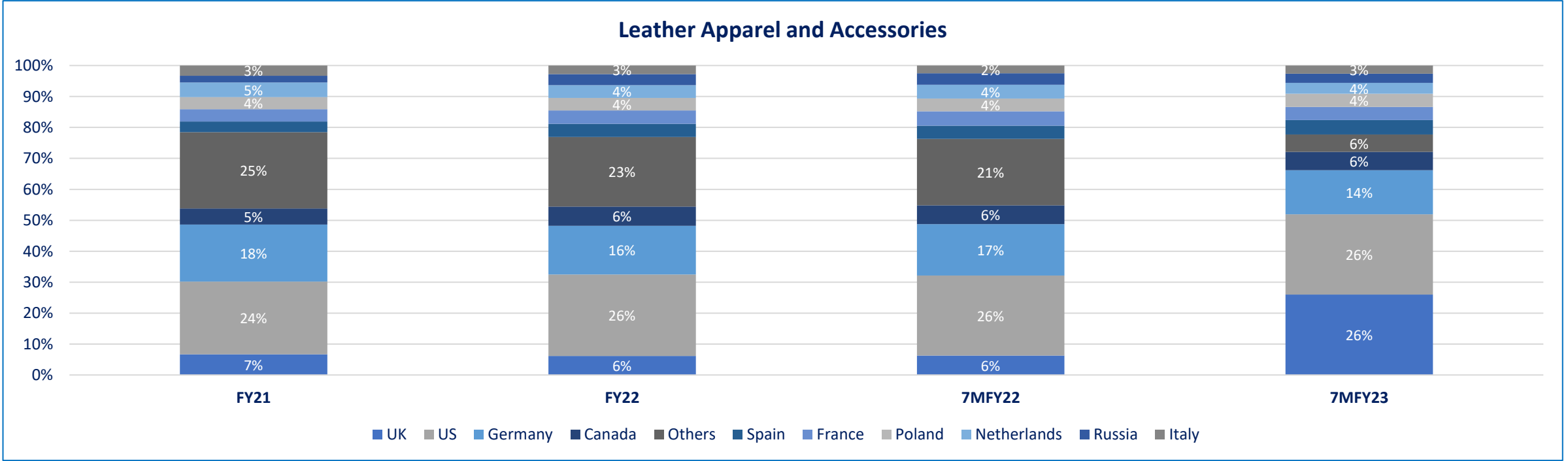
- Pakistan’s leather industry had a market size of PKR~178bln in FY22 (FY21: PKR~117bln). This increase has been attributable to an increase in the share of the leather in the large-scale manufacturing index in FY22 in addition to a value-based increase in the large-scale manufacturing amount.
- According to the Pakistan Tanners Association (PTA), Pakistan leather industry is ~95% export-oriented. Exports clocked in at PKR~169bln in FY22, up from PKR~111bln in FY21, depicting a growth of ~53%. The industry was helped by the surge in global and local demand following the resumption in economic activity after the COVID-19 pandemic. Leather exports accounted for ~3% of the country’s total exports in FY22.
- While the unit price per square meter of tanned leather fell from USD~13.5 to USD~12.9, or ~4%, in FY22, volumes increased by ~28%. Moreover, export volumes for other leather products also increased during FY22. Volume of leather garments registered an increase of ~38% while gloves and footwear surged by ~55% and ~2%, respectively.
- In 8MFY23 period, export revenue increased to PKR~149bln from PKR~115bln in the SPLY. Apart from an increase in the export volumes of leather footwear (increasing by ~44% from the SPLY), volumes across all other leather product segments declined due to a contraction in global economic growth and demand. During the same period, USD export revenue declined by ~4% (8MFY23: USD~617mln). This indicates that the key driver behind the export revenue growth was the devaluation of the average USD/PKR rate by ~30% in the same period.

Local Overview			
	FY21	FY22	8MFY23
Market Size (PKR bln)*	117	178	149
Market Cap (PKR bln)	53	52	31
Exports (PKR bln)	111	169	141
No. of players	~800 tanneries and 4 listed companies		
Exports Volume			
Leather Garments ('000 Dozen)	1,288	1,776	1,070
Leather Gloves ('000 Dozen)	6,911	10,696	6,258
Leather Tanned (MT)	12,558	16,077	7,200
Leather Footwear ('000 Pairs)	8,034	8,173	7,364
Industry Association			
<ul style="list-style-type: none"> • Pakistan Tanners Association (PTA) • Pakistan Leather Garments Manufacturers and Exporters (PLGMEA) • Pakistan Footwear Manufacturers Association (PFMA) 			

*Estimated based on internal calculations.

