FitchRatings

Fitch Downgrades Hela Apparel Holdings to 'AA-(lka)'; Outlook Negative

Fitch Ratings - Jakarta/Colombo - 30 Mar 2023: Fitch Ratings has downgraded Sri Lanka-based apparel manufacturer Hela Apparel Holdings PLC's National Long-Term Rating to 'AA-(lka)', from 'AA(lka)'. The Outlook is Negative.

The downgrade is based on our forecast that Hela's interest coverage and leverage will weaken to below our negative rating sensitivities in the financial year ending March 2023 (FY23) and FY24. The business requires high working capital for growth, while profitability is challenged by weakening global demand. The high interest-rate environment is also pressuring liquidity with high borrowing costs.

The Negative Outlook reflects the risk of prolonged weakness in end-market demand and potential supply-chain issues, which could delay an improvement in profitability. Our expectation of lower effective borrowing cost from 2025 is also at risk amid Sri Lanka's weak economic climate. Persistently high borrowing costs could keep interest coverage below 1.3x, which may pressure the 'AA-(lka)' rating.

KEY RATING DRIVERS

Tight Liquidity, Interest Coverage: Hela had around USD14 million in cash on hand at end-2022, against USD82 million of maturing loans. However, almost 90% of maturing debt is in working-capital facilities, which we believe the company will be able to repay or roll over, as we expect working-capital pressure to recede as demand slows. However, EBITDA interest coverage will weaken to below 1.0x by FYE23 due to weak margins amid supply-chain issues, and a surge in borrowing costs.

We expect interest coverage to improve to 1.3x in FY24, but potential supply-chain issues or high borrowing costs are risks to our forecasts. We estimate Hela's free cash flow will remain thin, considering the profitability pressure and significantly higher borrowing costs amid Sri Lanka's high country risk. We estimate that higher borrowing costs have tripled Hela's FY23 interest payment obligations to around USD13 million (FY22: USD5.2 million).

Moderate Leverage, Adequate Funding Access: We estimate EBITDA net leverage reached around 10.0x in FY23, but forecast the figure will drop to around 6x in FY24. Hela recently received funding facilities of USD14 million from Norway-based Norfund to fund the company's African operations. This supports Hela's funding access compared with that of many other Sri Lankan corporates amid the country risk.

Sovereign Risk; Diversified Operations: Hela is exposed to the economic pressure in Sri Lanka, which is the company's main production base. However, despite the sovereign risk, we believe Hela is better positioned than local peers due to its diversified production base in Africa, which mitigates operational risk. Hela has 10 manufacturing facilities spread across Sri Lanka, Kenya, Ethiopia and its newest production facility in Egypt.

Pressure on Global Apparel Demand: Weakening consumer demand in Europe and the US as a result of high inflation and tighter monetary policy is challenging Hela, as the two countries contributed 95% of total revenue in 9MFY23. This will lead to slower revenue growth in FY23, which we forecast at 1.0%. We expect revenue growth to improve in FY24 due to contribution from Hela's new Egyptian production facility, and a modest uplift in global economic conditions on the easing natural-gas crisis in Europe, still-steady US consumer spending and China's reopening.

Better Profitability Profile: We forecast Hela's EBITDA margin to improve to 5.3% in FY24 and 6.7% in FY25 after it narrowed to 3.4% in 9MFY23, from 5.0% in FY22 and 7.8% in FY21. The poor margin resulted from an interrupted supply chain, which caused the company to miss delivery targets and eventually raised its manufacturing and freight expenses, further pressuring profitability.

However, the company has improved its procurement system and is collaborating with suppliers that are located next its production facilities. We expect automation of some production processes to also boost cost efficiencies.

Small Scale; Solid Product Segments: Hela's business scale is small relative to that of larger apparel manufacturers, with estimated EBITDA of around USD15 million-20 million in 2023-2025. However, Hela has solid product segments in intimate, kids and active wear, which we believe are less affected by demand volatility during economic downturns and fashion trends. The company's strategy is to be careful in selecting customers and focus on building long-term and profitable customer relationships, including with some of the world's leading apparel brands.

