



The Pakistan Credit Rating Agency Limited

Rating Report

Sapphire Fibres Limited

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Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
23-Nov-2018	A+	A1	Stable	Maintain	-
29-May-2018	A+	A1	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings reflect Sapphire Fibres Limited (Sapphire Fibres) established business profile emanating from strong presence in the broader value-chain; enabling the company to manage volatility in textile business. Business risk profile has improved with diversification into denim segment, which started operations effectively beginning FY17. Concerted efforts on cost efficiencies led to improved margins in all segments, whereas denim margins are improving relative to first year of operations. Overall margins would strengthen further once denim touches optimal capacity utilization and achieves target market penetration. In second phase, the company has embarked to double the capacity of denim weaving unit in FY19, aiming to fully capitalize market potential. Recent currency devaluation has boded well for the company's margins and, in turn, profitability. A sizeable investment book (PKR 13bln /78% of equity), built over the years by deploying surplus funds augments the company's profile significantly. It generates sizeable stream of recurring non-core income in the form of dividend and capital gains, supplementing bottom-line. This provided ample cushion to bear financial burden for expansion; gearing clocks in at ~46% at end-Jun18. Financial risk profile remains in comfortable range with debt service-coverage-ratios taking support from recurring non-core income. Ratings incorporate association of the company with well-established Sapphire group.

The ratings are dependent upon sustained business profile of the company, herein achieving desired off takes from denim are important. This should benefit in improved margins and, hence, profitability. At the same time, sustainability of non-core income and prudent management of the surplus funds are important. Sustainability of coverages would remain critical.

Disclosure

Name of Rated Entity	Sapphire Fibres Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology Corporate Ratings(Jun-18),Methodology Criteria Rating Modifier(Jun-18),Methodology Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study Textile(Oct-18)
Rating Analysts	Muhammad Hassan muhammad.hassan@pacra.com +92-42-35869504

Profile

Legal Structure Sapphire Fibres Limited (Sapphire Fibres) is a public limited concern established in 1979. The company is listed on the Pakistan Stock Exchange.

Background Sapphire Group (SG) is one of the most distinguished business groups in Pakistan. Mr. Mohammad Abdullah, the chairman of the group, founded SG in 1969. He was succeeded by his sons, Mr. Shahid Abdullah, Mr. Nadeem Abdullah, Mr. Amer Abdullah and Mr. Yousaf Abdullah.

Operations Sapphire Fibres is a vertically integrated composite textile unit manufacturing cotton yarn, fabric and garments. Its products include Yarns, Woven, Knits, and Denim fabric and garments. The company has eight manufacturing facilities as well as captive power plants to generate electricity for its in-house use with a capacity of ~27.7MW.

Ownership

Ownership Structure Sapphire Fibres is the flagship company of SG. SG collectively continued to own majority (~85%) shares of the company directly through individuals (~33%) and group companies (~52%). Remaining (~15%) stake is well spread among financial institutions, companies, and the general public.

Stability SG established Sapphire Holdings Limited for the purposes of succession planning and managing investments in subsidiary and associated companies. It currently holds 15% ownership stake in Sapphire Fibres.

Business Acumen The Abdullah Family has more than 50 years of experience in the textile industry with full knowledge of internal working of Textile Mills as well as special knack in formulation of policies and strategic planning.

Financial Strength SG has a history spanning over 50 years, operating in various segments. It has one of the largest vertically integrated textile set ups in Pakistan having more than 30 production units including spinning, Denim weaving, finishing, home textiles in addition to interests in diversified sectors including power, dairy, cement and investment companies.

Governance

Board Structure The overall control of the company vests in eight member board of directors (BoD) chaired by Mr. Amer Abdullah. The board is dominated by five sponsoring family members. However, only two of them are involved in operations while rest are non-executive. Furthermore, inclusion of two independent directors provides fresh pair of eyes to the strategic matters. Hence, overall structure is considered strong.

