The Pakistan Credit Rating Agency Limited

Rating Report

Sapphire Finishing Mills Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
23-Nov-2023	A	A1	Stable	Maintain	-
25-Nov-2022	A	A1	Stable	Maintain	-
26-Nov-2021	A	A1	Stable	Maintain	-
27-Nov-2020	A	A1	Stable	Maintain	-
28-Nov-2019	A	A1	Stable	Maintain	-
29-May-2019	A	A1	Stable	Initial	-

Rating Rationale and Key Rating Drivers

The ratings of Sapphire Finishing Mills Limited ("Sapphire Finishing or the company") reflect its strong business profile emanating from an international presence in the broader value chain of late; enabling it to manage volatility in the textile industry. Sapphire Finishing is engaged in processing, dyeing, and finishing of the fabric, stitching of garments, and generation of power for self-consumption. The company has a well-equipped and experienced management team to spearhead the main departments. The company's revenue, being fundamentally export-based exhibited a noticeable growth during the preceding years. Sapphire Finishing has penetrated the international market through its wholly-owned marketing and trading companies, Sapphire Finishing Mills USA, Daletec AS, and Sapphire Europe BV. The company's foothold in the export market is increasing as depicted by an increase of 64% in Garment exports during FY23 through an established customer base. Locally, the company sells to several big players in the textile industry. The quantum of revenue base is large depicting a healthy growth of 24% (FY23: PKR 42.3bln; FY22: PKR 34.2bln) while the company's bottom line was recorded as historically high (FY23: PKR 3.9bln; FY22: PKR 2.4bln). The company secured good margins as compared to the peer universe since it operates in value-added segments, Workwear and Fashionwear, and has an in-house multifuel power generation boiler with a capacity of 5.5MW. The investment portfolio is meticulously worked out. Dividend income from Tricon Boston Consulting (Private). Limited registered a healthy growth during the last few years. The deployment of surplus funds in the Capital market supports the company's liquidity profile. A sizeable increase in cashflows exhibit that the company is generating sufficient cash to meet the debt obligations. The management adopted a conservative approach attributable to the high policy rate as evidenced by the intact borrowings. The company portrays a robust financial risk profile supported by good working capital management and coverages. Going forward, the company is planning to work on its compliance and sustainability profile in the ambit of the ESG framework. Ratings took comfort from the company's association with the well-established Sapphire Group which enjoys a distinguishing presence in several sectors. During FY23, textile exports were valued at $16.5 billion compared to $19.33 billion, reflecting a dip of 15% YoY – the declining trend has been witnessed by the start of FY23. During FY23, value-added products such as knitwear, bedwear, towels, and ready-made garments witnessed a decline of 13% YoY.

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 surplus funds is important. The sustainability of coverages would remain critical to avoid any drag on the financial profile.

Disclosure

Name of Rated Entity	Sapphire Finishing Mills Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Rating(Jul-23),Methodology | Correlation Between Long-term & Short-term Rating Scales(Jul-23),Methodology | Rating Modifiers(Apr-23)
Related Research	Sector Study | Composite and Garments(Dec-22)
Rating Analysts	Uswa Sikandar | uswa.sikandar@pacra.com | +92-42-35869504

Profile

Legal Structure Sapphire Finishing Mills Limited is an unlisted, public limited company, incorporated in July 2000.

Background The company commenced its commercial operations in November 2003. It is part of the Sapphire Group, one of the leading textile groups in Pakistan.

Operations The company is engaged in processing, dyeing, and finishing of fabric and stitching of garments (workwear and fashion apparel). Its production facility is located at Manga Road, Raiwind, near Lahore. The company has set up a 5.5MW power boiler which became operational in February 2019.

Ownership

Ownership Structure The company is wholly owned by the Sapphire Group, 8% of the stake is directly held by individuals of the Abdullah Family. While the remaining 92% stake rests with the other Group companies.

Stability The presence of a Group holding company, Sapphire Holdings (Pvt.) Limited, as well as formal documentation capturing the family ownership structure bodes well for the stability of the company.

Business Acumen The company has an interest in diversified sectors including textile, power, dairy, and investment companies. The CEO, Mr. Yousuf Abdullah is currently serving as the Chairman of Sapphire Fibres Limited. He became a director in various companies of Sapphire Group in 1995.

Financial Strength Sapphire Group is one of the largest vertically integrated textiles set-ups in Pakistan with Group has an annual turnover of over US $800 million with an asset base of over US $500 million. The Group has shown the willingness and ability to support the company if the need arises.

Governance

Board Structure The company has a seven-member board chaired by Mr. Mohammad Abdullah. Overall, the board comprises six sponsoring family members and one associate of the Sapphire Group, raising concern over its independent oversight function. Going forward, improvement in the corporate governance structure is considered important.

Members' Profile Mr. Mohammad Abdullah has over five decades of textile experience and guides management from time to time. The other board members also have significant experience in textile and finance and have been associated with the company for a reasonable time.

Board Effectiveness Attendance of directors in meetings remained satisfactory with all relevant information provided to them beforehand for discussion. No committees have been formed to assist the board. The company has an internal audit function in place. However, this department reports to the CEO.