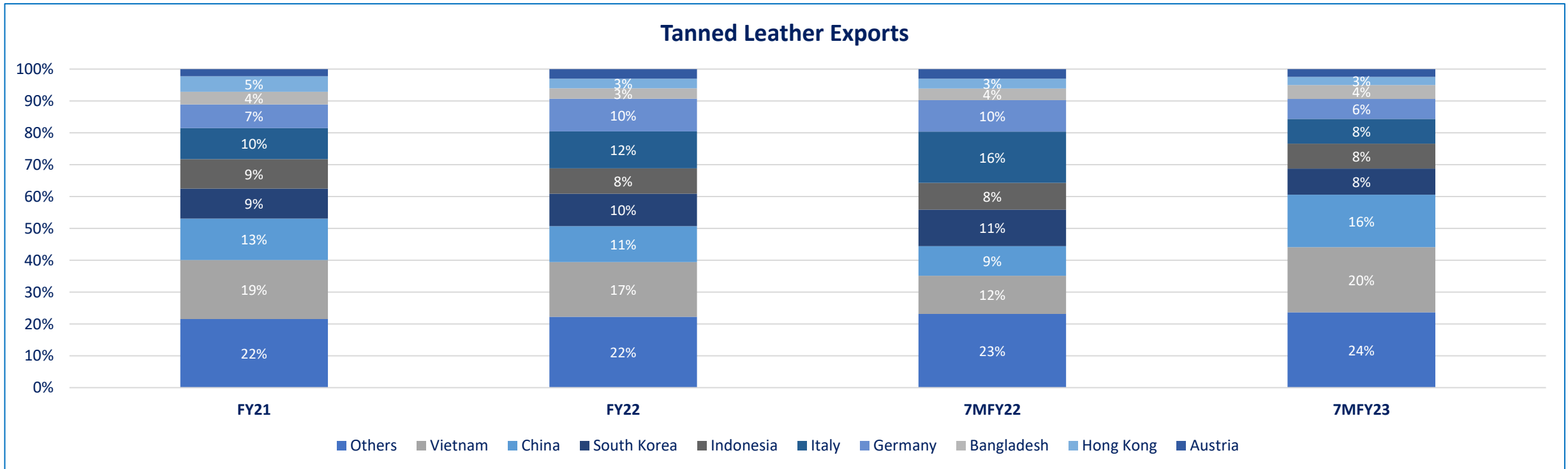
Local | Exports of Leather Apparel

- Pakistan’s export of leather apparel and accessories increased from USD~618mIn in FY21 to USD~705mIn in FY22. However, due to global recession and declining export volumes, export revenues in the 7MFY23 period amounted to USD~402mIn declining from the USD~411mIn level observed in the SPLY.
- The industry continues to be one of the five key export-oriented sectors (alongside textiles, sports goods, surgical goods and carpets) due to the fact that several of Pakistan’s leather products enjoy duty free access to the European Union (which is the largest consumer of leather goods globally) under the EU’s Generalized Scheme of Preferences (GSP+).
- Germany, USA, UK, France, and Italy are the most common export destinations for leather apparel and accessories.



