



The Pakistan Credit Rating Agency Limited

Rating Report

Sapphire Finishing Mills Limited

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Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
27-Nov-2020	A	A1	Stable	Maintain	-
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 an international presence in the broader value chain of late, business profile declined due to the negative impact of COVID-19 pandemic and withdrawal of zero-rated sales tax. During FY20, Company's gross, operating and net margins also showed declined. Over the years, the Company has built a trading portfolio that exposes it to market risk exhibited by volatility in the stock market, though investments are made predominantly in blue-chip stocks. An investment book (~PKR 3bln, ~40% of equity) built over the years by deploying surplus funds augments the Company's liquidity profile. Reduction in policy rates and the moratorium relief by SBP provided respite to the whole sector. The markets gradually opened in some parts of the world towards the end of 1QFY21. Going forward, the second wave of the pandemic has begun its course and lockdowns may be a cause of concern. However, the business community is expected to continue operations under strict SOPs, both; locally and in most of the export destinations of the Company. The Company took the SBP facility of deferment of the principal amount of the long-term loan. Financial risk of the company has breathing space due to the deferment facility resulting in an improvement in debt coverages. Ratings further incorporate the 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-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	Fahad Iqbal fahad.iqbal@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 Finishing.

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 textiles set ups in Pakistan with Group has an annual turnover of over US \$800 million with an asset base of over US \$500 million. 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 the 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, 2020.

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 The Covid-19 has severely hampered the demand for the country's textile exports during the last five months. The World is again going down in lock down where second wave and related ramifications are yet to be comprehended. The demand for textile products internationally deteriorated on account of lockdowns in major export destinations, the export market had under-performed in 2MFY21. Exports in the textile sector saw a dip in August 2020 after posting a growth in the first month. However, textile exports of the country increased by ~18% for 3MFY21 to stand at ~USD 1.19bln as compared to ~USD 1.007bln in 2MFY21 as the demand started to stabilize. Locally, the textile sector has found comfort in relief measures introduced by the State Bank of Pakistan such as deferment of loan payments for one-year, low-interest rates and salary refinance scheme.

Relative Position Sapphire Finishing contributed ~1% to the country's total export of ready-made garments during FY20. Due to penetration into the workwear 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 FY20, the top line decreased by ~3.5% clocking at ~PKR 20,284mln (FY19: ~PKR 21,028mln) attributable to the pandemic situation all around the world and the discontinuation of zero-rated sales tax policy. The revenue is dominated by export sales consisting of ~92% of total sales.

Margins Sapphire Finishing's gross margin declined slightly during FY20 amounting to ~17% (FY19: 18%) mainly due to the reduction in the revenues. Similarly, operating margin of the Company declined slightly and clocked at ~10.2% in FY20 (FY19: ~12.2%). Thus, despite a ~14% increase in the finance cost of the Company, the net margin for the period amounted to ~7.3% in FY20 (FY19: ~9.6%) with net profit clocking in at ~PKR 1,475mln in FY20 (FY19: ~PKR 2,023mln).

Sustainability Due to COVID-19, the Company suffered specially during the lockdown but the Company managed to sustain well. The Company has opted to avail relaxations introduced by SBP which will ease pressure on cashflows. Recently, with relaxation in the Company's export markets' lockdowns, export orders have started to come which may have a positive impact.

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 FY20, however, inventory was higher due to pandemic situation. As a result of this inventory days increased and net cash cycle resultantly rose to 73 days in FY20 (FY19: 65 days). Meanwhile, the Company's cushion at trade assets level clocked at ~33% in FY20 (FY19: ~1%).

Coverages During FY20, operating cash flows witnessed a decrease and stood at ~PKR 2,514mln (FY19: ~PKR 2,967mln), resulting from lower profitability. This led to the decline in Company's interest coverage ~6.4x in FY20 (FY19: ~8.7x) due to higher finance cost, though remained strong. Core debt coverage increased to ~5.6x in FY20 (FY19: ~3.5x) due to lower CMLTD.

