February 13, 2020

Sapphire Foods India Private Limited: [ICRA]BBB(Stable) assigned

Summary of rating action

Instrument*	Current Rated Amount (Rs. crore)	Rating Action
Issuer Rating	0.00	[ICRA]BBB(Stable); Assigned
Total	**0.00**	

**Instrument details are provided in Annexure-1*

Rationale

The assigned rating for Sapphire Foods India Private Limited (SFIPL) takes into account the established presence of the Pizza Hut and the KFC brands in the local and global markets, the growing penetration of the Quick Service Restaurant (QSR) industry in India, the investor- support to Sapphire Foods India Private Limited (SFIPL) through capital infusion, and its experienced management team. The rating also takes into account SFIPL's diversified presence across India, Sri Lanka and the Maldives through a chain of 169 KFC and 224 Pizza Hut stores. The rating also draws comfort from SFIPL's healthy financial profile characterised by a robust revenue growth, its comfortable capitalisation and coverage indicators and, lastly, low working capital requirements in FY2019. Furthermore, ICRA notes the improvement in operating profit in FY2019 and 9M FY2020, following a gradual stabilisation of the company's store operations.

The rating, however, is constrained by the company's continuing losses at the net level and its negative return on capital employed (RoCE) in FY2019, given the under-absorption of overheads and an ongoing expansion of stores. ICRA notes that the company's profitability is further impinged by Pizza Hut's low average daily sales (ADS) and, therefore, improving its sales is vital for the company's profitability. In addition, the company remains exposed to project execution risk associated with the opening of targeted new stores, as per the development agreement made with Yum Restaurants India Private Limited (Yum). A prudent funding pattern, with limited reliance on debt for aggressive expansion plans over the medium term, remains critical from the credit perspective. The rating also takes into account the increasing competition from players in the organised and the unorganised markets. Finally, ICRA also notes that KFC's sales are exposed to the inherent industry risk of a disease outbreak in case of birds (chicken), which may impact both the supply as well as the consumption of chicken and its related products.

The Stable outlook on the [ICRA]BBB rating reflects ICRA's opinion that SFIPL will continue to benefit from the experienced management and the healthy growth prospects of the QSR industry in India and Sri Lanka.

Key rating drivers and their description

Credit strengths

Established brand presence in local and global markets coupled with healthy growth prospects of QSR industry – The QSR segment is growing rapidly in India and the companies are benefiting from the increased habit of eating out amongst the consumers. Again, SFIPL is operating as one of the two franchisees of Pizza Hut and KFC brands (owned by Yum) in India. Yum! Brands Inc. has established over 49,000 restaurants in more than 145 countries and territories, with about 98% owned and operated by franchisees, licensees and affiliates.

Demonstrated support from promoter-spurred capital infusion over the years, and experienced management team – The company is promoted by QSR Management Trust, which is owned by Samara Capital. Sapphire Foods Mauritius Limited (owned by Samara and IDE Emerging Markets), Goldman Sachs, CX Partners and the Edelweiss Group are the other investors in the company. The investors have infused Rs. 681.93 crore – in the form of equity – and Rs. 224.99 crore – in the form of compulsorily convertible preference shares (CCPS) – during the past five financial years. The day-to-day operations are looked after by a management team with more than a decade's experience in the similar industry.

Geographically diversified presence in India and Sri Lanka – The Group has a diversified presence across the country and in Sri Lanka. SFIPL operates 169 KFC stores in the West, the North, the South and central India and 153 Pizza Hut stores in western, southern and central India as on September 30, 2019. The company also operates seven Pizza Hut stores in Gurugram (India), 64 Pizza Hut and three Taco Bell stores in Sri Lanka and two stores in the Maldives through its subsidiaries.

