# Service Global Footwear Limited



## Navigating success through diversified export excellence

*We reiterate our buy stance on Service Global Footwear Limited (SGF) with a Dec' 24 target price of PKR 76.4/share, offering an upside of 39% from current levels. Our liking for the stock is based upon:*

1. *Export market growth on the back of increased demand and dollarized revenue.*
2. *A robust consumer base providing pricing power, enabling the company to navigate rising raw material costs.*
3. *Stable gross margins attributed to local procurement of raw materials.*
4. *Anticipated massive contribution from SLM (Service Long March Tyres) due to increasing production capacity and growing demand both, locally and internationally.*
5. *Tax exemption and TERF-based loan for SLM due to greenfield investment.*

*We project the company to generate a 5-year forward earnings CAGR of 73.2%, hence, we recommend a 'BUY' on the scrip. Currently, the stock is trading at CY24F / CY25F PER of 6.2x / 3.8x.*

### Pinnacle in footwear exports: SGF's leading role in Pakistan

As a leading exporter of footwear, SGF has made significant strides in Pakistan's footwear export sector. In FY23, the country experienced a substantial 14% YoY growth in footwear exports, reaching USD 179mn. With a significant 32% market share in footwear exports, SGF is well-positioned to benefit from the increasing demand for footwear. In a short span, the company has achieved significant milestones, particularly evident in the improved overall performance. The company's top line has undergone a substantial improvement, attributed to the devaluation of the PKR, coupled with elevated footwear prices and augmented volumetric sales. In CY22, SGF reported a revenue of PKR 11.8bn, with export sales constituting 98% of the total revenue. In the coming five years, revenue is expected to grow at a 5-year CAGR of 28%. This impressive core revenue growth shows strong consumer confidence in SGF's product offerings.

### SGF's competitive edge in pricing

The company has consistently maintained a robust gross margin of approximately 20%. However, in CY22, the gross margins dipped to 18.6% due to increased raw material prices, inflationary pressures and delayed impact of pricing lag. However, during 9MCY23, the company's gross margins rebounded significantly, reaching 22.1%. We anticipate that SGF's gross margins will likely stabilize at 22% in CY24. This is attributed to the company's effective pricing strategies and a strong customer base, enabling it to offset cost pressures and maintain stable margins. It's noteworthy that over 90% of the company's leather requirement is sourced locally, covering about 47% of the total raw material cost. This localization strategy acts as a safeguard against PKR devaluation, contributing to the company's resilience in managing costs.

### Service long march's (SLM) role in shaping profit margins

Commercial vehicles, designed for extended travel and prolonged operational hours, face increased tire wear and tear, necessitating frequent replacements of TBR (Truck and Bus Radial) tires. Traditionally in Pakistan, the demand for TBR tires has been met through imports and the illegal smuggling of tires. However, SLM has pioneered a significant shift by becoming the first company to locally manufacture TBR tires within Pakistan, boasting an annual capacity of 740k units, which is expected to reach the capacity of 2.4mn units by FY28. The company is presently operating at 58% capacity utilization; however, this is expected to reach 85% in FY24 and FY25, fulfilling the