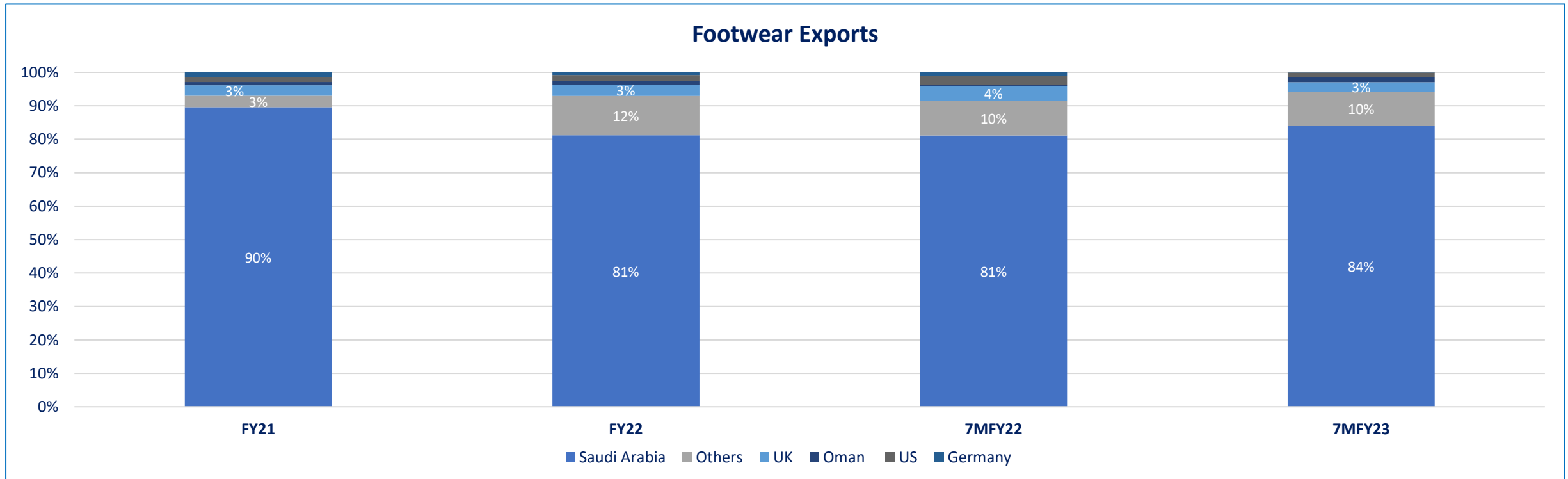
Local | Exports of Tanned Leather

- Pakistan’s tanned leather exports rose to USD~18mln by ~12.9% in FY22. However, in the 7MFY23 period, tanned leather exports dropped by ~10.2% to USD~31mln from the SPLY owing to global recessionary conditions which precipitated a decline in demand.
- Top tanned leather export destinations include Vietnam, China, South Korea, Indonesia and Italy.



Local | Exports of Footwear

