The Pakistan Credit Rating Agency Limited

Rating Report

Sapphire Finishing Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
28-Nov-2019	A	A1	Stable	Maintain	-
29-May-2019	A	A1	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings of Sapphire Finishing Mills Limited reflect the Company's strong business profile emanating from international presence in the broader value chain. Rising global demand for value-added textiles and the Company's penetration into the apparel niche of work wear has led to continuous growth in the topline in recent years while business risk profile has improved with diversification into fashion apparel segment. Currency devaluation over FY19 has boded well for the Company's export-oriented topline while also reflecting in significantly improved margins. While margins are expected to normalize going forward, they are expected to remain strong due to recent installation of power boiler reflecting in reduced power cost. Financial risk profile has improved recently on the back of strong core operations. This is reflected in improved profitability and strong coverages. Over the years, the Company has built a trading portfolio which exposes it to market risk exhibited by volatility in the stock market, despite investments made predominantly in blue-chip stocks. While leveraging remains high, financing at concessionary rates by the SBP shields the Company against recent interest rate hikes. Ratings further incorporate association of the Company with the well-established Sapphire Group.

The ratings are dependent on sustaining business profile of the Company by maintaining profitability and margins achieved from core textile operations. Sustainability of non-core income and prudent management of surplus funds will be ratings critical.

Disclosure

Name of Rated Entity	Sapphire Finishing Mills Limited
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 | Composite(Nov-19)
Rating Analysts	Muhammad Hassan | muhammad.hassan@pacra.com | +92-42-35869504

Profile

Legal Structure Sapphire Finishing Mills Limited (Sapphire Finishing) is an unlisted, public limited company, incorporated in July 2000.

Background The Company commenced its commercial operations in November 2003. It is part of the Sapphire Group, one of the leading textile groups in Pakistan.

Operations Sapphire Finishing is engaged in processing, dyeing and finishing of fabric and stitching of garments (work wear and fashion apparel). Its production facilities are located at Manga Road, Raiwind, near Lahore. The Company has set up a ~5.5MW power boiler which became operational in February, 2019.

Ownership

Ownership Structure Sapphire Finishing is wholly owned by the Sapphire Group: ~8% of the Company's shareholding lies directly with individuals of the Abdullah Family while ~92% is owned indirectly through other Group companies.

Stability The presence of a Group holding company, Sapphire Holdings (Pvt.) Limited, as well as formal documentation capturing the family ownership structure bodes well for the stability of Sapphire Fibres.

Business Acumen Founded by Mr. Mohammad Abdullah in 1969, the Group has acquired expertise in composite textile. It further has interests in diversified sectors including textile, power, dairy and investment companies.

Financial Strength Sapphire Group is one of the largest vertically integrated textile set ups in Pakistan with group equity amounting to ~PKR 60bln at end-Jun18 while Group revenue amounted to ~PKR 103bln. The Group has shown willingness and ability to support the Company if the need arises.

Governance

Board Structure Sapphire Finishing has a seven-member Board chaired by Mr. Mohammad Abdullah. Overall, the Board comprises five sponsoring family members and two associates of the Sapphire Group, raising concern over its independent oversight function. Going forward, improvement in corporate governance structure is considered important.

Members' Profile Mr. Mohammad Abdullah has over five decades of textile experience and provides guidance to the management from time to time. The other Board members also have significant experience regarding textile and finance and have been associated with the Company for a reasonable period of time.

Board Effectiveness Attendance of directors in meetings remains satisfactory with all relevant information provided to them beforehand for discussion. No committees have been formed to assist the Board. The Company, does, however, have an internal audit function in place. However, this department reports to the CEO which compromises its effectiveness as an independent oversight resource.

Financial Transparency M/s. Shinewing Hameed Chaudhri & Co. is the external auditor of the Company and is currently placed in the category "B" on panel of auditors maintained by State Bank of Pakistan. The auditor gave an unqualified opinion on the Company's financial statements for the year ended June 30th, 2019.

Management

Organizational Structure The Company's overall operations are segregated into eight broad functional departments. Every department is categorized into sub-divisions to ensure smooth flow of operations with a large number of senior executives reporting directly to the CEO.

Management Team CEO – Mr. Yousuf Abdullah – has over 20 years of experience in the textile sector with expertise in dyeing, knitting and finishing. He is supported by a team of qualified and experienced professionals, most whom been associated with the Sapphire Group for a reasonably long time but are relatively new to the Company's management team.

Effectiveness While there are no formal management committees, MIS reports relating to daily operations are generated and submitted to senior management for discussion on regular basis along with need-based meetings for discussion of issues.

