The Pakistan Credit Rating Agency Limited

# Rating Report

## Sapphire Fibres Limited

**Report Contents**

1. Rating Analysis
2. Financial Information
3. Rating Scale
4. Regulatory and Supplementary Disclosure

**Rating History**

| Dissemination Date | Long Term Rating | Short Term Rating | Outlook | Action | Rating Watch |
|---|---|---|---|---|---|
| 23-Nov-2020 | A+ | A1 | Stable | Maintain | - |
| 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 a strong presence in the broader value-chain; enabling the company to manage volatility in the textile industry. The business profile has improved on the back of the newly established denim weaving segment despite the negative impact of the COVID-19 pandemic and withdrawal of zero-rated sales tax. During FY20, Company's gross and net margins mostly remained stagnant while net margin improved on the back of dividend from Sapphire Electric. A sizable investment book (~PKR 10.6bln, ~67% of equity) built over the years by deploying surplus funds augments the Company's profile. 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. Reduction in policy rates and the moratorium relief by SBP provided respite to the whole sector. The markets gradually opened in some parts of the world towards the end of 1QFY21. Going forward, the second wave of the pandemic has begun its course and lockdowns may be a cause of concern. However, the business community is expecting to continue operations under strict SOPs, both; locally and in most of the export destinations of the Company. The Company took the SBP facility of deferment of the principal amount of the long-term loan. The financial risk of the company is stretched; as the debt coverage remained stretched, however, Company bounced back in 1QFY21 and the coverages improved due to a reduction in finance cost. Free cashflows have shown significant improvement due to better performance in core operations, reflected in improved coverages in 1QFY21 after being stagnant in FY20. The expected continuity of the dividend stream from Sapphire Electric will further supplement the bottom-line and coverages. Ratings incorporate association of the company with well-established Sapphire Group.

The ratings are dependent on sustaining the business profile of the Company by maintaining profitability and margins achieved from core textile operations. At the same time, the 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 a 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-20),Methodology \| Correlation Between Long-Term And Short-Term Rating Scale(Jun-20),Criteria \| Rating Modifier(Jun-20) |
| **Related Research** | Sector Study \| Composite(Nov-19) |
| **Rating Analysts** | Fahad Iqbal \| fahad.iqbal@pacra.com \| +92-42-35869504 |

## Profile

**Legal Structure** Sapphire 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 102,096.

## 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 the internal working of textile mills as well as a special knack in the 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 is $800mln.

## 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, the non-executive role of some family members and the 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 a 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, 2020. 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 the 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** The Covid-19 has severely hampered the demand for the country's textile exports during the last five months. The World is again going down in lock down where second wave and related ramifications are yet to be comprehended. The demand for textile products internationally deteriorated on account of lockdowns in major export destinations, the export market had under-performed in 2MFY21. Exports in the textile sector saw a dip in August 2020 after posting a growth in the first month. However, textile exports of the country increased by ~18% for 3MFY21 to stand at ~USD 1.19bln as compared to ~USD 1.007bln in 2MFY21 as the demand started to stabilize. Locally, the textile sector has found comfort in relief measures introduced by the State Bank of Pakistan such as deferment of loan payments for one-year, low-interest rates and salary refinance scheme.
**Relative Position** Sapphire Fibres' is among the major textile exporters of Pakistan, contributing ~6% to the Country's cotton yarn exports for FY20 while the 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 top line is dominated by exports (~82%). Revenues witnessed growth (~3%) in FY20, amounting to ~PKR 22.4bln (FY19: ~PKR 21.8bln) on the back of the newly established denim weaving segment despite the negative impact of COVID-19 pandemic and withdrawal of zero-rated sales tax. Overall topline was driven by i) better pricing and ii) higher revenue from exports, resulting in revenue growth. Topline in 1QFY21 clocked at ~PKR 5.7bln (1QFY20: ~PKR 6.2bln
**Margins** The Company's gross margin remained stagnant to ~12.6% in FY20 (FY19: ~13.2%). However, the operating margin declined (FY20: ~7.3%, FY19: ~8.4%) due to an increase in distribution cost as the business is export-oriented. Net margin improved (FY20: 5%, FY19: 3.5%) because dividends from the subsidiary, Sapphire Electric, was received ~PKR 867mln. Finance cost also increased significantly YoY due to higher interest rates (FY20: ~PKR 1.4bln, FY19: ~PKR 1.2ln) over the period. However, the Company's bottom-line amounted to ~PKR 1,125mln in FY20 (FY19:~PKR 755mln) due to high dividend income. Net income in 1QFY21 is ~PKR 553mln (1QFY20: ~PKR 294mln).
**Sustainability** Continuous BMR has 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 bottom-line. Meanwhile, the dividend stream from strategic investments has been a major determinant of profitability in the past and remains critical to the Company's performance amidst the outbreak of Covid-19. However, the Company managed to sustain well during the pandemic situation.