Financial profile characterised by robust revenue growth, comfortable capitalisation and coverage indicators and low working capital requirements – At a consolidated level, SFIPL commenced its operations with the acquisition of stores in 2015 and clocked sales of Rs. 328.73 crore in FY2016. With the acquisition of additional stores and the rising average daily sales, the consolidated revenues grew by 139% and 22% in FY2017 and FY2018, respectively. The company continued its growth spree in FY2019 when the consolidated operating income stood at Rs. 1193.82 crore. Its capitalisation and coverage indicators have remained comfortable owing to its strong tangible net worth base and limited reliance on external borrowings. The consolidated debt as on March 31, 2019 comprises term loans of Rs. 75.72 crore, working capital borrowings of Rs. 7.68 crore and a short-term loan of Rs. 12.50 crore. The interest coverage ratio stood at 4.31 times and net cash accruals/total debt at 30% in FY2019. SFIPL's inventory and debtor days have historically remained low due to the nature of its business. In addition, the company receives an extended credit period from its suppliers due to its high bargaining power, which has always kept its working capital requirement low.

Improvement in operating profitability during the past two years – It takes 6-18 months for a store to achieve break-even, depending on its location, due to overheads such as rentals and employee expenses. Furthermore, high corporate overheads exert pressure on the company's profit margin. Hence, the company reported losses in the initial two years. With the stabilisation of operations and improving same-store sales growth along with that of average daily sales, the company started achieving the benefits of economies of scale and reported an operating profit in FY2018, which improved further in FY2019 and 9M FY2020. The company also enjoys incentives for opening the target number of Pizza Hut stores, which further supports the operating profit. The company reported an OPM of 3.44% in FY2019 and 4.49% in 9M FY2020, at a consolidated level.

Credit challenges

Losses at net level and negative RoCE since inception – SFIPL's net margin has remained negative since inception due to modest operating profit margin and high depreciation expense. However, ICRA notes that the cash accruals have been improving since FY2018. The consolidated RoCE continues to remain negative, given the under-absorption of overheads and ongoing capital expenditure to set-up new stores.

Considerable planned capex over the medium term for opening targeted new stores, as per the development agreement with Yum! Brands, exposes the company to project execution risk; judicious funding plan to remain critical – SFIPL plans to open over 220 KFC and Pizza Hut stores in the next three years as per the development agreement with Yum! Brands. Thus, the company is exposed to project execution risk pertaining to finding a suitable location for new stores as well as the risk of venturing into new markets. Furthermore, the company would require an investment of Rs. 150-170 crore per annum towards opening of these stores. Going forward, a prudent funding pattern, with limited reliance on debt for aggressive expansion plans over the medium term, will remain crucial from the credit perspective. Adherence to the developmental agreement for both Pizza Hut and KFC will be an ongoing monitorable parameter and will be a key rating sensitivity.

Profitability impinged by Pizza Hut's low average daily sales; company's ability to increase Pizza Hut's sales remains critical – While SFIPL (Standalone) has almost the same number of stores for both Pizza Hut and KFC, it derives a majority of its revenues from KFC stores due to Pizza Hut's low average daily sales (ADS). The company's ability to improve ADS for the Pizza Hut stores remains critical from a credit perspective.

Increasing competition from organised and unorganised market – SFIPL faces intense competition from the unorganised as well as the organised QSR players like Dominos, McDonald's and Burger King. The company's ability to sustain its growth and improve its profit margin amid intense competition will remain critical.

Exposed to inherent industry risk of disease outbreak in case of birds (chicken), which may impact both supply as well as consumption of chicken and its related products – As SFIPL generates a majority of its revenues from KFC, its sales are exposed to uncontrollable factors like outbreak of diseases such as Avian Influenza (bird flu), which may impact both supply as well as consumption of chicken and its related products.

Liquidity position: Adequate

SFIPL's (consolidated) liquidity is **adequate** with a positive cash flow from operations during the past two years owing to the turnaround in operations and low working capital requirements. The cash flow from operation improved further in 9M FY2020 which stood higher than FY2019 following a stabilisation in operations and the better absorption of fixed overheads. SFIPL plans to incur a capex of ~Rs. 170.00 crore in FY2021 for opening new stores, which will be funded through internal accruals and a term loan of Rs. 120.00 crore. At a consolidated level, the company has repayment obligations of Rs. 26.05 crore (Rs.12.50 crore already paid) in FY2020; and Rs. 19.80 crore in FY2021.However, the accruals are expected to be sufficient to service these payments.