Financial Transparency M/s. Shinewing Hameed Chaudhri & Co. is the external auditor of the company and is currently placed in the category "B" on a panel of auditors maintained by the State Bank of Pakistan. The auditor gave an unqualified opinion on the company's financial statements for the year ended June 30th, 2023.

Management

Organizational Structure The company's overall operations are segregated into eight broad functional departments. Every department is categorized into sub-divisions to ensure a smooth flow of operations with a large number of senior executives reporting directly to the CEO.

Management Team The CEO - Mr. Yousuf Abdullah - has over 20 years of experience in the textile sector with expertise in dyeing, knitting, and finishing. He is supported by a team of qualified and experienced professionals, most of whom have been associated with the Sapphire Group for a reasonable time period.

Effectiveness There are two formal management committees. MIS reports relating to daily operations are generated and submitted to senior management for discussion on a regular basis along with need-based meetings for discussion of issues.

MIS The company has implemented an Oracle-based ERP solution - Oracle E-business suite, implemented in 2006, the system aids the integration of business processes and aids the management in timely decision-making. Further, the implementation of SAP is under process.

Control Environment The company's monthly reports comprise comprehensive performance reports reviewed frequently by senior management. Furthermore, the company also has several certifications. These factors aid adherence to quality standards throughout the production process.

Business Risk

Industry Dynamics During FY23, the textile exports were valued at $16.5 billion compared to $19.33 billion, reflecting a dip of 15% YoY – the declining trend has been witnessed by the start of FY23. The exports tumbled attributable to high energy costs, shortage of cotton, and uncertainty in the foreign exchange rate. The suppressed demand pattern exhibited by export avenues was also a challenge. During FY23, value-added products such as knitwear, bedwear, towels, and ready-made garments witnessed a decline of 13% YoY. The basic textiles including raw cotton, cotton yarn, and cotton cloth posted a drop of 21% YoY. During the month of June 2023, cotton yarn exports increased by 7% MoM. The value-added exports reported a volumetric increase of 16% on a MoM basis. Knitwear and readymade garments witnessed an incline at 18% and 19% respectively.

Relative Position The company contributed a small share of the country's total export of ready-made garments during FY23.

Revenues The company's topline has witnessed continuous growth in recent years owing to increasing global demand for value-added textile products including ready-made fashion clothing as well as its penetration into the apparel niche of work wear. The company has recently achieved notable geographical diversification in its sales mix and is continually making efforts to maintain the same. During FY23, the company's topline posted a growth of 23.6% amounting to PKR 42.3bln (FY22: PKR 34.2bln) despite the contraction in demand for Export avenues. Out of which, the local sales constitute 4% standing at PKR 1.7bln (FY22: PKR 1.5bln) and remained largely the same.

Margins During FY23, the gross margin of the company went up to 21.1% (FY22: 15.9%). The income from financial assets portrayed a dip clocking at PKR 264mln (FY22: PKR 375mln). The finance cost increased manifold to PKR 1.9bln (FY22: PKR 649bln) owing to historically high-interest rates. Despite this increase, the company witnessed a sizeable improvement in the bottom line (FY23: PKR 3.9bln; FY22: PKR 2.4bln). Hence, the company's net margin improved to 9.4% (FY22: 7.3%).

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

Financial Risk

Working Capital The company meets its working capital requirements through a mix of internal generation and short-term borrowings (STBs). The net working capital days displayed a sizeable increase during the period (end-Jun23: 103 days, end-Jun22: 82 days) attributable to an increase in the inventory days (end-Jun23: 98 days; end-Jun22: 86 days). The short-term trade leverage increased to 30.1% (end-Jun22: 19.8%) attributable to a decline in the Trade liabilities of the company (end-Jun23: 2.9bln; end-Jun22: 3.8bln).

Coverages During FY23, the free cash flows from operations illustrated a sizeable growth to stand at PKR 7.1bln (end-Jun22: PKR 3.8bln). The interest coverage of the company decreased to 4.1x (end-Jun22: 7x) due to a hike in finance cost. The debt coverage of the company remains unchanged YoY at 2.8x. The debt payback reduced to 1.1 years (end-Jun22: 1.8 years) reflecting that the company is generating enough cash to meet its obligations.

Capitalization The company has a moderately leveraged capital structure. As of end-Jun23, the Equity base of the company recorded an increase to stand at PKR 15.3bln (end-Jun22: PKR 11.4bln). The total borrowings reflected the same trend YoY and clocked at PKR 15.7bln (end-Jun22: PKR 15.5bln). Out of which, the short-term borrowings constitute 60.8%, while the leveraging of the company declined to 50.6% (end-Jun22: 57.5%).