MIS The Company has implemented an Oracle based ERP solution – Oracle E business suite. Initially implemented in 2006, the system aids integration of business processes and aids the management in timely decision making.

Control Environment The Company's monthly MIS comprises comprehensive performance reports reviewed frequently by senior management. Testing of chemically treated cloth is outsourced to international labs to ensure quality control. Furthermore, the Company also has several certifications.

Business Risk

Industry Dynamics Pakistan's textile exports displayed negative YoY growth of ~1% in dollar terms in FY19. While some leading textile categories displayed strong volumetric growth, the hit to unit prices on account of exporters having to share the benefit of the currency depreciation with buyers, curbed overall growth. Recent economic policies including the reimposition of 10% duty on ginned cotton, removal of zero-rated status of the textile sector and sharp rise in interest rates has pressurized margins of industry players. Meanwhile, anticipated increase in reliance on imported cotton due to cotton crop shortfall is likely to impact margins of textile companies given the current tax structure of imported cotton,

Relative Position Sapphire Finishing contributed ~2% to the country's total export of ready-made garments during FY19 and 3MFY20. Due to penetration into work wear market, its margins are on the higher side.

Revenues Sapphire Finishing's sales mix, which was previously dominated by processed fabric, is gradually becoming more balanced as the Company has expanded into fashion garments. In FY19, processed fabric made up ~60% of the top line (FY18: ~67%, FY17: ~79%), followed by garments. The Company's topline amounted to ~PKR 21bln in FY19, a ~24% YoY increase attributable to the currency devaluation, volumetric increase in sales of fashionwear and better prices of workwear fetched in the international market. Revenues continued to show strong growth in 3MFY20, rising ~27% YoY to amount to ~PKR 5bln. The growth was led mainly by volumetric increase in sales of the garments segment resulting from full operations.

Margins Sapphire Finishing's gross margin improved significantly during FY19 amounting to ~18% (FY18: 13%) mainly due to the currency devaluation impact on the export-oriented topline as well as synergies achieved in fashion-wear production and higher workwear prices. The same translated into higher operating margin of ~12% (FY18: ~7%). Thus, despite a ~22% increase in the finance cost of the Company, net margin for the period amounted to ~10% (FY18: ~4%) with net profit clocking in at ~PKR 2bln (FY18: ~PKR 651mln). Performance maintained a strong trajectory in 3MFY20, with the bottomline amounting to ~PKR 388mln (3MFY19: ~PKR 142mln).

Sustainability The Company's margins have witnessed an unusual jump due to the currency devaluation; however, are likely to drop and sustain around ~14%, going forward, once the power boiler becomes operational. Diversifying into fashion garments has also enhanced profitability. This, added to the government's initiative to give subsidized RLNG supply to the textile sector and payment of outstanding refunds is expected to benefit the Company. Expected income from strategic investments in wind power sector are also expected to enhance the risk profile.

Financial Risk

Working Capital Sapphire Finishing finances working capital requirements through a mix of internal generation and short term borrowings. Production is order-based, generally keeping inventory levels low. During FY19, however, inventory was higher to cater to fashion-wear orders. As a result of this and a change in revenue recognition policy as per IFRS15, inventory days increased and net cash cycle resultantly rose to 69 days (FY18: 48 days). Net cash cycle continued to increase in 3MFY20 to 85 days as inventory levels increased to to cater to upcoming peak demand season. With conversion of booked orders into sales, this is expected to decline in 2HFY20. Meanwhile, the Company maintains an adequate borrowing cushion.

Coverages During FY19, operating cash flows witnessed a twofold increase, resulting from strong core operations and profitability. This led to the Company's interest coverage improving to ~8.7x (FY18: ~5.7x) while core coverage increased to ~3.5x (FY18: ~3.0x). Coverages continued to remained strong in 3MFY20 as the Company's borrowing predominantly comprises borrowing at the SBP's concessionary rates (~94%).

Capitalization Sapphire Finishing has a significantly leveraged capital structure (58%). However, leveraging has been declining since FY18 (~67%) as the Company is retiring long-term debt obtained to finance its fashion unit and power boiler. The Company has also previously utilized short-term borrowing lines to finance its trading portfolio. Financing at concessionary rates by the SBP, however, shields the Company against interest rate hikes. Going forward, since the Company is not looking at any major capacity expansion, leveraging is expected to continue to decline.

