RATING REPORT

Denim Clothing Company

REPORT DATE:
March 17, 2021

RATING ANALYSTS:

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RATING DETAILS

Rating Category	Latest Rating	
	Long-term	Short-term
Entity (Indicative)	BBB	A-2
Rating Date	*March 17, 2021*	
Rating Outlook	Stable	
Rating Action	*Initial*	

COMPANY INFORMATION

Established in 2005	**External auditors:** Tanzeem & Co. Chartered Accountants
Sole Proprietorship Firm	**Chief Executive Officer:** Mr. Farhan Hanif

APPLICABLE METHODOLOGY(IES)

VIS Entity Rating Criteria: Corporates (May 2019)
https://www.vis.com.pk/kc-meth.aspx

Denim Clothing Company

OVERVIEW OF THE INSTITUTION

Denim Clothing Company was established as a sole proprietorship firm in 2005. The firm is engaged in the manufacturing of denim garments.

Denim Clothing Company is a part of Machiyara Group, a renowned business entity within the Pakistani construction industry since late 1970s.

External auditors of the firm are Tanzeem & Co. Chartered Accountants which possess a satisfactory QCR rating.

RATING RATIONALE

Denim Clothing Company (DCC) is engaged in the manufacturing of denim garments. Product portfolio includes Yarn dye, Coated Denim, Pure Indigo, Colour Denim, Premium Denim and Super Soft Denim. The firm currently operates through 3 owned units and 9 rented units. For backward integration, the company procures around 60% of its denim fabric requirement from its sister concern-Hantex. DCC belongs to the Machiyara Group of Companies which has known presence in the construction, textile, packaging, chemicals and tyre sectors. Sponsors possess sufficient experience in the textile and denim segment. DCC is currently in the process of corporatization and plans to become a private limited company by June 2021.

Power requirement of the manufacturing unit is around 5,893 KWH, 41% of which is met from KE and the remaining is fulfilled through gas and diesel based generators. The firm has compliance with major international safety and quality standards. The firm's laundry facilities are equipped with the latest Jeanologia laser, E- flow and Ozone machinery that consider the environmental impact of the garment finishing processes. DCC's units are ISO14001 and ISO9001 certified matching international quality standards. Focus on sustainability initiatives through continued investments is planned to continue.

Operations and Expansion

DCC's manufacturing unit encompasses selection, sampling, stitching, finishing and range processes. The sampling unit produces over 10,000 samples per year. Annual production capacity of the firm is reported at around 24m pieces at end-1HFY21. Capacity utilization has been reported at higher levels (above 90%) since the past three years. During FY20, utilization levels slightly dipped on account of temporary plant closure due to COVID-19 lockdown and due to order deferment led by lockdown in Europe. However, utilization levels have begun to regain its previous momentum in the ongoing year.

In the medium-term (2 years), DCC plans to convert the rented units into one fully owned unit and the estimated cost for the plan is Rs.7.0b which will be financed in a debt to equity ratio of 20:80. As a result of this plan, installed capacity is expected to increase by 15-20%.

Key Rating Drivers

Moderate business risk profile supported by stable and growing demand for denim products; US-China Trade disruption has enhanced sales as major buyers continue to diversify procurement. Even though impact of Covid-19's second wave remains elevated, we expect the order book for the industry to remain strong in the ongoing year, easing our business risk concerns.

Business risk profile is supported by stable and growing demand for denim products. VIS expects demand for denim products to remain stable over the medium term. Given the favorable policies & incentives of the government on enhancing exports and trade disruption between US and China, there is significant opportunity for local players to enhance exports. However, local and international expansion by major players is expected to keep pricing power and hence margins in check. Moreover, significant investment required by customers as part of sustainability initiative is expected to add to cost pressures for denim manufacturers. Increased expansion by leading denim and non-denim textile players is also on account of favorable demand and expected increase in orders. Even though impact of Covid-19's second wave remains elevated, we expect the order book for the industry to remain strong in the ongoing year, easing our business risk concerns.

Double-digit sales growth over the past three years led by volumetric increase in sales and higher average selling prices due to currency devaluation and shift towards higher value added fashion segment. Client concentration risk is considered on the higher side; however the same is mitigated with long term association with major clients. Going forward, as a result of projected increase in production capacity, sales revenue is expected to depict growth.

Sales revenue of the company has grown at a CAGR of 16% over the past three years (FY17-FY20). Sales revenue almost entirely comprises exports sales. Sales growth was recorded at 11% in FY20 and was on account of a 2% increase in quantity sold with the remaining contributed by higher average selling price due to currency devaluation and shift towards higher value added fashion segment. In terms of geographical concentration in revenues, around 90% of sales are generated from European counties. Going forward, in order to increase diversification, the company plans to tap the US, Australian and Canadian markets. Top 10 client concentration in total sales has improved on a timeline basis; however the same is considered to be on the higher side at 80% (FY20: 88%, FY19: 92%, FY18: 94%) during 1HFY21. Comfort is drawn from the long term association with clients. Given projected increase in production capacity, sales revenue is expected to depict growth, going forward; however the same is contingent upon uplifting of lockdown in Europe.