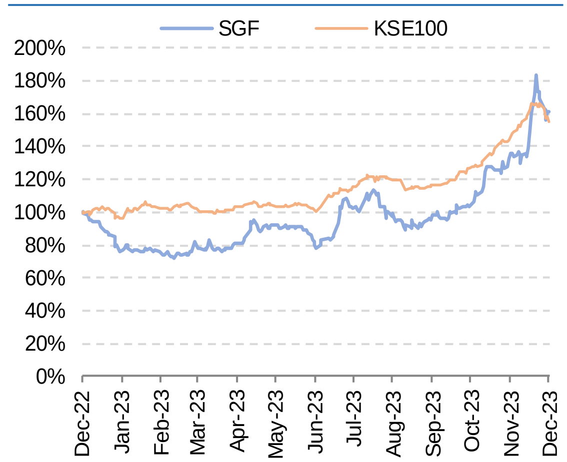
## SGF PA

### Summary Data

| | |
|---|---|
| Target Price (Dec'24) | 76.4 |
| Current Price | 55.0 |
| Upside (%) | 39.0% |
| Shares (mn) | 205.9 |
| Free float (%) | 20.0 |
| Market Cap. (PKR mn) | 11,315 |
| Market Cap. (USD mn) | 40 |
| **Major Shareholders** | **Service Industries Ltd.** |
| **Recommendation** | **BUY** |

| | 3M | 6M | 12M |
|---|---|---|---|
| Return (%) | 64.4 | 107.3 | 61.0 |
| Avg. Volume (000) | 309 | 258 | 152 |
| High Price - PKR | 61.8 | 61.8 | 61.8 |
| Low Price - PKR | 32.3 | 26.2 | 24.3 |

### Relative Performance




Source (s): PSX, AHL Research

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demand from both local and international markets. Additionally, the restrictions on smuggled vehicles have amplified demand for SLM, foreseeably contributing to a notable increase in the company's overall revenue.

**Exhibit: Valuation Snapshot**

| | | CY22A | CY23E | CY24F | CY25F |
|---|---|---|---|---|---|
| EPS* | PKR | 1.7 | 4.9 | 8.9 | 14.3 |
| DPS | PKR | 3.5 | 3.0 | 3.5 | 5.5 |
| P/E | x | 19.9 | 11.2 | 6.2 | 3.8 |
| P/B | x | 1.1 | 1.7 | 1.5 | 1.2 |

Source (s): Company financials, AHL Research, *@ 206mn Shares

## Valuation

We have valued Service Global footwear using the SoTP method including (DCF-based valuation of Service Long March) whereby our Dec'24 target price is set at PKR 76.4/share, which translates into an upside potential of 39% from the last closing of PKR 55.0/share. Our valuation parameters include a 5-year adjusted beta of 1.17x, a risk-free rate of 15.5%, and a risk premium of 6.0%, which gives a cost of equity of 22.5%. Currently, the stock is trading at CY24 and CY25 P/E of 6.2x and 3.8x, respectively. Hence, we recommend 'BUY' on the scrip.

**Valuation Criteria**

| | |
|---|---|
| Risk free Rate | 15.5% |
| Beta | 1.17 |
| Risk Premium | 6.0% |
| Cost of Equity | 22.5% |

Source (s): AHL Research

**Exhibit: Valuation Snapshot**

| (PKR mn) | CY24F | CY25F | CY26F | CY27F | CY28F |
|---|---|---|---|---|---|
| Profit after tax | 1,212 | 1,963 | 2,731 | 3,674 | 4,852 |
| Add: Depreciation | 282 | 331 | 381 | 433 | 486 |
| Capital Expenditure | (463) | (480) | (498) | (516) | (536) |
| ▲ in Working Capital | (1,058) | (1,121) | (970) | (704) | (1,004) |
| Free Cash Flow to Firm | (28) | 692 | 1,644 | 2,887 | 3,798 |
| Discounted Cash flows | (28) | 583 | 1,157 | 1,665 | 1,754 |

| | |
|---|---|
| Sum of PV | 5,132 |
| PV of terminal cash flows | 11,779 |
| Net Debt | (8,178) |
| Equity Value | 8,733 |
| Outstanding shares (mn) | 206 |
| Target Price (PKR/share) | 42.58 |

**SoTP**

| | |
|---|---|
| SGF Value | 8,733 |
| SLM Value (stake adjusted) | 6,935 |
| **Total** | **15,668** |
| **Total (PKR/share)** | **76.4** |