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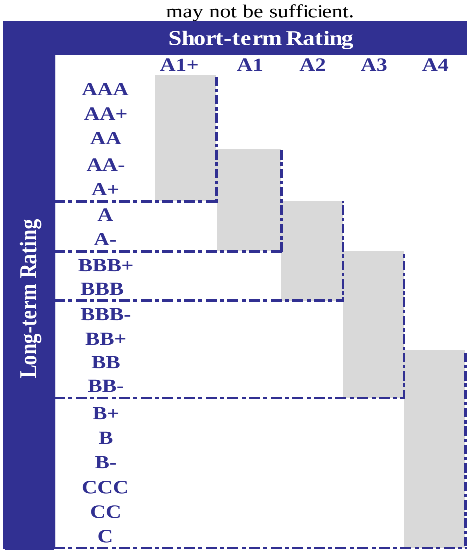
Sapphire Finishing Mills Limited Composite and Garments	Jun-23 12M	Jun-22 12M	Jun-21 12M	Jun-20 12M
A BALANCE SHEET				
1 Non-Current Assets	14,673	12,280	9,110	8,417
2 Investments	481	879	2,326	2,194
3 Related Party Exposure	983	600	647	800
4 Current Assets	21,510	20,228	12,259	9,927
a Inventories	*11,995*	*10,659*	*5,551*	*3,821*
b Trade Receivables	*2,934*	*3,125*	*2,788*	*1,092*
5 Total Assets	37,647	33,987	24,343	21,338
6 Current Liabilities	6,488	6,786	3,976	3,182
a Trade Payables	*1,942*	*2,950*	*2,096*	*1,416*
7 Borrowings	15,743	15,519	11,155	10,490
8 Related Party Exposure	36	197	4	1
9 Non-Current Liabilities	-	-	-	-
10 Net Assets	15,380	11,484	9,208	7,665
11 Shareholders' Equity	15,380	11,484	9,208	7,665
B INCOME STATEMENT				
1 Sales	42,348	34,253	21,799	20,284
a Cost of Good Sold	*(33,393)*	*(28,824)*	*(18,692)*	*(16,932)*
2 Gross Profit	8,955	5,429	3,107	3,352
a Operating Expenses	(2,428)	(2,024)	(1,316)	(1,286)
3 Operating Profit	6,527	3,405	1,791	2,065
a Non Operating Income or (Expense)	*17*	*280*	*221*	*93*
4 Profit or (Loss) before Interest and Tax	6,544	3,685	2,012	2,158
a Total Finance Cost	*(1,919)*	*(649)*	*(368)*	*(456)*
b Taxation	*(641)*	*(545)*	*(269)*	*(226)*
6 Net Income Or (Loss)	3,984	2,490	1,375	1,475
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*7,181*	*3,808*	*2,822*	*2,514*
b Net Cash from Operating Activities before Working Capital Changes	*5,706*	*3,292*	*2,533*	*2,124*
c Changes in Working Capital	*(2,807)*	*(5,389)*	*(3,000)*	*466*
1 Net Cash provided by Operating Activities	2,899	(2,096)	(467)	2,590
2 Net Cash (Used in) or Available From Investing Activities	(3,221)	(2,414)	(1,367)	(2,309)
3 Net Cash (Used in) or Available From Financing Activities	310	4,354	437	1,193
4 Net Cash generated or (Used) during the period	(12)	(156)	(1,397)	1,474
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	23.6%	57.1%	7.5%	-3.5%
b Gross Profit Margin	21.1%	15.9%	14.3%	16.5%
c Net Profit Margin	9.4%	7.3%	6.3%	7.3%
d Cash Conversion Efficiency (FCFO adjusted for Working Capital/Sales)	10.3%	-4.6%	-0.8%	14.7%
*e Return on Equity [Net Profit Margin * Asset Turnover * (Total Assets/Sh*	29.7%	24.1%	16.3%	21.2%
2 Working Capital Management				
a Gross Working Capital (Average Days)	124	118	111	97
b Net Working Capital (Average Days)	103	91	82	73
c Current Ratio (Current Assets / Current Liabilities)	3.3	3.0	3.1	3.1
3 Coverages				
a EBITDA / Finance Cost	4.4	7.9	9.2	7.8
b FCFO / Finance Cost+CMLTB+Excess STB	2.8	2.9	2.6	5.6
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	1.1	1.8	1.8	1.9
4 Capital Structure				
a Total Borrowings / (Total Borrowings+Shareholders' Equity)	50.6%	57.5%	54.8%	57.8%
b Interest or Markup Payable (Days)	135.0	142.9	97.3	73.7
c Entity Average Borrowing Rate	10.6%	4.1%	2.8%	4.0%

Credit Rating

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

Long-term Rating	
Scale	**Definition**
AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short-term Rating	
Scale	**Definition**
A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial
A4	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions. Liquidity may not be sufficient.



**The correlation shown is indicative and, in certain cases, may not hold.*

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

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

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s):

a) Broker Entity Rating
b) Corporate Rating
c) Debt Instrument Rating
d) Financial Institution Rating
e) Holding Company Rating
f) Independent Power Producer Rating
g) Microfinance Institution Rating
h) Non-Banking Finance Companies 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 | Clause 11-(A)(p).
(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 | 17-(a)
(19) PACRA reviews all the outstanding ratings periodically, on annual basis; Provided that public dissemination of annual review and, in an instance of change in rating will be made; | Chapter III | 17-(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 | 17-(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 | 17-(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 | 14-3(f)(vii)
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