



RATING ACTION COMMENTARY

Fitch Affirms Hela Apparel at 'BB+(Ika)' with Negative Outlook; Withdraws Rating

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Fitch Ratings - Jakarta - 20 Dec 2023: Fitch Ratings has affirmed Sri Lanka-based Hela Apparel Holdings PLC's National Long-Term Rating at 'BB+(Ika)' with Negative Outlook. At the same time, Fitch has withdrawn the rating.

The affirmation and Negative Outlook reflect our expectation that interest coverage will stay weak in the next 12 months, leading to continued strain on liquidity. We expect Hela's EBITDA losses to extend into the next 12 months, leaving the company entirely reliant on the success of its turnaround strategy and support of external lenders.

Fitch Ratings has chosen to withdraw the ratings on Hela for commercial reasons. Therefore, Fitch will no longer provide ratings or analytical coverage for Hela.

KEY RATING DRIVERS

Significant Financial Statement Adjustments: We believe Hela's financial transparency has weakened after the major adjustment of its annual financial accounts during its FY23 external audit. Hela says that during its migration to a new enterprise resource planning system in April 2023, the management identified an overstatement of raw material costs in work in progress, which resulted in a large inventory write-down of around USD5 million for FY23, but that its internal controls have improved since.

Weak Cashflows; Interest Coverage: We expect fund flow from operations (FFO) to remain negative in FY24-FY26 (FY23: negative USD14 million), as the pace of recovery in Hela's EBITDA in the next few years is unlikely to be sufficient to cover interest costs. This is underpinned by our belief that demand for apparel imports into the US and the EU - Hela's key markets - is likely to remain weak as elevated inflation and interest rates pressure

consumer purchasing power. The company has embarked on a cost saving strategy, but execution risks are high.

Tight Liquidity: Hela had USD11.4 million in cash at end-September 2023, against an estimated USD16 million in interest payments due in the 12 months, which it is unlikely to meet with internally generated cash. It has another USD5 million in maturing term debt during the period and over USD70 million in short-term working-capital lines due. Hela expects lenders to support rolling over its maturing working-capital debt and allowing it to draw down on uncommitted credit lines of around USD70 million as of 30 June 2023. However, challenges in improving its EBITDA could weaken lender access.

Uncertain Demand Environment: We forecast Hela's revenue to decline by more than 20% in FY24 (1H24: -29%), following weak demand from its key markets in the US and Europe due to elevated inflation and interest rates. The regions contributed 58% and 38%, respectively, to Hela's revenue in 1Q24. We expect revenue to improve by 5% in FY25, in line with our forecast for easing inflation and moderating interest rates in the US and eurozone in 2024-2025.

Heightened Strategy Execution Risk: Hela is undertaking a strategy to cut overhead costs that is subject to execution risk. It is switching to single shift operations in major factories, from double shifts; enhancing the supply-chain strategy by reducing lead times, and rationalising selling general & administrative costs. Hela scaled up its operation over FY22-FY23 to cater to heightened demand, but if the current period of weak demand persists, it may decide to scale down to secure its margin and maintain its long-term business profile.

High Leverage: We forecast leverage to remain above 10x in FY24-FY26 (FY23: 24x), as Hela resorts to external financing for its operational requirements and debt servicing in the next 12-18 months amid limited internal cash generation. The company does not have major investment needs in FY24-FY26, as we forecast capex of around USD2.5 million-3.5 million for maintenance, subject to funding access. The need for working capital will also be limited considering the weak sales.

Small Scale; Long-Term Customer Relationship: Hela business scale is small relative to larger apparel manufacturers, with EBITDA of less than USD15 million. Its product segments are in intimate wear (1Q24 revenue contribution: 54%), kids wear (23%) and active wear (24%). The company's strategy is careful customer selection and a focus on building long-term and profitable customer relationships, which include some of the world's leading apparel brands. The top-10 customers generated an average of 80% of Hela's total revenue in FY20-FY23 (1Q24: 83%).

DERIVATION SUMMARY

Hela's rating is two notches below Sri Lanka-based power producer, Resus Energy PLC (BBB(Ika)/Negative). Resus faces heightened liquidity risk due to the weak credit profile of its sole counterparty, Ceylon Electricity Board (CEB, BB+(Ika)/Stable). However, positive developments at CEB, including raised electricity tariffs, have resulted in higher payments to Resus, bringing down its receivable months to 10, from 13 at FYE23. Consequently, we expect Resus's interest coverage to remain adequate at around 1.3x-1.6x in the next one to two years, compared with Hela's inability to meet its interest costs from internally generated funds.

Hela's rating is three notches above that of Kotagala Plantations PLC (B+(Ika)/Negative). Kotagala faces weak liquidity and high credit risk due to limited funding access, volatile operating cash flow and limited medium-term prospects stemming from the inherent weaknesses in its tea and rubber plantation businesses. The company still faces challenges in securing adequate credit lines to fund its operation, despite its recent debt restructuring.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

- Demand to continue to weaken in FY24, translating into a more than 20% drop in sales (1Q24: 26% drop), then slowly improving by 5% in FY25.
- EBITDA loss in FY24 as a result of lower sales generation and higher administrative expenses.
- No investment capex in FY24-FY26, only maintenance capex of USD2.5 million-3.5 million a year
- Interest rate on the new US dollar debt at around 11%-12% for FY24-FY26.

RATING SENSITIVITIES

No longer relevant as the ratings are being withdrawn.

LIQUIDITY AND DEBT STRUCTURE

Weak Liquidity, Funding Risks: Hela's liquidity is weak. The company is likely to remain reliant on cash on hand and undrawn, but uncommitted, credit lines to fund its operating losses and interest payments. Its ability to access undrawn lines hinges on the success of its

turnaround strategy to cut costs and improve cash flow, but we believe this carries high execution risks.

ISSUER PROFILE

Hela is an apparel manufacturer with diversified operations in Sri Lanka, Kenya, Ethiopia and Egypt. Its key products, including intimate, kids, and active 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 BB+(Ika) Rating Outlook Negative Affirmed	BB+ (Ika) Rating Outlook Negative
	Natl LT WD(Ika) Withdrawn	BB+ (Ika) Rating Outlook Negative

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[National Scale Rating Criteria \(pub. 22 Dec 2020\)](#)

[Corporate Rating Criteria \(pub. 04 Nov 2023\) \(including rating assumption sensitivity\)](#)

[Sector Navigators – Addendum to the Corporate Rating Criteria \(pub. 04 Nov 2023\)](#)

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

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ENDORSEMENT STATUS

Hela Apparel Holdings PLC

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