Source (s): Company Financials, AHL Research

# Service Global Footwear Limited



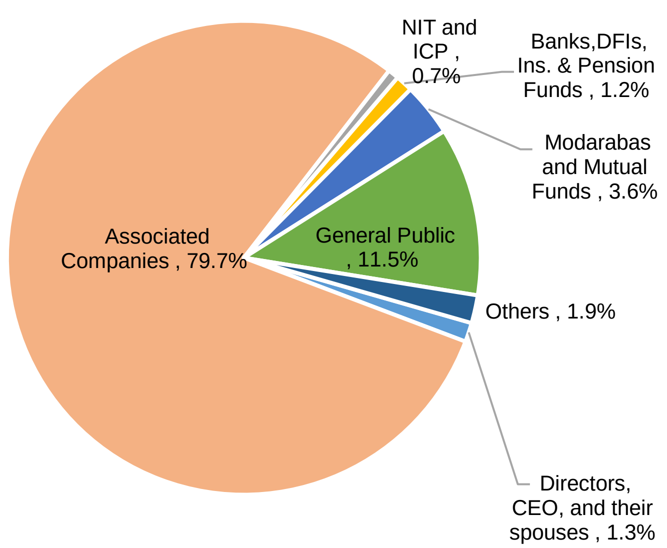
## About the Company

Service Global Footwear Limited (SGF), a subsidiary of Service Industries Limited – Servis group, has been a key player in the footwear industry since its integration into Service Industries Limited ("SIL") in 1988. However, a strategic demerger in 2019 transformed SGF into a distinct entity, aiming to capitalize on maximum tax and duty benefits available to export oriented units. Notably, SGF is the largest footwear exporter in Pakistan, contributing to over 32% of the total leather footwear exports. As part of its global footprint, SGF exports nearly 98% of its production to more than 20 countries across 5 continents.

The primary source of revenue comes from export sales to Europe (79.1%), followed by North America (11.5%). These export sales act as a safeguard against currency depreciation. Moreover, SGF stands out as the first solar-powered shoe manufacturer in Asia, boasting a remarkable solar electricity generation capacity of 2 MW.

The company holds 18.91% stake (Long term investment: PKR 2.4bn) in Service Long March (SLM), a pioneering venture by Service Industries Limited (SIL) into the production of "All Steel Radial" tires for trucks and buses (TBR Tyres). Pertinently, through a stock exchange notice, SGF has announced to further add up to PKR 1.5bn long term equity investment in SLM. Furthermore, SGF has also set up a wholly-owned subsidiary in China, Dongguan Service Global Limited (DSGL), to undertake procurement, marketing and product development activities for footwear products. China, being the hub of the global footwear industry, presents an opportunity for expanding the customer base and sourcing directly at optimum prices with maximum efficiency. This will also help SGF in reducing average procurement prices by 3% to 4%.

**Figure: Shareholding Pattern (as of Dec'22)**




Source (s): Company Financials, AHL Research

## Export surge propels impressive revenue growth

As the largest footwear exporter in Pakistan, SGFL plays a pivotal role, contributing to over 32% of the nation's total leather footwear exports. With an extensive global presence, SGFL exports nearly 98% of its entire production to more than twenty (20) countries across five (5) continents. The company establishes direct connections and onboard prospective clients, leveraging its physical presence in China to access new export markets. In CY23, the company added dedicated product lines through a strategic alliance with one of the largest footwear companies in the USA. Additionally, the management is in discussions with renowned European brands to initiate sourcing from SGF in the near future. Furthermore, the company has introduced a product line for safety footwear in response to increasing demand in European countries, with sales to commence in CY24.

SGFL exports nearly 98% of its entire production to more than twenty (20) countries across five (5) continents.

The company's total revenue clocked in at PKR 11.8bn in CY22. This revenue is diversified across various streams, making up PKR 11.5bn in export sales for CY22. Meanwhile, the local market contributed 2% (PKR 257mn) to total sales. Notably, SGFL's total production for CY22 reached to 3.6mn pairs of shoes, with capacity utilization of 95%.