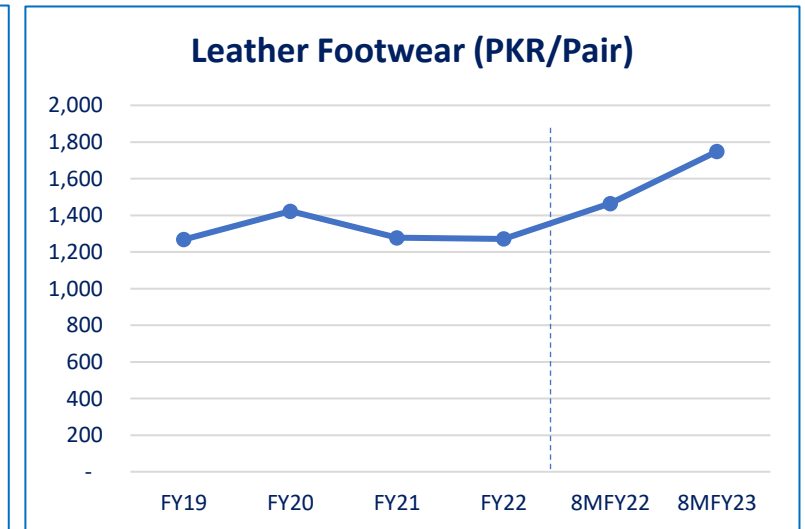
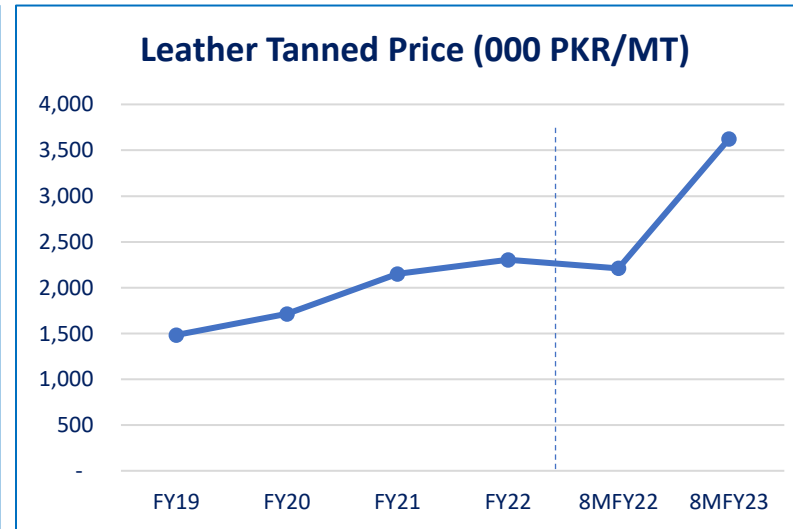
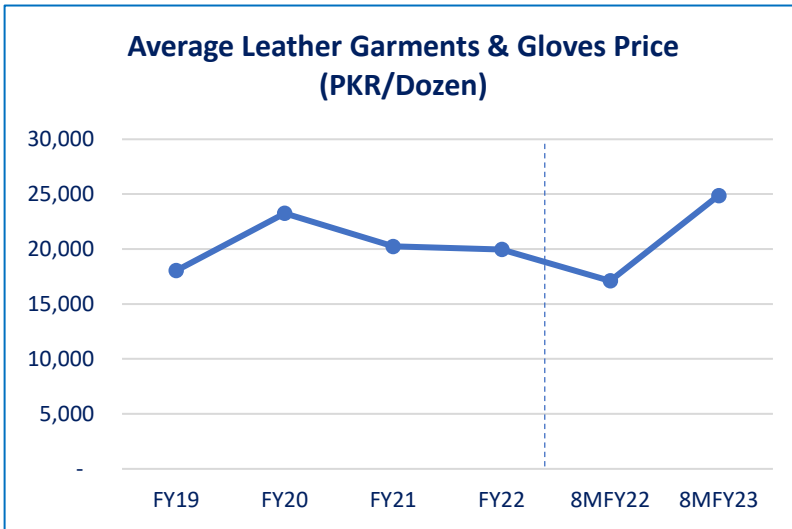
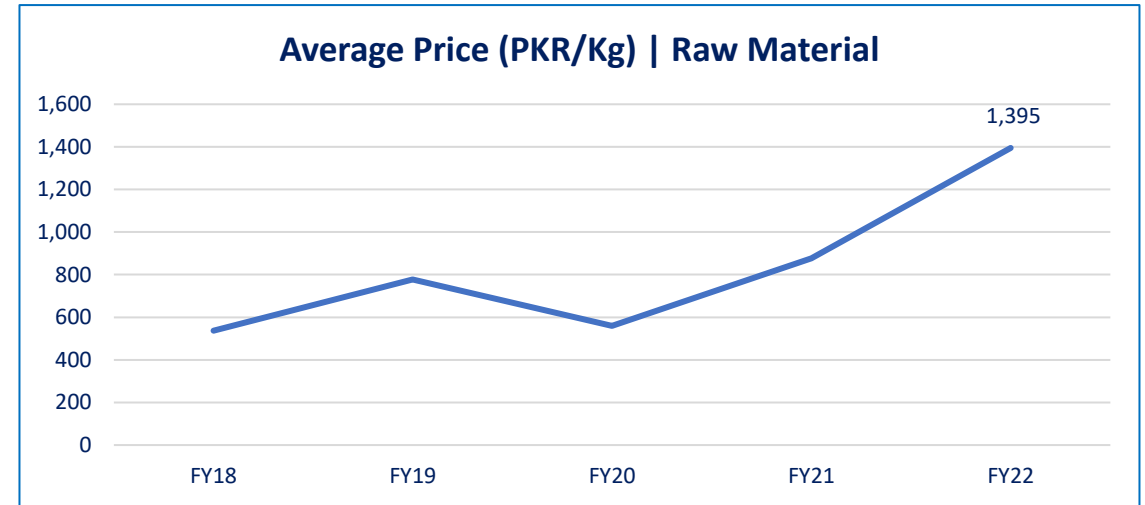
- Pakistan's footwear exports rose by ~17.2% to USD~18mln in FY22. Demand for footwear remained stable in the 7MFY23 period compared to the SPLY with export revenue equaling USD~9mln.
- Saudi Arabia is the top destination for footwear exports followed by the UK, Oman and US.



