



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
24-May-2019	A+	A1	Stable	Maintain	-
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's (Sapphire Fibres) established business profile emanating from strong presence in the broader value-chain; enabling the company to manage volatility in the textile industry. Business profile has improved since diversification into the denim segment in FY17, where optimal capacity utilization has led to strong revenue growth and improved margins. During 9MFY19, currency devaluation led to significant growth in the Company's export-oriented topline. A sizable investment book (PKR ~12bln, 76% of equity) built over the years by deploying surplus funds augments the company's profile and has generated a steady stream of recurring non-core income, supplementing its bottom-line in the past. Recent economic conditions and volatility in the stock market diminished portfolio performance and ensuing income. Although the Company's investment portfolio comprises blue-chip stocks, rising interest cost and subdued performance of stock market is likely to put pressure on investment income. Financial risk of the company is stretched in the absence of non-core income to support core debt coverages. Free cashflows have shown significant improvement due to better performance in core operations. This provided relief to the risk profile of the company; sustainability of the same is important. Ratings incorporate association of the company with 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. At the same time, sustainability of non-core income and prudent management of the surplus funds are important. Sustainability of coverages would remain critical to avoid any drag on financial profile due to prolonged downturn in capital markets.

#### Disclosure

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

## Profile

**Legal Structure** Sapphire Fibres Limited (Sapphire Fibres) is a listed, public limited concern established in 1979.

**Background** Sapphire Fibres is the flagship Company of the Sapphire Group, one of the most distinguished business groups in Pakistan. Mr. Mohammad Abdullah, the Chairman of the group, founded Sapphire Group 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 engaged in the production of yarn, knitwear and denim fabric. The Company has eight manufacturing facilities in and around Lahore as well as captive power plants to generate electricity for its in-house use with a capacity of ~27.7MW. The company currently operates with 101,136 spindles and 96 looms.

## Ownership

**Ownership Structure** Sapphire Group collectively continues 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** 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** 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** The Sapphire Group has one of the largest vertically integrated textile set ups in Pakistan with more than 30 production units. It also has interests in diversified sectors including power, dairy, cement and investment companies with the Group's collective revenue exceeding ~PKR 100bln in FY18.

## Governance

**Board Structure** The overall control of the Company vests in an eight-member board of directors chaired by Mr. Amer Abdullah. The Board is dominated by Sapphire Group with six members. However, non-executive role of some family members and presence of two independent directors on the Board makes the overall governance structure 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** Attendance of members in Board meetings remains strong while meeting minutes are well documented. Two committees – Audit, and Human Resource & Remuneration – are in place to assist the board on relevant matters. Both committees are chaired by independent directors.

**Financial Transparency** M/s. Shinewing Hameed Chaudhri & Company – currently placed in category “B” on the SBP panel of auditors – is the external auditor of the Company. The auditor gave an unqualified opinion on the Company's financial statements for the period ended June 30th, 2018 and December 31st, 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 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. He is assisted by the COO, Mr. Shayan Abdullah.

**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** During 9MFY19, Pakistan's textile exports stagnated (~0.1% growth YoY). Even though major segments including cotton cloth, knitwear, garments and bedwear displayed strong volumetric growth, a unit price dip resulting from having to share currency devaluation benefits with customers curbed overall growth. Cotton yarn also displayed double-digit volumetric decline on account of the US-China trade war. Going forward, the devalued currency, recently announced relief in electricity tariffs for textile players as well as expected payment of tax refunds is expected to boost exports.

**Relative Position** Sapphire Fibres' contribution to the country's total knitwear exports and fabric exports amounted to ~1.5% and ~1% respectively. The Company faces competition from other vertically integrated textile players who enjoy higher margins due to penetration further up the value chain with products including home textiles and retail.

**Revenues** The Company's topline is export oriented (~80%) with exports mainly to China, France and Belgium. Revenues for 9MFY19 witnessed healthy growth of ~18% YoY driven by the currency devaluation as well as volumetric growth in sales of the denim segment as a result of full operations, post-expansion. Yarn continued to be the highest contributor to the topline followed by knitwear and denim fabric. Customer concentration remains moderately high.

**Margins** During 9MFY19, gross margin improved significantly (9MFY19: ~13%, 9MFY18: ~9%) on account of synergies achieved in denim fabric production as well as BMR conducted in spinning units during FY18. The same translated into operating margins while net margin deteriorated significantly (9MFY19: ~3%, 9MFY18 ~8%) due to lower dividend income (9MFY19: ~PKR 356mln, 9MFY18: ~PKR 1.2bln) mainly since dividend from subsidiary, Sapphire Electric, was not received. Finance cost also increased significantly on the back of higher short-term borrowings to finance working capital needs of the denim segment. Resultantly, the Company's bottomline amounted to ~PKR 442mln in 9MFY19 (9MFY18: ~PKR 963mln).

**Sustainability** Recent expansion into denim weaving and BMR have resulted in improving the turnover and margins of the Company and the benefits are expected to sustain, going forward. Sapphire Fibres has diversified its income streams with a sizable investment portfolio comprising strategic investments in various sectors as well as a trading portfolio. However, the poor performance of the stock market has significantly impacted the portfolio's performance, reflected in poor dividend income and revaluation losses. Dividend income from the portfolio has been a major determinant of profitability in the past and remains critical to the Company's performance, going forward.

## Financial Risk

**Working Capital** During 9MFY19, utilization of short-term borrowing lines increased to cater to higher inventory needs as higher raw material for the denim segment was procured as well as cotton inventory in anticipation of rising cotton prices. This led to the higher inventory days which translated into the net cash cycle increasing significantly (9MFY19: 164 days, 9MFY18: 125 days). At total current assets level, the Company maintains a comfortable borrowing cushion owing to its sizeable investment portfolio.