DERIVATION SUMMARY

Hela's National Long-Term Rating is similar to that of consumer-durable retailer, Abans PLC (AA-(lka)/Negative). However, we believe Hela has a better business profile due to its diversified operation outside Sri Lanka and because most of its revenue comes from exports, mitigating the risk posed by local import restrictions that are likely to disrupt Abans' business.

Both companies are subject to rising borrowing costs, but Abans has stronger interest coverage, although we forecast Hela's interest coverage will improve and converge with that of Abans in FY25. We also forecast higher leverage for Hela, with EBITDA net leverage of above 6.5x in FY23 and FY24 against Abans' below 5.0x.

Hela's rating is one notch lower than that of Sri Lankan diversified manufacturer DSI Samson Group (Private) Limited (DSG, AA(lka)/Stable). DSG benefits from ongoing import restrictions on footwear and tires, which sustain demand for its locally manufactured products. Our expectation of lower sales volume amid weak purchasing power should be somewhat mitigated by increasing import substitution. We also forecast lower EBITDA interest coverage for Hela of around 1.0x-1.3x in FY23-FY24, against DSG's above 2.0x.

Hela's rating is one notch higher than that of the domestic consumer-durable retail market leader, Singer (Sri Lanka) PLC (A+(lka)/Negative). Singer is significantly exposed to Sri Lanka's weak market, where demand is deteriorating amid high inflation, contracting incomes and import restrictions that are disrupting the company's operations. We believe Hela is better positioned due to its lower dependency on the domestic market from high export sales.

KEY ASSUMPTIONS

Our key assumptions for Hela's rating case are:

- Revenue to rise by an average 7.5% in 2024-2026

- Profitability to fall to 3.2% in 2023 before improving to around 6.7% in 2025

- Capex of around USD3.5 million a year

- Adjustment of non-recourse factoring to on-balance-sheet by assuming 60% of sales are generated from the non-recourse facility with a 45-day credit period

- Dividend payout at 33% of net profit from FY25

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Not meeting the negative sensitivities for an extended period could lead to the Outlook being revised to Stable.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- EBITDA interest coverage falling to below 1.3x for a sustained period.

- EBITDA net leverage exceeding 7.0x for a sustained period.

- Further weakening in liquidity.

LIQUIDITY AND DEBT STRUCTURE

Tight Liquidity, Adequate Funding Access: Hela had around USD14 million in cash on hand against USD82 million of maturing loans at end-2022. However, almost 90% of maturing debt comprises working capital facilities, which we expect the company to roll over, as the debt is backed by a similar amount of net working capital assets.

We believe Hela has better funding access than many other local corporates due to its export-oriented business that is less exposed to domestic economic challenges. The company has been able to continue to finance its working capital needs, albeit at a significantly higher cost amid Sri Lanka's elevated country risk, and is seeking alternative funding sources to reduce costs. The new funding facilities from Norfund support this effort.

ISSUER PROFILE

Hela is an apparel manufacturer with diversified operations in Sri Lanka, Kenya, Ethiopia and Egypt. Its key products, including intimate, kids, active and medical wear, are mainly sold to global luxury and lifestyle brands and European retailers.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Hela Apparel Holdings PLC	Natl LT	AA-(lka)	Downgrade	AA(lka)

PREVIOUS Page 1 of 1 10 rows NEXT

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

- National Scale Rating Criteria (pub. 22 Dec 2020)
- Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 29 Oct 2022)
- Corporate Rating Criteria (pub. 29 Oct 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

- Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

- Solicitation Status
- Endorsement Policy
- Potential Conflicts Resulting from Revenue Concentrations

ENDORSEMENT STATUS

Hela Apparel Holdings PLC -

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following

READ MORE

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.