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
26-Nov-2021	A	A1	Stable	Maintain	-
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; enabling the Company to manage volatility in the textile industry. Sapphire Finishing is engaged in processing, dyeing and finishing of fabric, stitching of garments and generation of power for self-consumption. During FY21, Company’s gross, operating and net margins exhibited slight attrition. 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 2.9bln, 32.2% of equity) built over the years by deploying surplus funds augments the Company’s liquidity profile. Dividend income improved in FY21. Improved domestic demand and rising exports resulted in slight uptick in revenues. The demand for exports has surged after Dec’20 and the Company capitalized on it. The exports increased by PKR 1.9bln YoY to clock in at PKR 20.6bln YoY. However, operating profit recorded downward trend due to the profitability of the Company declined due to increase in the input costs. Financial risk of the company has breathing space with an improvement in coverages. Ratings further incorporate the association of the Company with the well-established Sapphire Group which enjoys distinguishing presence in several sectors

The ratings are dependent on sustaining the 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 Rating(Jun-21),Criteria | Correlation Between Long-term & Short-term Rating Scales(Jun-21),Criteria | Rating Modifiers(Jun-21)
Related Research	Sector Study | Composite(Nov-20)
Rating Analysts	Muhammad 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 (workwear 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 textiles. 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 a 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 a panel of auditors maintained by the State Bank of Pakistan. The auditor gave an unqualified opinion on the Company's financial statements for the year ended June 30th, 2021.

Management

Organizational Structure The Company's overall operations are segregated into eight broad functional departments. Every department is categorized into sub-divisions to ensure a 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 of whom have 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 the 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 and clothing exports declined by over 1% year-on-year in August 2020, from ~PKR 2.3bln in Aug last year to ~PKR 2.28bln. Textile exports of the country recorded an increase of 28.6% to stand at USD 2.9bln as compared to USD 2.3bln from July 21 to Aug 21 due to an increase in demand for textile products internationally, led by a good recovery around the globe post-pandemic. Going forward, the textile sector's outlook is expected to stay stable in the medium term where the demand for textile products is expected to increase. The probability of little attrition in demand remains on the horizon attributable to the outbreak of COVID-19 variants. In the local market, the textile sector has recorded strong performance. The 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 also provided comfort to the sector.

Relative Position Sapphire Finishing contributed ~2% 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 The Company's top line is predominantly export-oriented (FY21: 94.8%, FY20: 92.3%) constituting majorly of processed fabric followed by garments and a minimal portion of trading of yarn and fibers. Sapphire Finishing has recently achieved notable geographical diversification in its sales mix and is continually making efforts to maintain the same. The Company's topline amounted to PKR 21.8bln in FY21, a 7.46% YoY increase led by increased sales from its new fashion wear segment as well as the favorable impact of the rupee devaluation.

Margins Gross margins witnessed a decline of 14.3% (FY20: 16.5%) due to an increase in input cost. The Company's major non-core expenses are driven by selling and distribution. Due to the high level of exports, the company incurs significant costs on commissions and freight expenses; thus its distribution expenses amounted to 83.1% of operating costs in FY21 (FY17: 85%). Income received from short-term investments amounted to PKR 74mln during the year. Driven by growth in revenue, however, net profit for the year clocked in at PKR 1.4bln (FY20: PKR 1.5bln) still lower YoY due to increase in costs, bringing net margins to stand at 6.3% compared to 7.3% during the preceding period.

Sustainability The Company's strategy of diversified investments to place reliance on different income streams is also expected to bode well for its risk profile; however, this is subject to the performance of the stock market.

Financial Risk

Working Capital During FY21, the Company purchased a significant inventory of greige fabric, foreseeing the rupee devaluation. This, coupled with the high demand for fashion apparel and limited supply of chemicals increased inventory needs, reflected in a higher net cash cycle (FY21: 82 days, FY20: 73 days). Relative to working capital needs, the company has high short-term borrowings in order to finance a portion of its capital expenditure for the new power boiler, as well as partial financing of short-term investments in the past.

Coverages During FY21, operating cash flows increased to PKR 2.7bln (FY20: PKR 2.5bln). However, the full benefit of the same into debt coverage ratio could not be achieved due to scheduled repayments from long-term loans and increased interest expense. Nevertheless, core coverage improved YoY (FY21: 8.7x, FY20: 6.4x) which is considered adequate.

Capitalization Sapphire Finishing has a moderately leveraged capital structure. The company's total debt amounted to PKR 11.1bln in FY21, comprising 59.3% of short-term borrowing while the remaining portion constitutes long-term debt, mostly LTFF. Going forward, since the Company is not looking at any major capacity expansion, leveraging should improve further.