LEATHER

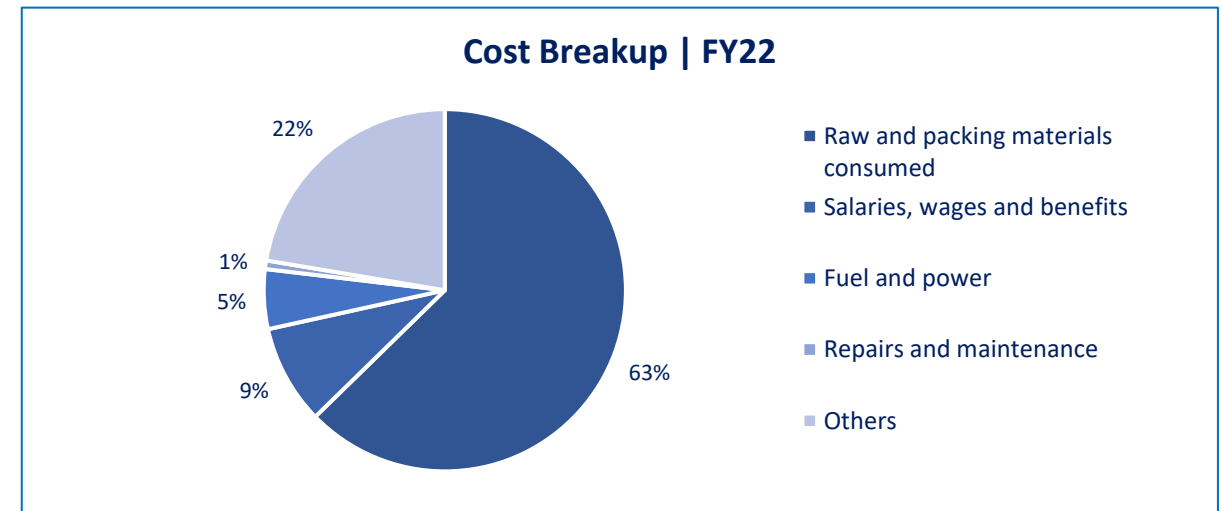
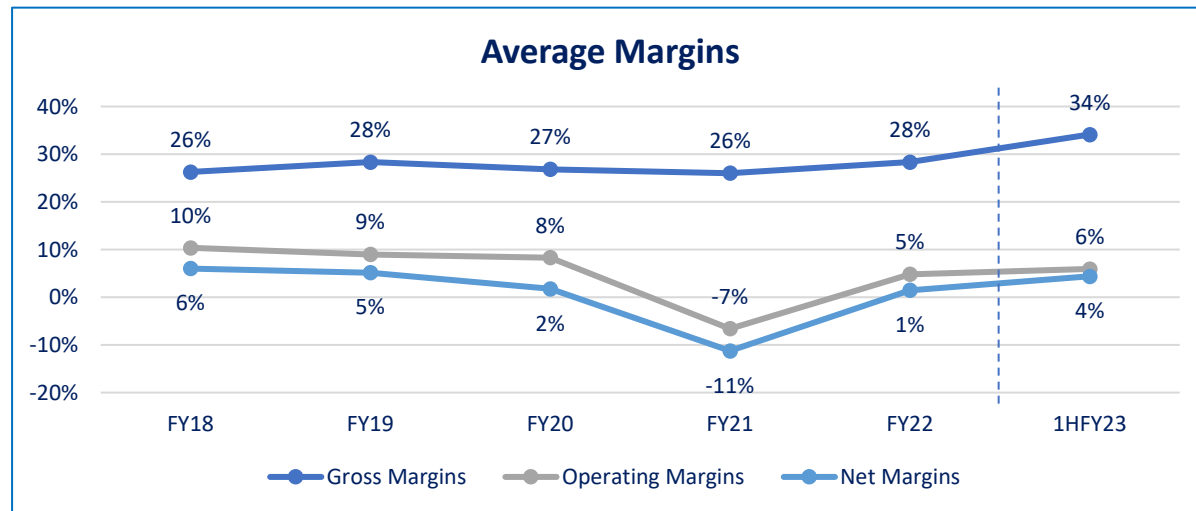
Business Risk | Prices

