

RATINGS (JUNE 2011)

SAPPHIRE FIBRES LIMITED (SFL)

ENTITY	NEW
Long Term	A
Short Term	A2

FINANCIAL DATA

PKR (MLN)

	Mar-11*	Jun-10	Jun-09
Total Assets	16,000.4	11,927.1	10,174.8
Adj. Equity**	8,949.8	6,663.6	5,193.6
Pure Equity	6,835.0	5,104.2	4,380.4
Turnover	11,232.6	9,235.9	7,452.4
Net Income	1,760.4	723.8	387.2
Gross Margin (%)	25.3	20.7	18.4
RoE (%)	30.1^	11.7	7.0
Total Debt/Total Debt+Equity (%)	38.7	39.3	43.2
EBITDA /Interest	5.4	2.6	1.8

*Based on un-audited accounts for nine months

**Including revaluation surplus on investments

^Simple Annualized

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RATING RATIONALE AND KEY DRIVERS

- The ratings reflect SFL's demonstrated ability to maintain its gross margin, predominantly through horizontal value-addition in its main business segment - spinning. Meanwhile, SFL has been investing significantly in balancing, modernizing and replacement over the last couple of years, which has resulted in more efficient production processes. The company has a diversified investment portfolio, providing a stable income stream to its bottom-line. At the same time, SFL's strong risk absorption capacity, mainly emanating from its low leveraged capital structure, is a key rating factor.
- The ratings are dependent on the company's ability to sustain its steady growth without compromising its competitive positioning among its peers. Meanwhile, any adverse changes in the economic environment deteriorating its margins and putting financial coverages under significant pressure would have negative impact upon the ratings.

ASSESSMENT

- Textile sector experienced significant growth in the recent period, primarily attributed to improved exports (9MFY11: PKR 9.8bln, 30% YoY). This was driven by hike in prices, as the cost of cotton observed a rising trend in the wake supply constraints. During 9MFY11, ready-made garment segment was the major contributor in terms of both value and quantity after knitwear segment. The highest price rise was witnessed for yarn that almost doubled, though the export quantity declined as demand in the local market increased. Key risks faced by the industry are volatility in cotton pricing, continued power shortage, stubborn inflation, high interest rate, and weak law & order situation.
- SFL has been experiencing significant growth in its turnover over the last couple of years. This is attributable to the company's focus on the production of specialized yarn – Tencel, Mélange, Mock Twist, Core Spun and Lycra – as against being relatively commoditized count yarn manufacturing facility. This along with modest presence in value addition segments (dyeing, stitching and knitting) has helped the company to sustain pressure on its gross margin. During 9MFY11, the company, while benefiting from favorable supply/demand equilibrium in the international market, experienced substantial price-led surge in its turnover. Meanwhile, due to early buying of cotton at a relatively lower rate, the company registered higher gross and operating margins. Moreover, other operating income along with largely maintained finance cost enabled SFL to report robust net income.

- Going forward, the management intends to continue with its current business model while strengthening its foothold in its key markets. The company does not plan any expansion in its product capacity though emphasis on value-addition would continue.
- The company operates an Oracle based ERP which helps the management in establishing a better control environment and achieving efficiency in MIS reporting. The company manages its credit risk by conducting business through LC or having an insurance cover.
- SFL has a sizeable investment book (PKR 6.3bln), constituting ~70% of its equity base at end-Mar11. The investment book is mainly dominated by group investments (52%). The group holdings mainly consists investments in power, textile and dairy sectors. Sapphire Electric Company Limited, a subsidiary of SFL (~59% ownership), has commenced its power production in October 2010, and is expected to provide a stable dividend stream to SFL. The non-group book is dominated by a large investment in MCB (PKR ~2.7bln). SFL carries a revaluation surplus of ~ PKR 2bln on it. Meanwhile, the group intends to develop a holding company structure by transferring its key investments in associates to SFL's wholly-owned subsidiary – SFL Limited.
- SFL's working capital requirement is mainly a function of its inventory levels, for which the company resorts to short-term borrowings. The company's short-term assets exceed its short-term obligations, signifying room for further borrowing. The company has utilized surplus cash generated through robust profitability in its working capital, resulting in negative operating cash flows. Nevertheless, SFL enjoys strong cash flow coverages prior to working capital related adjustments.
- SFL, with considerable revaluation surplus, has been a low leveraged company. During 9MFY11, the company improved its leveraging structure mainly on the back of retained profits and increased revaluation surplus. Meanwhile, the company's debt is dominant by short term borrowing (83%). Going forward, SFL intends to gradually deleverage its balance sheet.

PROFILE

- Sapphire Fibers Limited (SFL), incorporated in 1979 and listed on all three bourses of the country, is one of the largest specialized yarn manufacturing company in Pakistan. Apart from producing a range of finer quality yarn, the company also operates a modest capacity of dyeing, finishing, and stitching. SFL has five manufacturing facilities: three are located in Sheikhpura; one at Manga Raiwind Road and the other in Lahore. Sapphire family together with other group companies collectively owns majority (80%) shares of the company.
- SFL has a seven-member board including the CEO. The Chairman of the board is Mr. Mohammad Abdullah, who is the group founder as well as Chairman. The board is dominated by Abdullah family members. The CEO, Mr. Shahid Abdullah, possesses rich textile industry experience and has been associated with the company since its inception. He is assisted by a team of experienced management.