Rating sensitivities

Positive triggers – ICRA could upgrade SFIPL's rating if there is: a) continued increase in its revenues on the back of a continuous business expansion, as planned; and b) sustained improvement in the profit margin and the return indicators, driven by better absorption of its overheads and an improving ADS.

Negative triggers – Negative pressure on SFIPL's rating could arise in case: a) a lower-than-expected sales growth coupled with a delay in stabilisation of new stores leading to lower than expected profitability; b) an unanticipated debt-funded capex resulting in leveraged capital structure and moderation in debt coverage indicators; and c) a non-adherence to the clauses of development agreements with Yum! Brands which will put pressure on SFIPL's rating.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	[Corporate Credit Rating Methodology]
Parent/Group Support	No
Consolidation/Standalone	For arriving at the rating, ICRA has considered the consolidated financials of SFIPL. As on March 31, 2019, the subsidiaries of SFIPL are enlisted in Annexure-2.

About the company

Incorporated in November 2009 as Samarjit Advisors Private Limited, the entity was renamed as Sapphire Foods India Private Limited in 2015. SFIPL is a franchise partners of Yum. for Pizza Hut and KFC brands. It was promoted by QSR Management Trust, which is owned by Samara Capital. In FY2016, QMT's stake diluted to 7.24%, pursuant to fresh investment by Sapphire Foods Mauritius Limited (owned by Samara and IDE Emerging Markets), Goldman Sachs and CX Partners. The Edelweiss Group subscribed to CCPS and joined the company as an investor in FY2019.

The company operates 169 KFC stores and 153 Pizza Hut stores in India as on September 30, 2019. In addition, it operates 64 stores in Sri Lanka, two in Maldives and seven in Gurugram (India) through its subsidiaries. As on September 30, 2019, the company holds 99% stake in Gamma Pizzakraft (Overseas) Private Limited, which is an investment company, and has subsidiaries operating in Gurugram (India), and in Sri Lanka and the Maldives.

In FY2019, SFIPL, on a consolidated basis, reported a net loss of Rs. 44.66 crore on an OI of Rs. 1193.82 crore compared to a net loss of Rs. 41.25 crore on an OI of Rs. 957.16 crore in the previous year.

Key financial indicators

	Standalone		Consolidated	
	FY2018	FY2019	FY2018	FY2019
Operating Income (Rs. crore)	761.34	960.50	957.16	1193.82
PAT (Rs. crore)	-35.91	-42.05	-41.25	-44.66
OPBDIT/OI (%)	0.19%	2.27%	1.79%	3.44%
RoCE (%)	-6.47%	-5.05%	-6.78%	-5.16%
Total Outside Liabilities/Tangible Net Worth (times)	0.29	0.29	0.69	0.53
Total Debt/OPBDIT (times)	13.63	3.32	1.79	2.34
Interest Coverage (times)	1.04	2.71	7.18	4.31
DSCR	1.78	0.64	4.50	1.24

Source: SFIPL

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for the past three years

	Instrument	Current Rating (FY2020)				Rating History for the Past 3 Years		
		Type	Amount Rated	Amount Outstanding	Rating 13-Feb-2020	FY2019 -	FY2018 -	FY2017 -
1	Issuer Rating	-	-	-	[ICRA]BBB(Stable)	-	-	-

Amount in Rs. crore

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Issuer Rating	-	-	-	-	[ICRA]BBB(Stable)

Source: SFIPL

Annexure-2: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
Subsidiary Companies		
Gamma Pizzakraft Overseas Private Limited	73%	Full Consolidation
Gamma Pizzakraft Private Limited	100%	Full Consolidation
Gamma Pizzakraft Lanka Private Limited	100%	Full Consolidation
French Restaurants Private Limited	100%	Full Consolidation
Gamma Island Food Private Limited	51%	Full Consolidation

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About ICRA Limited:

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