- Raw material for leather production largely includes raw hides and skins. Prices have been tracing an upward trend since FY20, and increased from PKR~876/Kg in FY21 to PKR~1,395/Kg in FY22.
- Average export prices for leather garment and gloves clocked in at PKR~24,872/Dozen during 8MFY23, an increase of ~45% compared with SPLY.
- Similarly, export prices for tanned leather recorded at PKR~3,624 thousand, a YoY increase of ~64%, while those for leather footwear were recorded at PKR~1,748/Pair, compared with PKR~1,564/Pair in SPLY.



Business Risk | Margins & Cost Structure

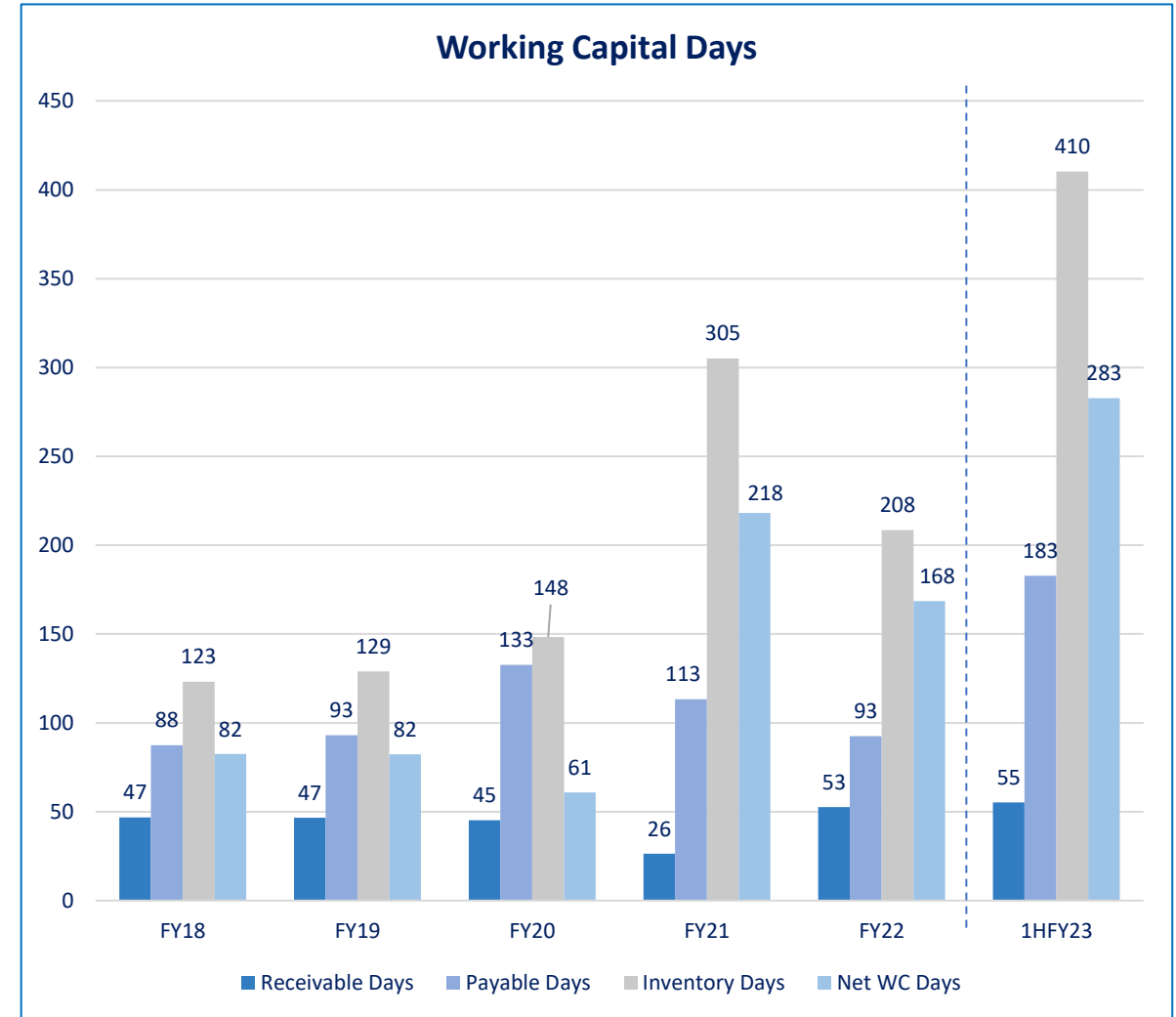
- The average gross margins of the leather sector for the past five years (FY18-22) remained largely stable standing at ~27%. In FY22, gross margins increased to ~28% (FY21: ~26%) while net margins increased to ~1% (FY21: ~-11%). FY22 proved to be a challenging year for the demand of leather and allied products as the export and local markets faced the impact of rising inflation. Sector players have met this challenge by increasing the prices of sold products.
- The increase in operating margins in FY22 comes on the back of efforts by local players to improve supply chain efficiency and efficient management of operating costs. Net profit margins also responded positively to management’s efforts of cost management and price increases to counter rising material costs, lower sales volume, higher energy costs and average increase in finance costs of ~68%.
- In the 1HFY23 period, estimated finance costs declined by ~35% owing to lower borrowings undertaken by one sector player. Whereas, the import bill of raw material increased by ~17.7% YoY during the same period, against declining volumes due to restrictions on LCs set in place by the SBP. Hence, increased gross margins are likely reflective of increased prices being passed on to consumers.
- Raw material and packing costs constitute ~63% of the total COGS, followed by salaries and wages (~11%) and fuel costs (~5%).