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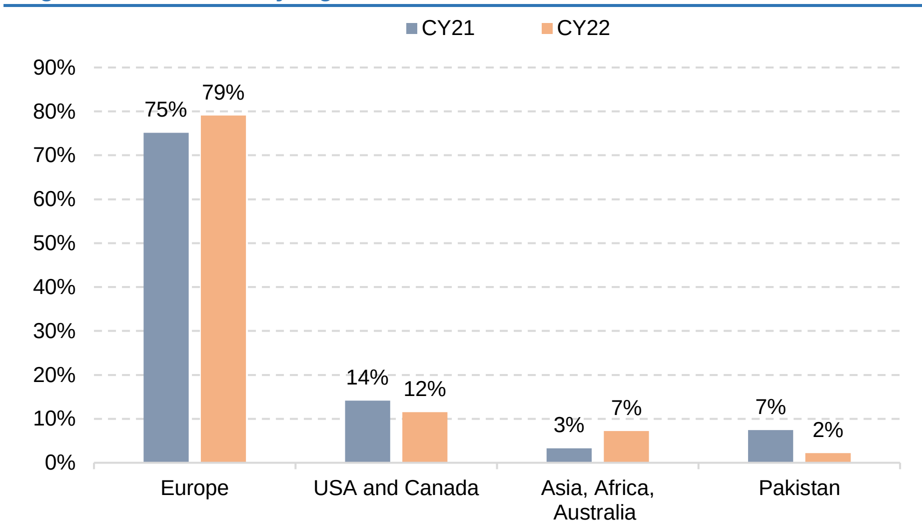
Moreover, the company has strategically capitalized on the depreciation of the PKR against the EURO to enhance its competitive pricing position, crucial for effective competition against regional players. SGF adeptly leverages advantages provided by the Government of Pakistan to export-related entities. Notably, the company benefits from subsidized borrowing through the Export Refinance Scheme (ERF), securing financing at rates below 3% of the SBP's policy rate. This facility is supporting the company in the current elevated interest rate scenario. As a licensed export-oriented unit (EOU), SGF enjoys privileges such as the ability to import plant & machinery, raw materials, packing materials, and accessories without incurring custom duties and taxes. Additionally, the company taps into government subsidies through schemes like custom duty drawbacks.

**Figure: Revenue mix by region**




Source (s): Company Financials, AHL Research

# Service Global Footwear Limited



## Strong pricing power

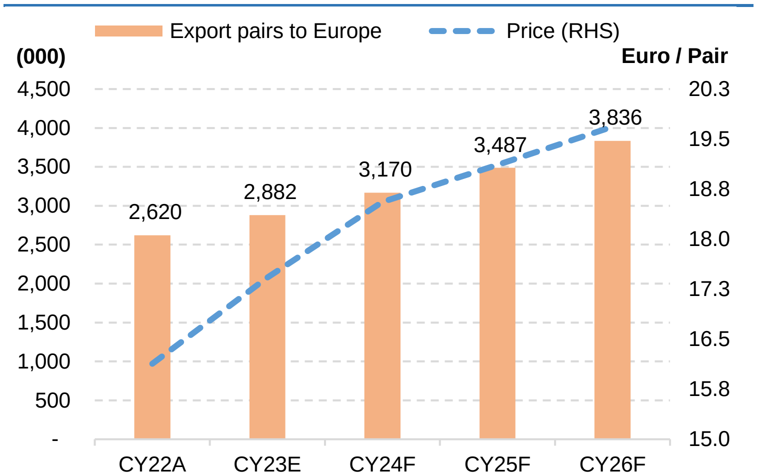
SGF demonstrated substantial profitability growth in CY22 as the company expanded its production capacity and profitability growth trend is likely to continue going forward, we view. The optimistic outlook is rooted in key factors, including a robust customer base, and expertise in stitch-and-turn shoe manufacturing. With a solid consumer foundation, SGF possesses the capability to seamlessly pass on any rise in costs to its customers. The company's well-established reputation for crafting top-quality shoes ensures that such cost pass-ons have negligible impacts on sales. Notably, SGF has a proven track record of effectively adjusting selling prices in response to increased raw material costs, instilling confidence that the company will adeptly navigate and continue passing on higher prices to its consumers. This is attributed to the company's effective pricing strategies and a strong customer base, allowing it to offset cost pressures and maintain stable margins.