Capitalization Sapphire Finishing has a moderately leveraged capital structure though decreased in FY20 to ~58% (FY19: ~60%). Leveraging continues to decline 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.



Sapphire Finishing Mills Limited Textile Composite	Jun-20 12M	Jun-19 12M	Jun-18 12M
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A BALANCE SHEET

1 Non-Current Assets	8,417	8,082	8,084
2 Investments	2,194	1,068	1,247
3 Related Party Exposure	800	611	606
4 Current Assets	9,927	8,937	5,743
a Inventories	3,821	4,342	3,108
b Trade Receivables	1,092	1,472	856
5 Total Assets	21,338	18,698	15,680
6 Current Liabilities	3,182	3,109	2,171
a Trade Payables	1,416	1,243	1,006
7 Borrowings	10,490	9,297	8,980
8 Related Party Exposure	1	23	-
9 Non-Current Liabilities	-	-	-
10 Net Assets	7,665	6,269	4,529
11 Shareholders' Equity	7,665	6,269	4,529

B INCOME STATEMENT

1 Sales	20,284	21,028	16,966
a Cost of Good Sold	(16,932)	(17,254)	(14,849)
2 Gross Profit	3,352	3,774	2,117
a Operating Expenses	(1,286)	(1,215)	(954)
3 Operating Profit	2,065	2,559	1,163
a Non Operating Income or (Expense)	93	(48)	(18)
4 Profit or (Loss) before Interest and Tax	2,158	2,511	1,145
a Total Finance Cost	(456)	(399)	(328)
b Taxation	(226)	(89)	(167)
6 Net Income Or (Loss)	1,475	2,023	651

C CASH FLOW STATEMENT

a Free Cash Flows from Operations (FCFO)	2,514	2,967	1,549
b Net Cash from Operating Activities before Working Capital Changes	2,124	2,632	1,177
c Changes in Working Capital	466	(1,171)	(564)
1 Net Cash provided by Operating Activities	2,590	1,461	612
2 Net Cash (Used in) or Available From Investing Activities	(2,309)	(694)	(2,731)
3 Net Cash (Used in) or Available From Financing Activities	1,193	318	2,130
4 Net Cash generated or (Used) during the period	1,474	1,084	11

D RATIO ANALYSIS

1 Performance			
a Sales Growth (for the period)	-3.5%	23.9%	14.5%
b Gross Profit Margin	16.5%	17.9%	12.5%
c Net Profit Margin	7.3%	9.6%	3.8%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	14.7%	8.5%	5.8%
e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Sh.	20.5%	35.1%	15.7%
2 Working Capital Management			
a Gross Working Capital (Average Days)	97	85	71
b Net Working Capital (Average Days)	73	65	48
c Current Ratio (Current Assets / Current Liabilities)	3.1	2.9	2.6
3 Coverages			
a EBITDA / Finance Cost	7.8	9.6	6.7
b FCFO / Finance Cost+CMLTB+Excess STB	5.6	3.5	3.0
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	1.9	1.6	3.4
4 Capital Structure			
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	57.8%	59.7%	66.5%
b Interest or Markup Payable (Days)	73.7	80.3	86.8
c Entity Average Borrowing Rate	4.0%	3.7%	3.2%

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.

Scale	Long-term Rating Definition
AAA	Highest credit quality. Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
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.
AA-	
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.
A-	
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.
BBB-	
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.
BB	
BB-	
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.
B-	
CCC	
CC	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.
C	
D	Obligations are currently in default.

Scale	Short-term Rating 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 conditions.
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 surveil 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):

<p>Entities</p> <ul style="list-style-type: none"> 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 	<p>Instruments</p> <ul style="list-style-type: none"> a) Basel III Compliant Debt Instrument Rating b) Debt Instrument Rating c) Sukuk Rating
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- 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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- (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.
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- (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)
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- (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)
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- (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)

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