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Financial Summary
PKR mln

Sapphire Finishing Mills Limited Textile Composite	Jun-21 12M	Jun-20 12M	Jun-19 12M	Jun-18 12M
A BALANCE SHEET				
1 Non-Current Assets	9,110	8,417	8,082	8,084
2 Investments	2,326	2,194	1,068	1,247
3 Related Party Exposure	647	800	611	606
4 Current Assets	12,259	9,927	8,937	5,743
a Inventories	*5,551*	*3,821*	*4,342*	*3,108*
b Trade Receivables	*2,788*	*1,092*	*1,472*	*856*
5 Total Assets	24,343	21,338	18,698	15,680
6 Current Liabilities	3,976	3,182	3,109	2,171
a Trade Payables	*2,096*	*1,416*	*1,243*	*1,006*
7 Borrowings	11,155	10,490	9,297	8,980
8 Related Party Exposure	4	1	23	-
9 Non-Current Liabilities	-	-	-	-
10 Net Assets	9,208	7,665	6,269	4,529
11 Shareholders' Equity	9,208	7,665	6,269	4,529
B INCOME STATEMENT				
1 Sales	21,799	20,284	21,028	16,966
a Cost of Good Sold	*(18,692)*	*(16,932)*	*(17,254)*	*(14,849)*
2 Gross Profit	3,107	3,352	3,774	2,117
a Operating Expenses	(1,316)	(1,286)	(1,215)	(954)
3 Operating Profit	1,791	2,065	2,559	1,163
a Non Operating Income or (Expense)	*221*	*93*	*(48)*	*(18)*
4 Profit or (Loss) before Interest and Tax	2,012	2,158	2,511	1,145
a Total Finance Cost	*(368)*	*(456)*	*(399)*	*(328)*
b Taxation	*(269)*	*(226)*	*(89)*	*(167)*
6 Net Income Or (Loss)	1,375	1,475	2,023	651
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*2,822*	*2,514*	*2,967*	*1,549*
b Net Cash from Operating Activities before Working Capital Changes	*2,533*	*2,124*	*2,632*	*1,177*
c Changes in Working Capital	*(3,000)*	*466*	*(1,171)*	*(564)*
1 Net Cash provided by Operating Activities	(467)	2,590	1,461	612
2 Net Cash (Used in) or Available From Investing Activities	(1,367)	(2,309)	(694)	(2,731)
3 Net Cash (Used in) or Available From Financing Activities	437	1,193	318	2,130
4 Net Cash generated or (Used) during the period	(1,397)	1,474	1,084	11
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	7.5%	-3.5%	23.9%	14.5%
b Gross Profit Margin	14.3%	16.5%	17.9%	12.5%
c Net Profit Margin	6.3%	7.3%	9.6%	3.8%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	-0.8%	14.7%	8.5%	5.8%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Sh*	15.9%	20.5%	35.1%	15.7%
2 Working Capital Management				
a Gross Working Capital (Average Days)	111	97	85	71
b Net Working Capital (Average Days)	82	73	65	48
c Current Ratio (Current Assets / Current Liabilities)	3.1	3.1	2.9	2.6
3 Coverages				
a EBITDA / Finance Cost	9.2	7.8	9.6	6.7
b FCFO / Finance Cost+CMLTB+Excess STB	2.6	5.6	3.5	3.0
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	1.8	1.9	1.6	3.4
4 Capital Structure				
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	54.8%	57.8%	59.7%	66.5%
b Interest or Markup Payable (Days)	97.3	73.7	80.3	86.8
c Entity Average Borrowing Rate	2.8%	4.0%	3.7%	3.2%

Credit Rating

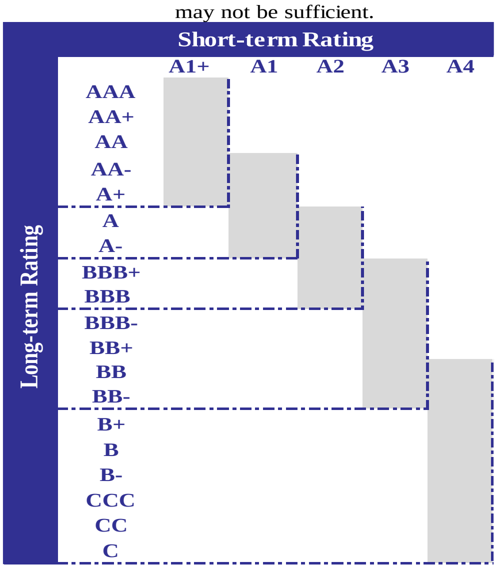
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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):

Entities
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

Instruments
a) Basel III Compliant Debt Instrument Rating
b) Debt Instrument Rating
c) Sukuk Rating

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