## Locally sourced raw materials to help the gross margins...

Raw material costs contribute over 60% to the overall cost of goods sold, with 55% of the raw material sourced locally and the remainder imported. As a shoe manufacturer, leather is the primary raw material, and over 90% of it is procured locally. This is because imported leather prices are considerably higher, coupled with elevated duties, making locally sourced hides far more economical. The company has consistently maintained a robust gross margin of approximately 20%. However, in CY22, the gross margins dipped to 18.6% due to increased raw material prices and inflationary pressures. Nevertheless, by 9MCY23, the company's gross margins rebounded significantly, reaching 22.1%. Anticipating stability, we project that SGF's gross margins will likely stabilize at 22% in CY24.

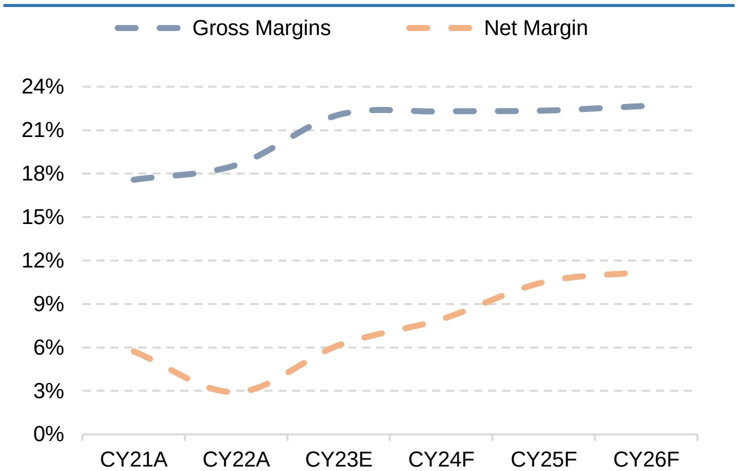
During 9MCY23, the company's gross margins rebounded significantly, reaching 22.1%.

**Figure: Export of pair of shoes**




Source (s): Company Financials, AHL Research

**Figure: Margins trend**




Source (s): Company Financials, AHL Research

# Service Global Footwear Limited



## Service Long March adding value to the company

SGF utilized the capital generated from its initial public offering (IPO) to secure an equity stake in Service Long March Tyres (Pvt.) Limited (SLM), establishing a shareholding position of approximately 18.9% in SLM. As a groundbreaking initiative in Pakistan's industrial landscape, Service Long March Tyres (Pvt) Limited stands out as the first facility to manufacture All-Steel Radial Truck & Bus Tyres. SLM is the first company in Pakistan to be granted Sole Enterprise Special Economic Zone and Greenfield Industrial Undertaking status, which entitles the company to duty- and tax-free import of plant and machinery and 10 years income tax exemption. SLM serves as a substantial contributor to the national exchequer, with projections estimating a contribution of approximately PKR 23bn in Custom Duties, Sales Tax, and Income Tax over its initial 10 years of commercial operations SLM commenced operations in FY23 with a production capacity of 740k tyres per annum. Phases 2 and 3 are poised to elevate production to 2.4mn tyres annually by CY28.

Internationally, the imposition of anti-dumping duties by the USA and Europe on imports from China has significantly impacted the Chinese market, leading to an increased demand for tires from Pakistan. Meanwhile, on the domestic front, the annual demand for tires is approximately 1.6mn, which is predominantly met through the illegal smuggling of tires. This creates a substantial opportunity for SLM, as there is ample demand for the company to address and fill the existing gap. SLM is well-positioned to capitalize on this demand surge, possessing a comprehensive line-up of tires to meet both local and international requirements.