Note: Calculations are based on financials of 3 listed and 1 PACRA-rated client. 1HFY23 figures are based on estimated data

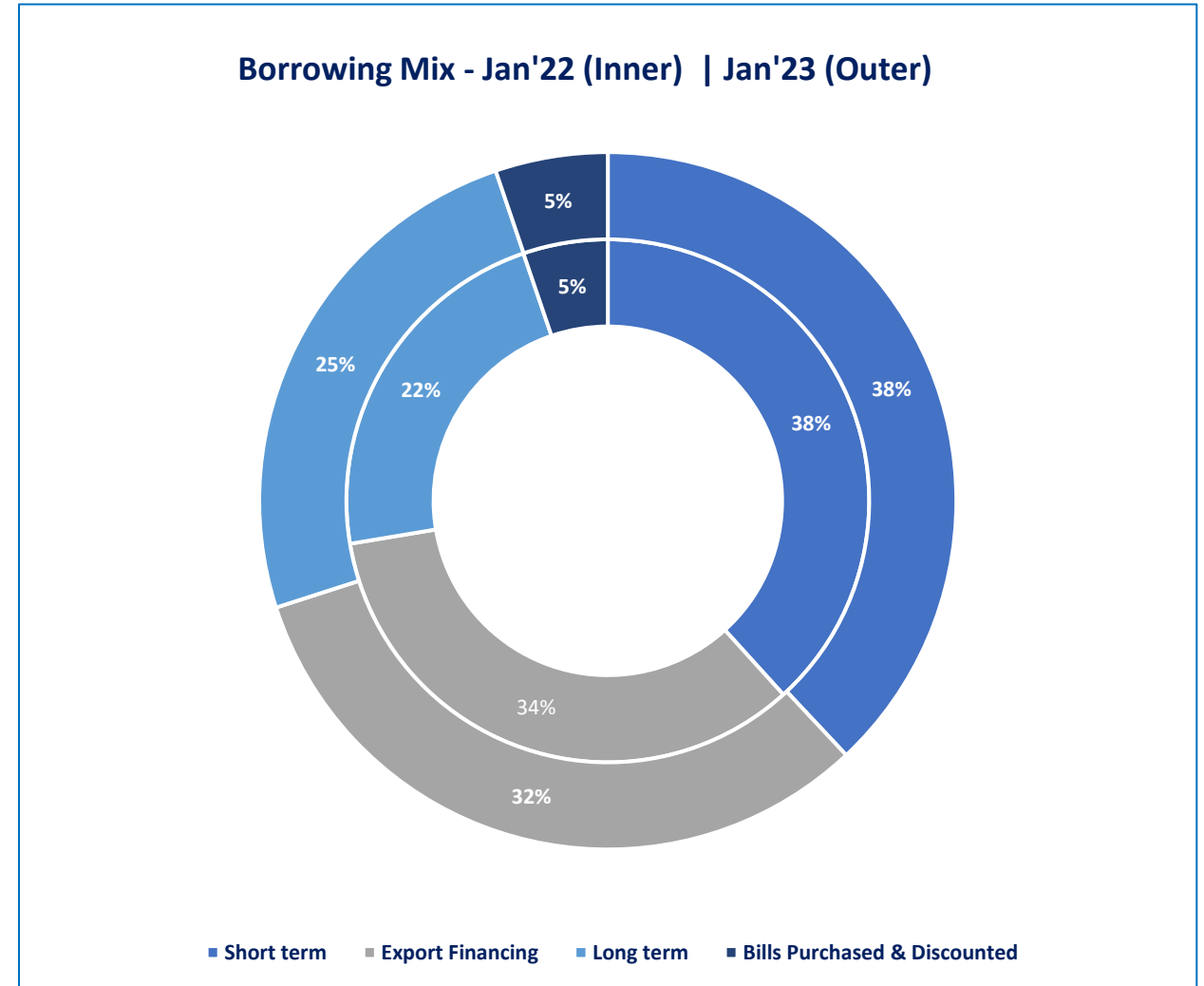
Financial Risk – Working Capital

- In FY22, net working capital days of the sector were recorded at ~180 days, down ~17% YoY (FY21: ~218 days).
- Net working capital days of the sector decreased due to a decrease in inventory days to ~222 days in FY22 (FY21: ~305 days).
- Receivable days of the sector were recorded at ~57 days during FY22 (FY21: ~36 days). Companies have sold their products at a credit of almost two months in FY22 which has risen from a period of one month. On the other side, payable days have reduced in FY22 in comparison to the level observed in FY21 (~99 versus ~113 days, respectively). This factor can have negative short-term liquidity implications.
- While inventory days reduced from FY21 to FY22 by ~83 days, much of this decline was attributable to a rise in cost of goods sold as opposed to a decline in inventory levels. In addition, a majority of the sector players experienced a buildup in inventory levels following a drop in local and export orders.
- In the 1HFY23 period, a dramatic increase was observed in the working capital days owing primarily to a sharp rise in inventory days after declining in FY22. This can be attributable to the slowdown in sales activity.



Financial Risk

- The total outstanding debt of the sector was recorded at PKR~53,274mln at End-Jan'23, as compared to PKR~46,841 at End-Jan'22, depicting a growth of ~14%.
- Short-term financing constitutes the major portion (~38%) of total debt as the sector is export-oriented.
- Export financing, which has been segregated from short-term borrowing, constitutes the second largest proportion standing at ~32% in End-Jan'23 (End-Jan'22: ~34%).
- Long-term financing constituted ~25% of total borrowing at End-Jan'23 (End-Jan'22: ~22%).
- The sector is moderately leveraged. Gearing ratio of the sector was recorded at ~46% during FY22 (FY21: ~40%).



Tax and Regulatory Structure

PCT Code	Description	Custom Duty		Additional Custom Duty		Regulatory Duty		Total	
		FY22	FY23	FY22	FY23	FY22	FY23	FY22	FY23
42.03	Articles of apparel and clothing accessories, of leather or of composition leather.	20%	20%	7%	6%	0%	50%	27%	76%
64.03	Footwear with outer soles of rubber, plastics, leather or composition leather and uppers of leather.	20%	20%	7%	6%	0%	20-40%	27%	56%
4202.112	Suit-cases, of leather or composition leather	20%	20%	7%	6%	0%	49%	27%	75%
4202.21	Handbags, whether or not with shoulder strap, including those without handle: With outer surface of leather or of composition leather	20%	20%	7%	6%	0%	49%	27%	75%
4202.31	Articles of a kind normally carried in the pocket or in the handbag: With outer surface of leather or of composition leather	20%	20%	7%	6%	0%	49%	27%	75%

SWOT Analysis

- Ample availability of raw material (hides and skins of animals) locally.
- Export-friendly government policies.

- Insufficient degree of advanced technology, resulting in higher cost of production as compared to international competitors.
- Lack of skilled labor force in the country
- Lack of strong presence in the global fashion market.