Members' Profile The Chairman, Mr. Amer Abdullah, has over five decades of experience in the textile industry. All board members have diversified industrial and professional experience and have reasonably long association with the company.

Board Effectiveness During FY18, attendance of members in BoD meetings remained strong while meeting minutes are well documented. To ensure proper oversight, the company has also formed two committees – Audit, and Human Resource & Remuneration – to assist the board on relevant matters. Both the committees are chaired by independent directors.

Financial Transparency M/s. Shinewing Hameed Chaudhri & Company – ICAP QCR rated and currently placed in category “B” on panel of auditors maintained by SBP – is the external auditor of the company. The auditor gave an unqualified opinion on the company’s financial statements for the year ended June 30, 2018. Sapphire Fibres has also established Internal Audit function, with quarterly reporting to the Audit Committee.

Management

Organizational Structure The Company’s overall operations are segregated into eight broad functional divisions which are further categorized into various sub-divisions to ensure smooth flow of operations with a large number of senior executives reporting directly to the CEO.

Management Team The management team comprises of qualified and experienced professionals, led by the CEO – Mr. Shahid Abdullah – who possesses rich textile industry experience and has been associated with the company since its inception.

Effectiveness The management tier ensures effective delegation of functional responsibility across various departments, facilitating a smooth flow of operations while the implementation of IT systems covers integration of business processes, optimizing resources using synchronization and planning.

MIS The company has implemented an Oracle based ERP – Oracle E business suite – to cater to the large-scale and diversified operations of the company. Regular updates to the software aid the management in timely decision making.

Control Environment The Company’s monthly MIS reports which comprise comprehensive segment and unit wise performance reports are reviewed formally by the CEO along with monthly accounts.

Business Risk

Industry Dynamics Textile exports of the country grew by ~9% for FY18 backed by devaluation of the rupee, bailout package from the government and GSP Plus Scheme of the EU. This growth was led mainly by the value added segment, including knitwear, home textile and ready-made garments. Going forward, exports are expected to remain strong on account of devalued currency.

Relative Position The country’s total exports for FY18 amounted to ~\$13.53 bln, of which Sapphire Fibres contributed ~5.6% in the export of yarn and 1% in the export of garments. Sapphire faces competition from major textile players such as Kohinoor Textile Mills, Nishat Mills and Gul Ahmed all of whom have displayed superior business margins to Sapphire Fibres for FY18.

Revenues During FY18, majority of the company’s topline remained export oriented (~82%). The top three exporting countries include are China, France and Belgium. Revenues for the year witnessed high growth of ~23% YoY driven mainly by currency devaluation with the sales mix being tilted towards yarn, the highest contributor (61%) followed by Garments (~18%), weaving (15%) and Knitting & Dyeing (~5%). Top ten export customer concentration remained moderately high during the year (FY18: ~42%, FY17:38%).

Margins During FY18, despite core business expenses increasing by ~18.5% on YoY basis, gross margin improved significantly (FY18: 10.2%, FY17: 6.7%) on account of synergies achieved in Denim fabric production, started during 2016. This translated into an equal increase in operating margin (FY18: 5.2%, FY17: 1.4%). The company has also established a stable stream of non-core income from a strategic book of investments – this income comprises ~74% of the company’s bottom-line in FY18 (FY17: ~76%). Despite above factors, net margin witnessed a decrease of ~1.3% YoY essentially due to ~36% higher finance cost on account of increased short and long term borrowing as well as impact of currency devaluation on short term foreign obligations.

Sustainability Notable diversification in sectors such as power, dairy and cement has placed reliance on a variety of income streams which continues to be a positive factor for the company’s risk profile. Regular BMR in spinning and weaving segments in FY18 is likely to have a positive impact on productivity going forward.

Financial Risk

Working Capital Sapphire Fibres meets its working capital requirements through a mix of internal generation and short term borrowings (STBs). Though utilization of STB lines increased (end-Jun18: PKR 9,002mln; end-Jun17: PKR 7,290mln), room to borrow increased by ~14% YoY. In FY18, inventory levels surged as the company purchased a significant amount of inventory, foreseeing the rupee devaluation. Resultantly, net cash cycle also increased significantly (FY18: 141 days, FY17: 108 days).