**Coverages** During 9MFY19, free cashflows improved significantly resulting from full operations of the denim segment. However, the same could not be translated into debt service coverage (9MFY19: 1.6x, 9MFY18: 1.5x) and core coverage (9MFY19: 0.9x, 9MFY18: 0.8x) on account of: i) High interest cost due to higher short-term borrowings and ii) Starting of scheduled repayments from LTFF acquired in FY17.

**Capitalization** Sapphire Fibres has a moderately leveraged capital structure (9MFY19: ~52%, 9MFY18: ~44%) mainly constituting short-term borrowings. Going forward, leveraging is expected to largely remain at the same level since no major capex in planned.



**Sapphire Fibres Limited**

**Listed Public Limited**

BALANCE SHEET	Mar-19	Jun-18	Jun-17	Jun-16
	9M	12M	12M	12M
<b>a Non-Current Assets</b>	<b>10,280</b>	<b>10,338</b>	<b>8,858</b>	<b>8,285</b>
<b>b Investments (Incl. Associates)</b>	<b>12,126</b>	<b>12,677</b>	<b>14,574</b>	<b>12,218</b>
Equity Instruments	12,080	12,631	14,528	12,172
Debt Instruments	14	14	14	14
Investment Property	32	32	32	32
<b>c Current Assets</b>	<b>13,719</b>	<b>9,641</b>	<b>7,408</b>	<b>6,023</b>
Inventory	8,140	4,796	3,764	2,893
Trade Receivables	3,394	2,851	1,713	1,265
Others	2,185	1,994	1,931	1,865
<b>d Total Assets</b>	<b>36,124</b>	<b>32,656</b>	<b>30,840</b>	<b>26,526</b>
<b>e Debt/Borrowings</b>	<b>17,064</b>	<b>13,683</b>	<b>11,001</b>	<b>9,023</b>
Short-Term	12,456	9,002	7,290	6,894
Long-Term (Incl. Current Maturity of Long-Term Debt)	4,608	4,682	3,712	2,129
Other Short-Term Liabilities	2,787	2,212	2,149	1,675
Other Long-Term Liabilities	358	477	635	464
<b>f Shareholder's Equity</b>	<b>15,915</b>	<b>16,284</b>	<b>17,055</b>	<b>15,364</b>
<b>g Total Liabilities &amp; Equity</b>	<b>36,124</b>	<b>32,656</b>	<b>30,840</b>	<b>26,526</b>

**INCOME STATEMENT**

<b>a Turnover</b>	<b>15,132</b>	<b>17,828</b>	<b>14,466</b>	<b>12,478</b>
<b>b Gross Profit</b>	<b>1,939</b>	<b>1,825</b>	<b>974</b>	<b>1,090</b>
c Net Other Income	223	728	956	773
d Financial Charges	(901)	(733)	(537)	(424)
<b>e Net Income</b>	<b>442</b>	<b>1,166</b>	<b>1,139</b>	<b>1,403</b>

**CASH FLOW STATEMENT**

a Free Cash Flow from Operations (FCFO)	1,369	1,209	476	501
b Total Cashflows (TCF)	1,369	2,602	1,966	2,011
c Net Cash changes in Working Capital	(3,318)	(2,212)	(807)	(1,096)
d Net Cash from Operating Activities	(2,769)	(332)	664	507
e Net Cash from Investing Activities	(355)	(2,328)	(2,340)	(4,817)
f Net Cash from Financing Activities	3,145	2,652	1,606	4,279
g Net Cash generated during the period	21	(7)	(70)	(31)

**RATIO ANALYSIS**

<b>a Performance</b>				
Turnover Growth	18%	23%	16%	-7%
Gross Margin	13%	10%	7%	9%
Net Margin	3%	7%	8%	11%
ROE	4%	7%	7%	9%
<b>b Coverages</b>				
Debt Service Coverage (X) (FCFO/Gross Interest+CMLTD+U)	0.9	0.8	0.8	1.3
Interest Coverage (X) (FCFO/Gross Interest)	1.6	1.8	1.0	1.3
Debt Payback (Years) (Total Debt (excluding Covered Short T	6.5	8.9	-206.3	18.1
<b>c Capital Structure (Total Debt/Total Debt+Equity)</b>				
Net Cash Cycle (Inventory Days + Receivable Days - Payable L	164	124	108	104
<b>d Capital Structure (Total Debt/Total Debt+Equity)</b>	<b>52%</b>	<b>46%</b>	<b>39%</b>	<b>37%</b>

**Sapphire Fibres Limited**

**May-19**

## 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	
<b>AAA</b>	<b>Highest credit quality.</b> Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments	<b>A1+</b>	The highest capacity for timely repayment.
<b>AA+</b> <b>AA</b> <b>AA-</b>	<b>Very high credit quality.</b> 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.	<b>A1</b>	A strong capacity for timely repayment.
<b>A+</b> <b>A</b> <b>A-</b>	<b>High credit quality.</b> 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.	<b>A2</b>	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
<b>BBB+</b> <b>BBB</b> <b>BBB-</b>	<b>Good credit quality.</b> 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.	<b>A3</b>	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
<b>BB+</b> <b>BB</b> <b>BB-</b>	<b>Moderate risk.</b> 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>	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
<b>B+</b> <b>B</b> <b>B-</b>	<b>High credit risk.</b> 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>C</b>	An inadequate capacity to ensure timely repayment.
<b>CCC</b> <b>CC</b> <b>C</b>	<b>Very high credit risk.</b> 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.		
<b>D</b>	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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(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)

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- i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
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- 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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- (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)
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- (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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