Gross profitability of the company improved during FY20 largely due to higher margins emanating from value-added fashion segment and currency devaluation. On the flip side, overall profitability of the firm has declined on account of higher finance cost incurred on elevated borrowings. Going forward, post expansion, profitability levels are expected to improve with increase in efficiency and reduced overall expenses.

Gross margins (GMs) of the firm have increased during the outgoing year due to currency devaluation and contribution by the value added fashion segment. GMs were reported at 19.7% (FY19: 17.5%) in FY20. Administrative and selling expenses increased by 28% during FY20 on account of higher insurance expenses, export clearing and forwarding expenses and freight outward charges. In addition, finance charges also increased due to higher quantum of debt drawdown and higher interest rates most of the year until the last quarter of FY20. Resultantly, overall net profitability margin of the company was reported lower at 1.0% (FY19; 1.8%; FY18: 2.3%) during FY20. During 1HFY21, profitability profile remained subdued due to higher finance cost and administrative expenses. Going forward, post expansion, profitability levels are expected to improve with increase in efficiency and reduced overall expenses.

Liquidity profile of the firm needs room for improvement since cash flow coverages of outstanding obligation declined on a timeline basis on account of extended working capital cycle mainly due to COVID-19.

Liquidity profile of the company reflects room for improvement in view of declining cash flows coverages of outstanding obligations on account of extended working capital cycle. Trade debts have increased on a timeline basis because of extended working capital cycle majorly because of COVID-19 whereby; the average days to collect receivables are around 150 days. Improvement in the same is considered important from a ratings perspective. However, trade debts and inventory provide sufficient coverage to short term borrowings. Given higher working capital requirements, total debt has increased significantly on a timeline basis mainly due to COVID-19. FFO to total debt and long term debt was reported at 6% (FY20: 3%, FY19: 5%) and 25% (FY20: 24%, FY19: 42%) during 1HFY21, respectively. Going forward, in line with projected increase in profitability, cash flow coverages are expected to improve with reduction in receivable turnover from 150 days to 90 days.

Leverage indicators are on the higher side due to increase in working capital requirements. Albeit having a subdued affect in overall capitalization profile, leverage indicators are expected to improve on the back of planned equity injection by sponsors in 1QFY22

Equity base of the company has grown at a CAGR of 16% over the last 3 years due to profit retention. Around 15% of the debt profile comprises long-term debt with the remaining representing short-term debt. Total debt of the company has been increasing on a timeline basis to finance both capital expenditure and working capital requirements. Leverage indicators have increased on a timeline basis due to increase in quantum of working capital requirements. At end-Dec'20, leverage and gearing were reported at 6.32x (FY20: 6.12x, FY19: 6.48x) and 3.55x (FY20: 3.41x, FY19: 3.20x), respectively. Given management's plan of replacing current long term debt with a new debt, equity injection expected during 1QFY22 and projected increase in equity base through higher profitability, leverage indicators are expected to improve, going forward.

Corporate Governance framework has room for improvement.

Ratings of Denim Clothing Company are constrained by the current corporate infrastructure given firm's status of a sole proprietorship firm. The firm is currently in the process of converting into a private limited company, materialization of which is considered important. Senior management team comprises professionals who have had a lengthy association with the firm. Functioning of the IT department is considered adequate with two separate softwares used- i) SQL based in-house developed ERP system and ii) Oracle 10G based accounting and finance application. The ERP encompasses modules including order, planning, procurement, inventory, production and HR management. All accounting related transactions are recorded in the finance software. Both the softwares are under the process of integration. DCC also has two to three data back-up sites available. Improvement in corporate governance framework over the rating horizon shall be tracked by VIS.

ISSUE/ISSUER RATING SCALE & DEFINITION Appendix I

VIS Credit Rating Company Limited

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

<table>
<tr><th>REGULATORY DISCLOSURES</th><th colspan="5">Appendix II</th></tr>
<tr><td>Name of Rated Entity</td><td colspan="5">Denim Clothing Company</td></tr>
<tr><td>Sector</td><td colspan="5">Textile Industry</td></tr>
<tr><td>Type of Relationship</td><td colspan="5">Solicited</td></tr>
<tr><td>Purpose of Rating</td><td colspan="5">Entity Rating</td></tr>
<tr><td rowspan="3">Rating History</td><td>Rating Date</td><td>Medium to Long Term</td><td>Short Term</td><td>Rating Outlook</td><td>Rating Action</td></tr>
<tr><td colspan="5">RATING TYPE: ENTITY</td></tr>
<tr><td>Mar-17-21</td><td>BBB</td><td>A-2</td><td>Stable</td><td>Initial</td></tr>
<tr><td>Instrument Structure</td><td colspan="5">N/A</td></tr>
<tr><td>Statement by the Rating Team</td><td colspan="5">VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.</td></tr>
<tr><td>Probability of Default</td><td colspan="5">VIS’ ratings opinions express ordinal ranking of risk, from strongest to weakest, within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.</td></tr>
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<tr><td rowspan="2">Due Diligence Meetings Conducted</td><td colspan="2">Name</td><td colspan="2">Designation</td><td>Date</td></tr>
<tr><td colspan="2">Mr. Muhammad Mudassir</td><td colspan="2">Financial Controller</td><td>19-Feb-2021</td></tr>
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