## Financial Risk

**Working Capital** The Company's net cash cycle increased YoY (FY20: 156 days, FY19: 148 days) mainly due to an increase in inventory and payables and an increase in revenues. Similarly, Company's borrowing at the trade asset level remained negative to -3% in FY20 (FY19: -4%). Meanwhile, the Company maintains a comfortable borrowing cushion at the total assets level owing to its sizable investment portfolio. Net working capital in 1QFY21 is 155 days (1QFY20: 146 days).
**Coverages** Despite an increase in cashflows (FY20: PKR 2,112mln. FY19: PKR 2,176mln) interest coverage increased slightly and clocked-in at 1.6x in FY20 (FY19: 1.8x) due to higher finance cost. The Company has partially opted to defer its long term repayments for one year as part of SBP relaxations due to COVID-19, which lead to an improvement in debt coverage (FY20:1.2x FY19: 1.1x). Company's FCFO in 1QFY21 is ~PKR 688mln (1QFY20: ~PKR 532mln).
**Capitalization** Sapphire Fibres maintains a moderately leveraged capital structure (FY20: ~48.4%, FY19: ~51.5%), with financing mainly comprising of short-term borrowing (~66%). 34% of the borrowings are borrowed at concessionary rates from SBP. Leveraging in 1QFY21 is 46.6% (1QFY20: 49.8%).

