The Pakistan Credit Rating Agency Limited

Rating Report

Sapphire Fibres Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
23-Nov-2019	A+	A1	Stable	Maintain	-
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 where optimal capacity utilization has led to strong revenue growth and improved margins. During FY19, currency devaluation led to significant growth in the Company's export-oriented topline. A sizable investment book (~PKR 11bln, ~73% of equity) built over the years by deploying surplus funds augments the Company's profile. Dividend income from subsidiary – Sapphire Electric – which contributed significantly to profitability in the past, has been impeded due to liquidity issues in the power sector. Meanwhile, recent economic conditions and volatility in the stock market diminished trading portfolio performance and ensuing income, despite investment in blue-chip stocks. However, strong core operations have led to continued improvement in profitability. 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, reflected in improved coverages. Expected continuity of dividend stream from Sapphire Electric will further supplement the bottomline and coverages. 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

Name of Rated Entity	Sapphire Fibres 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 Fibres Limited (Sapphire Fibres) is a listed, public limited concern established in 1979.

Background Sapphire Fibres is the flagship Company of Sapphire Group. Mr. Mohammad Abdullah, Chairman of the Group, founded Sapphire Group in 1969 and is 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. The Company currently operates with 104,536 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 polices 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 Overall control 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 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 & Co. – 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, 2019. Sapphire Fibres also has an Internal Audit function.

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 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 in the extremely competitive international market, curbed overall growth. Meanwhile, cotton yarn exports witnessed a ~18% decline, driven by falling yarn prices as well as the US-China trade war. 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, cotton production is yet again expected to fall short of the target. This will result in the need to import 4-5mln bales which, given the current tax structure of imported cotton, is likely to impact margins of textile companies.

Relative Position Sapphire Fibres' is among the major textile exporters of Pakistan, contributing ~6% to the Country's cotton yarn exports for FY19 while share in knitwear exports and fabric exports amounted to ~1% each. 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%). Revenues witnessed healthy growth (~22%) in FY19, amounting to ~PKR 22bln. The star performer continued to be the denim weaving segment, wherein export sales doubled YoY following capacity expansion undertaken in FY18. Overall topline was driven by i) currency devaluation and ii) expansion in denim weaving capacity, resulting in volumetric revenue growth. The benefit of beefed-up capacity was visible in 3MFY20 revenue as well, which showed ~30% YoY growth. Yarn continues to be the highest contributor to the topline, however, its share declined ~8% YoY and was taken up by denim fabric while knitwear followed. Customer concentration remains moderately high.

Margins The Company's gross margin improved to ~13% in FY19 (FY18: ~10%) on account of timely inventory procurement, currency devaluation and impact of past BMR. The same translated into higher operating margin (FY19: ~8%, FY18: ~6%). Meanwhile, net margin dipped ~2% YoY (FY19: ~4%, FY18: ~6%) since dividend from subsidiary, Sapphire Electric, was not received due to liquidity issues of the power sector in FY19. However, dividend from other equity investments (FY19: ~PKR 474mln, FY18: ~PKR 514mln) continued to supplement the bottomline. Finance cost also increased significantly YoY due to the spike in interest rates over the period and higher short-term borrowing to finance inventory of the expanded denim segment. Resultantly, the Company's bottomline amounted to ~PKR 759mln in FY19 (FY18: ~PKR 1,145mln). Gross margin continued to improve in 3MFY20 (~16%) due to utilization of carried over inventory procured at lower cost, while the bottomline doubled YoY to ~PKR 376mln owing to strong revenue growth.

Sustainability Recent expansion into denim weaving and continuous BMR have resulted in improving the turnover and margins of the Company and the benefits are expected to sustain, going forward. Dividend income from the Company's trading portfolio continues to supplement the bottomline. Meanwhile, dividend stream from strategic investments has been a major determinant of profitability in the past and remains critical to the Company's performance, going forward.

Financial Risk

Working Capital The Company's net cash cycle increased YoY (FY19: 148 days, FY18: 124 days) mainly due to significant finished inventory piled up to meet upcoming customer orders. This led to increased borrowing needs, leaving little borrowing cushion at trade assets level. With the conversion of booked orders into sales, the liquidity position is likely to improve. Meanwhile, the Company maintains a comfortable borrowing cushion at total assets level owing to its sizable investment portfolio.

Coverages Coverages showed no significant improvement over FY19 despite an ~80% surge in free cashflows resulting from improved profitability. Due to: i) high finance cost on account of higher short-term borrowing and ii) limited availability of Export Refinance facility due to high portion of spinning in revenues. Total coverage stood at 1.2x, owing to dividend income. Meanwhile, core coverage showed some improvement (FY19: 1.1x, FY18: 0.8x) as the previous short-term borrowing mismatch diminished. Meanwhile, coverages showed YoY improvement in 3MFY20 amounting 1.5x and 1.0x respectively due to higher profitability from core operations.