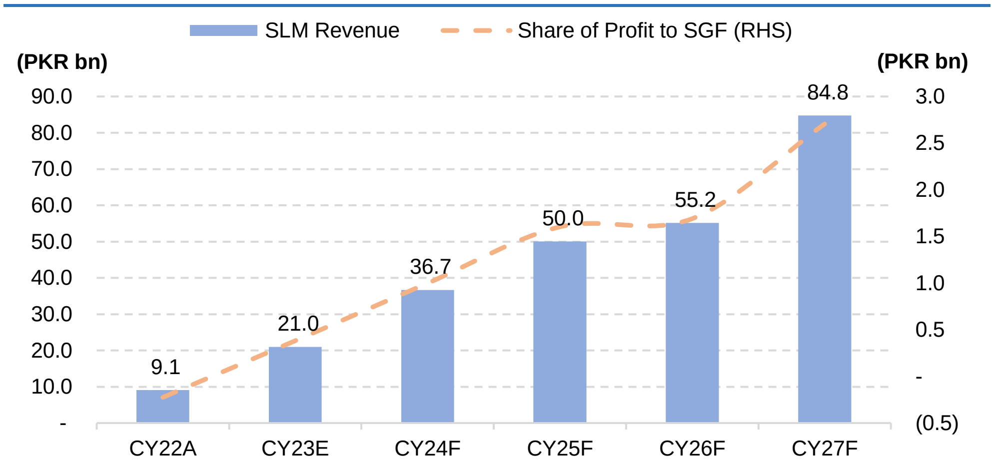
**Service Long March - Shareholding**

| | |
|---|---|
| Service Industries Limited | 32.1% |
| Chaoyang Long March Tyre Co. | 44.0% |
| Service Global Footware Limited | 18.9% |
| Myco Corporation | 5.0% |

SLM is currently serving the USA, Brazil, and the UAE markets. Although initially planning to export 85% of its production, with a targeted annual export projection of USD 70mn in FY23, the company experienced a shift in sales dynamics. Contrary to the plan, a significant portion of sales was fulfilled locally due to robust demand within the country. In FY23, net sales reached PKR 16.1bn, with only 28% contributed through exports, while the majority was met by the local market. Looking ahead to FY24, we anticipate sales to escalate to PKR 28.9bn, maintaining stable gross margins at 20.2%. The projected PAT for FY24 is expected to be PKR 2.7bn. Anticipating continued growth, we expect SLM to contribute PKR 999mn (EPS impact of PKR 4.85) in CY24. Moreover, with the commercial operation of phase 2 and phase 3, we foresee a substantial increase in its contribution, reaching PKR 2.7bn (EPS impact of PKR 13.1) by CY27. This trajectory highlights SLM's potential for sustained growth and a significant impact on earnings in the coming years.

A significant portion (72%) of sales was fulfilled locally due to robust demand within the country.

**Figure: SLM revenue and share of profit to SGF**




Source (s): Company Financials, AHL Research

# Service Global Footwear Limited



## Key Risk

- Unfavorable movements in currency exchange rates.
- The removal or modification of incentives by the government.
- Sustained periods of extremely high-interest rates could elevate the company's borrowing costs, impacting its financial health and operational capabilities.
- A surge in energy prices could lead to a higher cost of power for the company.
- Delays in the execution of the expansion plan
- Changes in international markets, trade relations, or economic downturns could influence demand for the company's products and services.