The Pakistan Credit Rating Agency Limited

*Financial Summary*
*PKR mln*

| Sapphire Fibres Limited<br>Textile Composite | Jun-20<br>12M | Jun-19<br>12M | Jun-18<br>12M |
|---|---|---|---|
| **A BALANCE SHEET** | | | |
| 1 Non-Current Assets | 11,901 | 10,592 | 10,338 |
| 2 Investments | 6,173 | 7,031 | 8,644 |
| 3 Related Party Exposure | 4,492 | 4,318 | 4,033 |
| 4 Current Assets | 11,751 | 12,961 | 9,641 |
| *a Inventories* | *7,538* | *6,831* | *4,796* |
| *b Trade Receivables* | *2,226* | *4,233* | *2,851* |
| **5 Total Assets** | 34,317 | 34,903 | 32,656 |
| 6 Current Liabilities | 3,062 | 3,029 | 2,212 |
| *a Trade Payables* | *946* | *661* | *459* |
| 7 Borrowings | 14,912 | 16,094 | 13,682 |
| 8 Related Party Exposure | - | 124 | - |
| 9 Non-Current Liabilities | 454 | 369 | 477 |
| **10 Net Assets** | 15,888 | 15,287 | 16,284 |
| **11 Shareholders' Equity** | 15,888 | 15,287 | 16,284 |
| **B INCOME STATEMENT** | | | |
| **1 Sales** | 22,492 | 21,750 | 17,828 |
| *a Cost of Good Sold* | *(19,668)* | *(18,886)* | *(16,003)* |
| **2 Gross Profit** | 2,824 | 2,865 | 1,825 |
| *a Operating Expenses* | (1,179) | (1,034) | (894) |
| **3 Operating Profit** | 1,645 | 1,830 | 931 |
| *a Non Operating Income or (Expense)* | *1,329* | *448* | *1,250* |
| **4 Profit or (Loss) before Interest and Tax** | 2,974 | 2,278 | 2,181 |
| *a Total Finance Cost* | *(1,463)* | *(1,262)* | *(733)* |
| *b Taxation* | *(386)* | *(257)* | *(304)* |
| **6 Net Income Or (Loss)** | 1,125 | 759 | 1,145 |
| **C CASH FLOW STATEMENT** | | | |
| *a Free Cash Flows from Operations (FCFO)* | *2,112* | *2,176* | *1,209* |
| *b Net Cash from Operating Activities before Working Capital Changes* | *2,017* | *1,463* | *1,880* |
| *c Changes in Working Capital* | *1,034* | *(2,553)* | *(2,212)* |
| **1 Net Cash provided by Operating Activities** | 3,051 | (1,091) | (332) |
| **2 Net Cash (Used in) or Available From Investing Activities** | (1,852) | (1,156) | (2,328) |
| **3 Net Cash (Used in) or Available From Financing Activities** | (1,207) | 2,299 | 2,652 |
| **4 Net Cash generated or (Used) during the period** | (8) | 53 | (7) |
| **D RATIO ANALYSIS** | | | |
| **1 Performance** | | | |
| *a Sales Growth (for the period)* | 3.4% | 22.0% | 23.2% |
| *b Gross Profit Margin* | 12.6% | 13.2% | 10.2% |
| *c Net Profit Margin* | 5.0% | 3.5% | 6.4% |
| *d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)* | 14.0% | -1.7% | -5.6% |
| *e Return on Equity [ Net Profit Margin * Asset Turnover * (Total Assets/Sh* | 7.0% | 5.1% | 7.2% |
| **2 Working Capital Management** | | | |
| *a Gross Working Capital (Average Days)* | 169 | 157 | 134 |
| *b Net Working Capital (Average Days)* | 156 | 148 | 124 |
| *c Current Ratio (Current Assets / Current Liabilities)* | 3.8 | 4.3 | 4.4 |
| **3 Coverages** | | | |
| *a EBITDA / Finance Cost* | 1.9 | 2.3 | 2.5 |
| *b FCFO / Finance Cost+CMLTB+Excess STB* | 1.2 | 1.1 | 0.8 |
| *c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)* | 6.4 | 4.6 | 8.9 |
| **4 Capital Structure** | | | |
| *a Total Borrowings / (Total Borrowings+Shareholders' Equity)* | 48.4% | 51.5% | 45.7% |
| *b Interest or Markup Payable (Days)* | 50.3 | 67.0 | 67.0 |
| *c Entity Average Borrowing Rate* | 8.6% | 7.3% | 5.4% |

## Credit Rating

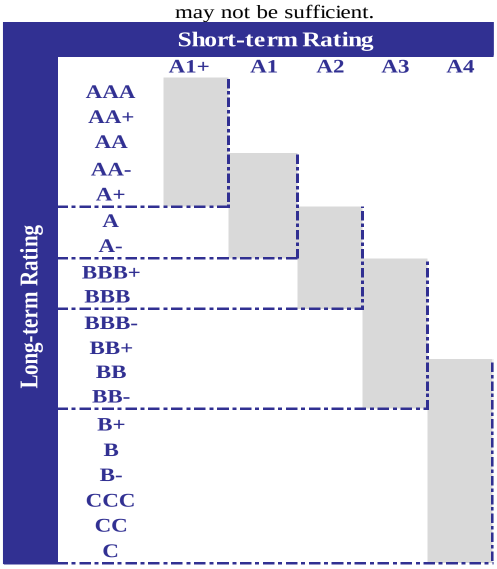
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

**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+<br>AA<br>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+<br>A<br>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+<br>BBB<br>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+<br>BB<br>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+<br>B<br>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<br>CC<br>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**