Capitalization Sapphire Fibres maintains a moderately leveraged capital structure (FY19: ~52%, FY18: ~46%), with financing mainly comprising of short-term borrowing (~72%). Going forward, leveraging is expected to largely remain at the same level since no major capex is planned.

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Sapphire Fibres Limited	Sep-19	Jun-19	Jun-18	Jun-17
Textile Composite	3M	12M	12M	12M
A BALANCE SHEET				
1 Non-Current Assets	10,700	10,592	10,338	8,858
2 Investments	6,872	7,031	8,644	10,749
3 Related Party Exposure	4,319	4,318	4,033	3,825
4 Current Assets	12,513	12,961	9,641	7,408
a Inventories	*6,647*	*6,831*	*4,796*	*3,764*
b Trade Receivables	*3,561*	*4,233*	*2,851*	*1,713*
5 Total Assets	34,404	34,903	32,656	30,840
6 Current Liabilities	3,302	3,029	2,212	2,149
a Trade Payables	*706*	*661*	*459*	*557*
7 Borrowings	15,152	16,094	13,682	11,001
8 Related Party Exposure	132	124	-	-
9 Non-Current Liabilities	385	369	477	635
10 Net Assets	15,433	15,287	16,284	17,055
11 Shareholders' Equity	15,433	15,287	16,284	17,055
B INCOME STATEMENT				
1 Sales	6,219	21,750	17,828	14,466
a Cost of Good Sold	*(5,248)*	*(18,886)*	*(16,003)*	*(13,492)*
2 Gross Profit	971	2,865	1,825	974
a Operating Expenses	(305)	(1,034)	(894)	(766)
3 Operating Profit	665	1,830	931	208
a Non Operating Income	*106*	*448*	*1,250*	*1,728*
4 Profit or (Loss) before Interest and Tax	772	2,278	2,181	1,936
a Total Finance Cost	*(385)*	*(1,262)*	*(733)*	*(537)*
b Taxation	*(92)*	*(257)*	*(304)*	*(260)*
6 Net Income Or (Loss)	294	759	1,145	1,139
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*532*	*2,176*	*1,209*	*476*
b Net Cash from Operating Activities before Working Capital Changes	*247*	*1,463*	*1,880*	*1,472*
c Changes in Working Capital	*1,088*	*(2,553)*	*(2,212)*	*(807)*
1 Net Cash provided by Operating Activities	1,335	(1,091)	(332)	664
2 Net Cash (Used in) or Available From Investing Activities	(305)	(1,156)	(2,328)	(2,340)
3 Net Cash (Used in) or Available From Financing Activities	(1,066)	2,299	2,652	1,606
4 Net Cash generated or (Used) during the period	(36)	53	(7)	(70)
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	14.4%	22.0%	23.2%	15.9%
b Gross Profit Margin	15.6%	13.2%	10.2%	6.7%
c Net Profit Margin	4.7%	3.5%	6.4%	7.9%
d Cash Conversion Efficiency (EBITDA/Sales)	14.4%	12.5%	9.7%	6.7%
e Return on Equity (ROE)	7.7%	4.8%	6.9%	7.0%
2 Working Capital Management				
a Gross Working Capital (Average Days)	156	157	134	122
b Net Working Capital (Average Days)	146	148	124	108
c Current Ratio (Total Current Assets/Total Current Liabilities)	3.8	4.3	4.4	3.4
3 Coverages				
a EBITDA / Finance Cost	2.5	2.3	2.5	2.0
b FCFO / Finance Cost+CMLTB+Excess STB	1.0	1.1	0.8	0.8
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	6.4	4.6	8.9	-206.3
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	49.8%	51.5%	45.7%	39.2%
b Short-Term Borrowings / Total Borrowings	0.7	0.7	0.7	0.7
c Average Borrowing Rate	9.2%	7.9%	5.5%	4.9%

Rating Scale | Corporate

2019

Credit Rating Scale & Definitions

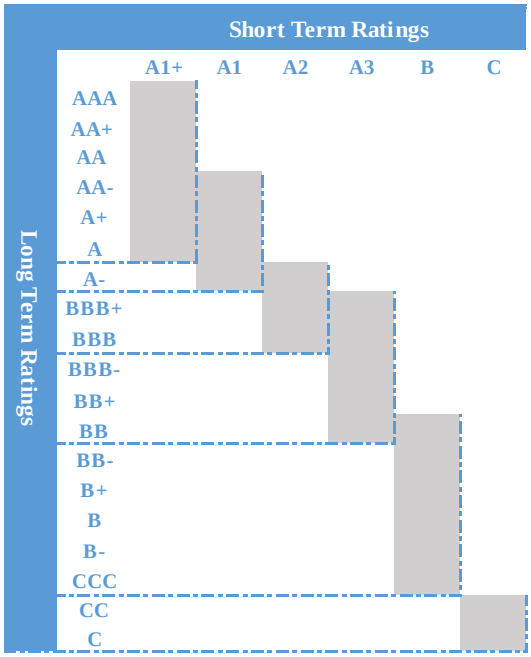
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

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.

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