### Service GlobalFootwear Ltd. (SGF)

| Current Price | 55.0 | Upside | 39.0% |
|---|---|---|---|
| Target Price | 76.4 | Recommendation | BUY |

| PKR mn | CY22A | CY23E | CY24F | CY25F |
|---|---|---|---|---|
| **Income Statement Items** | | | | |
| Net Sales | 11,753 | 16,411 | 22,915 | 27,986 |
| Cost of Sales | 5,802 | 9,567 | 12,790 | 17,806 |
| Gross Profit | 5,951 | 6,844 | 10,125 | 10,180 |
| EBITDA | 1,342 | 2,931 | 4,466 | 5,987 |
| Operating Profit | 742 | 1,664 | 2,842 | 3,739 |
| Financial Charges | 467 | 1,163 | 1,199 | 835 |
| Profit Before Tax | 688 | 1,535 | 2,985 | 4,821 |
| Profit After Tax | 342 | 1,010 | 1,821 | 2,941 |
| **Balance Sheet Items** | | | | |
| Paid-up Capital | 2,051 | 2,051 | 2,051 | 2,051 |
| Total Equity | 6,165 | 6,559 | 7,662 | 9,475 |
| Current Liabilities | 7,683 | 10,857 | 11,891 | 11,876 |
| Non-Current Liabilities | 518 | 457 | 406 | 355 |
| Current Assets | 7,779 | 10,070 | 11,975 | 13,572 |
| Non-Current Assets | 6,586 | 7,803 | 7,985 | 8,134 |
| Total Assets | 14,365 | 17,873 | 19,960 | 21,706 |

| | Unit | CY22A | CY23F | CY24F | CY25F |
|---|---|---|---|---|---|
| **Per Share** | | | | | |
| Earnings* | PKR | 1.7 | 4.9 | 8.9 | 14.3 |
| Earning Growth | % | (15.2) | 195.3 | 80.3 | 61.5 |
| Dividend | PKR | 3.5 | 3.0 | 3.5 | 5.5 |
| Book Value | PKR | 30.1 | 32.0 | 37.4 | 46.2 |
| **Valuation** | | | | | |
| P/E | x | 19.9 | 11.2 | 6.2 | 3.8 |
| Dividend Yield | % | 10.6 | 5.5 | 6.4 | 10.0 |
| P/B | x | 1.1 | 1.7 | 1.5 | 1.2 |
| Payout Ratio | % | 209.8 | 60.9 | 39.4 | 38.4 |
| RoE | % | 5.3 | 15.9 | 25.6 | 34.3 |
| RoA | % | 2.5 | 6.3 | 9.6 | 14.1 |
| D/E | x | 1.0 | 1.3 | 1.1 | 0.8 |
| **Margins** | | | | | |
| Gross Margin | % | 18.6 | 22.1 | 22.3 | 22.4 |
| EBITDA Margin | % | 11.4 | 17.9 | 19.5 | 21.4 |
| Net Profit Margin | % | 2.9 | 6.2 | 7.9 | 10.5 |

Source (s): Company Financials, AHL Research, *@ 206mn shares

# Service Global Footwear Limited



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Arif Habib Limited (AHL) uses three rating categories, depending upon return form current market price, with Target period as Dec'24 for Target Price. In addition, return excludes all type of taxes. For more details kindly refer the following table;

| Rating | Description |
|---|---|
| BUY | Upside* of subject security(ies) is more than +15% from last closing of market price(s) |
| HOLD | Upside* of subject security(ies) is between -15% and +15% from last closing of market price(s) |
| SELL | Upside* of subject security(ies) is less than -15% from last closing of market price(s) |

### Equity Valuation Methodology

AHL Research uses the following valuation technique(s) to arrive at the period end target prices;

- **Discounted Cash Flow (DCF)**
- **Dividend Discounted Model (DDM)**
- **Sum of the Parts (SoTP)**
- **Justified Price to Book (JPTB)**
- **Reserved Base Valuation (RBV)**

### Risks

The following risks may potentially impact our valuations of subject security (ies);

- **Market risk**
- **Interest Rate Risk**
- **Exchange Rate (Currency) Risk**

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