Coverages During FY18, operating cash flows significantly improved to PKR 1,209mln (FY17: PKR 476mln), resulting from full operations of recently expanded denim segment. However, full benefit of the same into debt service coverage ratio could not be achieved (FY18: 0.8x, FY17: 0.7x) due to scheduled repayments from long-term loans (CMLTD; FY18: PKR 804mln, FY17: PKR 122mln), resulting in continued inadequate coverages. The company received dividend (FY18: ~PKR1,392mln, FY17: ~PKR1,490mln) which continued to supported total cash flows and coverages (FY18: 1.7x, FY17: 3.0x).

Capitalization Sapphire Fibres has a moderately leveraged capital structure (FY18: 46%, FY17: 39%) with ~51% being comprised of short-term borrowings. Leveraging of the company has increased over the years owing to recently acquired long-term debt for addition of 32 looms for denim segment.



The Pakistan Credit Rating Agency Limited

Sapphire Fibres Limited

BALANCE SHEET	30-Jun-18	30-Jun-17	30-Jun-16
	FY18	FY17	FY16
Non-Current Assets	10,369	8,890	8,317
Investments (incl. Associates)	12,645	14,516	12,187
Equity	12,645	14,516	12,187
Current Assets	9,642	7,434	6,023
Inventory	4,796	3,764	2,893
Trade Receivables	2,851	1,713	1,265
Others	1,994	1,957	1,865
Total Assets	32,656	30,840	26,526
Debt	13,683	11,001	9,023
Short-term	9,002	7,290	6,894
Long-term (incl. Current Maturity of Long-Term debt)	4,682	3,712	2,129
Other Short-term Liabilities	2,212	2,149	1,675
Other Long-term Liabilities	477	635	464
Shareholder's Equity	16,284	17,055	15,364
Total Liabilities & Equity	32,656	30,840	26,526

INCOME STATEMENT

Turnover	17,828	14,466	12,478
Gross Profit	1,825	974	1,090
Other Income	1,278	1,728	1,485
Financial Charges	(733)	(537)	(424)
Net Income	1,173	1,139	1,402

Cashflow Statement

Free Cashflow from Operations (FCFO)	1,209	476	501
Net Cash changes in Working Capital	(2,212)	(807)	(1,096)
Net Cash from Operating Activities	(332)	664	507
Net Cash from Investing Activities	(2,328)	(2,340)	(4,817)
Net Cash from Financing Activities	2,652	1,606	4,279
Net Cash generated during the period	(7)	(70)	(31)

Ratio Analysis

Performance			
Turnover Growth	23.2%	15.9%	-6.5%
Gross Margin	10.2%	6.7%	8.7%
Net Margin	6.6%	7.9%	11.2%
ROE	7.4%	6.7%	9.1%
Coverages			
Debt Service Coverage (x) (FCFO/Gross Interest+CMLTD+Uncovered STB)	0.8	0.9	1.1
Interest Coverage (x) (FCFO/Gross Interest)	1.9	1.2	1.2
Debt Payback (Total LT Debt Including UnCovered Total STBs) / (FCFO- Gross Interest)	3.8	3.8	1.3
Liquidity			
Net Cash Cycle (Inventory Days + Receivable Days - Payable Days)	141	108	104
Capital Structure (Total Debt/Total Debt+Equity)	45.7%	39.2%	37.0%

Sapphire Fibres Limited

November '18

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		Short Term Ratings	
AAA	Highest credit quality. Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments	A1+	The highest capacity for timely repayment.
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.	A1	A strong capacity for timely repayment.
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.	A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial 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.	A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
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	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
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.	C	An inadequate capacity to ensure timely repayment.
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.		



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 surveil the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

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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

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- (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.
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- (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)
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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)
- (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)

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