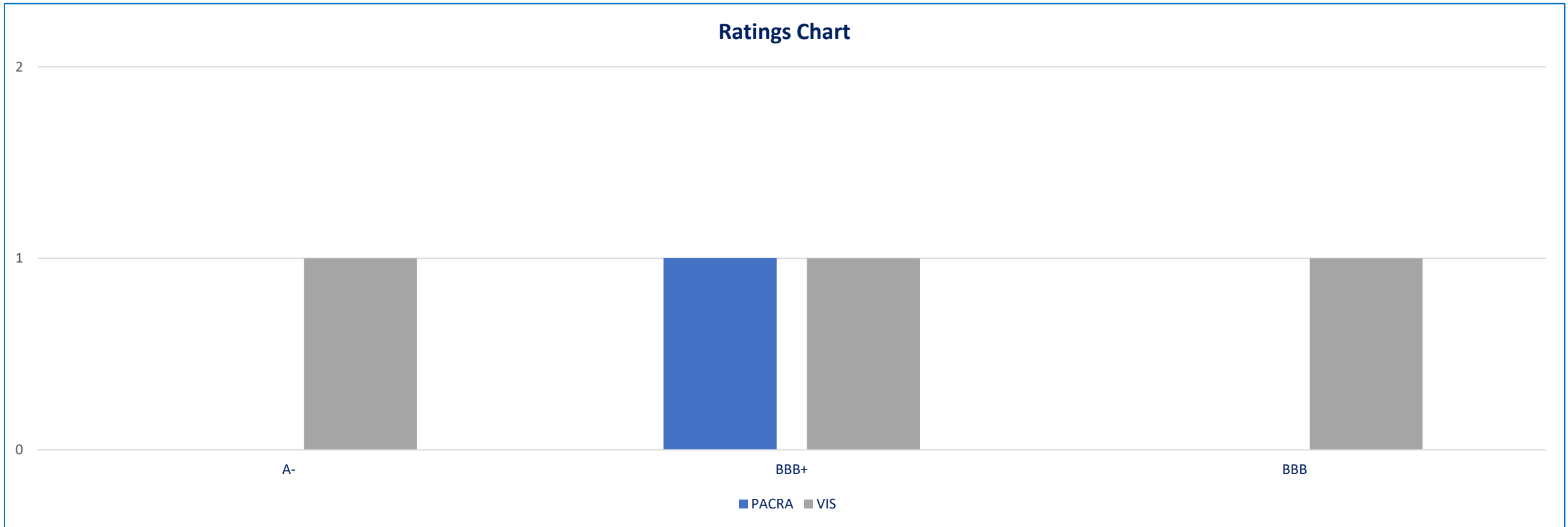


- Introduction of low-priced alternatives, such as synthetic leather.
- High concentration in the European market.

- Increasing fashion consciousness, resulting in a new market for leather garments and footwear.
- High untapped potential for exports in USA and China.
- Depreciating PKR, resulting in increased revenue.

Rating Chart

- PACRA rates only one client in the leather sector.
- The rating scale for the leather sector ranges from BBB to A-.



Outlook: Negative

- In FY22, Pakistan's Real GDP witnessed a growth of ~6.00% (FY21: ~5.70%) while the LSM index grew by ~12.00% (FY21: ~12.00).
- From Sep'21, inflationary pressures started to mount as global supply chain pressures resulted from an acceleration in demand. Accordingly, the SBP responded by raising the policy rate by 25 basis points to 7.25%. This rate hike was followed by a series of rate hikes throughout the remaining three quarters of FY22 as well as into the first eight months of FY23. The policy rate stood at 17.00% as at Jan'23 and this has been hiked by 300 basis points to 20.00% in Mar'23.
- This has led to an increase in EFS and LTFF rates to ~17.00% each in Mar'23, which, in turn has increased both subsidized and non-subsidized financing rates. As ~32.0% of the total sector borrowings in Jan'23 comprised EFS borrowings, increase in policy and EFS rates will negatively impact the sector's future profitability and squeeze margins.
- In addition, global inflation and economic slowdown have affected export volumes which, as outlined in the report, have decreased for all the categories except for leather footwear. This comes in the wake of a successful FY22 in which export volumes and revenues for the sector were promising. This global economic slowdown coupled with local inflationary conditions can deeply hurt sector revenue and profitability.
- Historically, the sector has been classified as a zero-rated export sector allowing it to benefit from subsidized gas tariffs and Regionally Competitive Energy Tariffs (RCET). However, in Mar'23, the GoP announced the cessation of the regional competitive energy electricity tariff of PKR~19.99/kWh (announced in Oct'22) while the RLNG tariff increased from USD 6.50/MMBTU to USD 9.00/MMBTU. This will likely reduce sector profitability and increase prices of the finished products.
- Moreover, gas shortage in the winter months of FY23 has meant that the industry had to rely on alternative fuel sources thereby increasing input costs.
- In the 7MFY23 period, the sector managed to achieve a growth of ~3.5% in production, indicating resilience in these difficult economic times.
- In the days to come, energy costs, interest rates, inflation and obsolete technology will prove significant hurdles in achieving growth. Beginning Mar'23, a 25% sales tax rate on luxury items has been imposed and several leather categories will be sold at this new rate. This will serve to further impair local demand.

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