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Financial Summary
PKR mln

Sapphire Finishing Mills Limited Textile Composite	Sep-19 3M	Jun-19 12M	Jun-18 12M	Jun-17 12M
A BALANCE SHEET				
1 Non-Current Assets	7,955	8,082	8,084	5,668
2 Investments	1,778	1,068	1,247	1,787
3 Related Party Exposure	606	611	606	598
4 Current Assets	8,572	8,937	5,743	4,997
a Inventories	*4,334*	*4,342*	*3,108*	*2,121*
b Trade Receivables	*1,404*	*1,472*	*856*	*515*
5 Total Assets	18,910	18,698	15,680	13,050
6 Current Liabilities	3,104	3,109	2,171	1,894
a Trade Payables	*1,165*	*1,243*	*1,006*	*1,096*
7 Borrowings	9,149	9,297	8,980	6,847
8 Related Party Exposure	1	23	-	-
9 Non-Current Liabilities	-	-	-	-
10 Net Assets	6,656	6,269	4,529	4,309
11 Shareholders' Equity	6,656	6,269	4,529	4,309
B INCOME STATEMENT				
1 Sales	5,097	21,028	16,966	14,823
a Cost of Good Sold	*(4,266)*	*(17,254)*	*(14,849)*	*(13,337)*
2 Gross Profit	831	3,774	2,117	1,486
a Operating Expenses	(294)	(1,215)	(954)	(930)
3 Operating Profit	536	2,559	1,163	556
a Non Operating Income	*16*	*(48)*	*(18)*	*95*
4 Profit or (Loss) before Interest and Tax	552	2,511	1,145	651
a Total Finance Cost	*(113)*	*(399)*	*(328)*	*(275)*
b Taxation	*(51)*	*(89)*	*(167)*	*(125)*
6 Net Income Or (Loss)	388	2,023	651	251
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*701*	*2,967*	*1,549*	*898*
b Net Cash from Operating Activities before Working Capital Changes	*568*	*2,632*	*1,177*	*460*
c Changes in Working Capital	*(385)*	*(1,171)*	*(564)*	*(607)*
1 Net Cash provided by Operating Activities	183	1,461	612	(147)
2 Net Cash (Used in) or Available From Investing Activities	(783)	(694)	(2,731)	(1,847)
3 Net Cash (Used in) or Available From Financing Activities	(148)	318	2,130	2,006
4 Net Cash generated or (Used) during the period	(748)	1,084	11	12
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-3.0%	23.9%	14.5%	5.5%
b Gross Profit Margin	16.3%	17.9%	12.5%	10.0%
c Net Profit Margin	7.6%	9.6%	3.8%	1.7%
d Cash Conversion Efficiency (EBITDA/Sales)	14.9%	15.5%	10.7%	8.0%
e Return on Equity (ROE)	24.0%	37.5%	14.7%	6.0%
2 Working Capital Management				
a Gross Working Capital (Average Days)	103	85	71	59
b Net Working Capital (Average Days)	82	65	48	32
c Current Ratio (Total Current Assets/Total Current Liabilities)	2.8	2.9	2.6	2.6
3 Coverages				
a EBITDA / Finance Cost	8.0	9.6	6.7	5.4
b FCFO / Finance Cost+CMLTB+Excess STB	2.8	3.5	3.0	2.6
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	1.6	1.6	3.4	3.3
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	57.9%	59.7%	66.5%	61.4%
b Short-Term Borrowings / Total Borrowings	0.6	0.6	0.5	0.7
c Average Borrowing Rate	4.1%	3.7%	3.4%	3.8%

Credit Rating Scale & Definitions

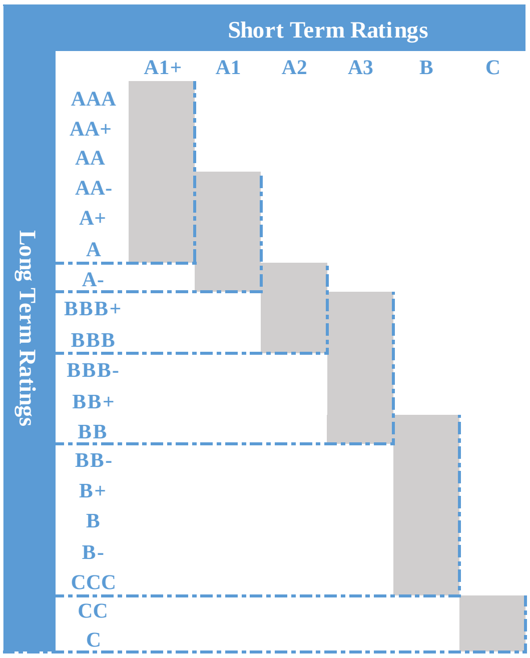
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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

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