RATING REPORT

Artistic Garments Industries (AGI Denim) (Private) Limited

REPORT DATE:
July 20, 2022

RATING ANALYSTS:
Asfia Aziz
asfia.aziz@vis.com.pk

Sundus Qureshi
sundus.qureshi@vis.com.pk

RATING DETAILS		
Rating	Initial Rating	
Category	Long-term	Short-term
Entity	A	A-2
Rating Outlook	Stable	
Rating Date	July 20, 2022	
Rating Action	Initial	

COMPANY INFORMATION	
Incorporated in 1988	**External auditors:** EY Ford Rhodes-Chartered Accountants
Private Limited Company	**Chief Executive Officer:** Mr. Javed Ahmed
Key Shareholders (with stake 5% or more):	
Mr. Javed Ahmed- 99.0%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria Methodology – Industrial Corporates (August 2021) https://docs.vis.com.pk/docs/CorporateMethodology202108.pdf

Artistic Garment Industries (AGI Denim) (Private) Limited

OVERVIEW OF THE INSTITUTION

AGI Denim is engaged in the manufacturing of denim garments. The company segregated its Spinning and Fabric segments under the Scheme of Arrangements. AGIDPL began its operations from January 01, 2022. It is registered as a private limited company. The registered office of the company is situated at Karachi. The company has 12 units situated in Korangi, 4 units in Malir and 3 unit in Landhi Industrial Trading Estate, Karachi.

Profile of CEO

Javed Ahmed is the CEO of AGI Denim. He graduated with BSc in Business Administration from The Ohio State University, USA. He is a seasoned professional with over 28 years of experience as a business leader and entrepreneur. He started his career with AGI Denim (Formerly known as AFGI) in 1988. Along his career path, he owned two corporate entities; Prime Holdings (FZC) and Associated General trading (FZC) in

RATING RATIONALE

Artistic Garments Industries (AGI Denim)(Private) Limited (AGIDPL) is a vertically integrated company that deals in manufacturing and sale of denim fabric, yarn and all kinds of ready-made denim garments, dresses and clothes. Product portfolio includes Denim pants, shorts, jackets, skirts, shirts and blouses. The company is involved in the processes of spinning, weaving, dyeing and finishing of denim garments.

Formerly, the company was known as Artistic Fabric and Garment Industries (Pvt.) Limited and de-merged in December'2019 into two entities- Artistic Garment Industries (AGI Denim) and Artistic Fabric Mills (Private) Limited. Financial statements for FY20 take into account 6 month impact of the de-merger.

AGI denim is a vertically integrated company with a large-scale operation based in 19 locations across Karachi, Pakistan. Around 75% of the yarn requirement is met through in-house production with the remaining met through mix of local and imported procurement. The company has marketing liaison offices in USA, Turkey, Denmark, and Bangladesh.

Power requirement of the manufacturing units is met through a combination of grid based power, diesel and gas generators. The company has recently also installed solar power production panels to aid in electricity generation. In FY21, AGI Denim installed 1.85MW of renewable energy across four sites. Moreover, the company recycles 600,000 gallons of water daily and possesses Recycled 100 claim standard. The firm's production processes are compliant with major international safety and quality standards. AGI Denim also owns one of the highest LEED Gold certified building in Pakistan with SGS approved in-house laboratories. AGI Denim's units are ISO14001 and SA8000 certified matching international quality standards. Focus on sustainability initiatives through continued investments is planned to continue.

Operations and Expansion

Ratings incorporate the company's strength emanating from 25+ years of service and innovation within the denim industry. On an annual basis, the company carries a 22m kilogram of yarn capacity, 50m meters of denim fabric capacity and 24m pieces of garments capacity. Capacity utilization of denim and garment divisions has been reported higher at 81% (FY20: 66%) and 85% (FY20: 71%) during FY21, respectively. During FY21, utilization levels depicted an increase on account of escalation in orders leading higher production levels. The growth momentum in order base has continued in the ongoing year. Division of production capacity and further enhancement in the same post de-merger is explained in the table below:

2007 and 2017, respectively.

	Before De-Merger	After De-Merger	Current Capacity (Post Expansion in Capacity after de-merger)
Spinning	70,000 Spindles (1,800 bags of 100lb yarn/day capacity)	Nil	30,000 spindles installed which commenced operations in October'2021. (1,200 bags of 100lb yarn/day capacity)
Denim Fabric	380 Looms (4.8m yards/month capacity)	220 Looms (3m yards/month capacity)	304 Looms (4m yards/month capacity)
Denim Garments	2m pieces/month capacity	2m pieces/month capacity	2m pieces/month capacity

Furthermore, during FY20, FY21 and 9MFY22, the company has incurred sizeable capital expenditure to finance expansion plans across spinning and weaving segments. The expansion was financed through a mix of ITERF/LTFF), internal cash generation and loan from a director). COD of the spinning unit was achieved in September'21 and the denim unit commenced operations in January'22. Summary of expansion plans going forward in the medium-term and long-term is as follows:

Medium-Term (1 to 3 years)	Long-Term (>3 years)
• Installation of 40,000 spindles • Denim fabric expansion: latest rope dyeing and finishing technology along with 120 additional weaving looms. The aforementioned is planned to be financed through internal cash generation. Cost of the same has not been estimated given ongoing uncertainty in the macroeconomic environment.	• BMR (Balancing, Modernizing and Replacing) the technology at existing units. • Explore other countries of origin for production.

Rating Drivers

Recovery in industry wide exports post ease in COVID-19 lockdown measures support business risk profile of the company.

- Subsequent to posting export contraction in FY20 - owing to the pandemic-induced slowdown experienced in H2'FY20 – Pakistan's export base grew by 14% in FY21, which is partly attributable to a low base effect. Pakistan's export proceeds have oscillated in the range of USD 22-25b during the past decade (FY11-FY21). Therefore, the uptick is largely aligned with historical numbers and is not considered material.
- Share of textile exports in total exports has oscillated in the range of 54-59%, coming in at 57% during the past 2-years (FY20-21). In FY21, owing to the similar low-base effect, as discussed above, textile exports were up 13%.

- In USD' terms textile exports have grown at a CAGR of 4.4% during the past 3-year period (FY19-FY21), despite depreciation in average USD/PKR parity of 24%, 16%, and 1% in FY19, FY20 and FY21 respectively.
- In the textile sector, the highest exports were of Knitwear segment with a growth of 37% on a YoY basis. The Knitwear exports were $ 3.83 billion in FY21 compared to $ 2.80 billion in FY20. Whereas, Exports of Bed Wear and Readymade Garment's segments had substantial growth by 29% YoY and 19% YoY, respectively.
- Textile exports in Q1'FY22 were 37% higher than SPLY. Inclusive of textile exports for Oct'2021, the number for 4M'FY22 textile exports came in at USD 6b. With additional capacities coming online in January 2022, textile exports for FY22 are likely to exceed the annualized figure of USD 18b.
- The composition of textile exports has depicted improvement in the last 4-year period, with contribution from higher value added segment increasing from 72.9% in FY18 to 80.7% in FY21 of aggregate textile exports.
- Cotton production in Pakistan, on the other hand, was at its lowest level in decades for FY21. Cotton prices rose to a new 11-year high of ~Rs. 13,000/maund as a result of the production shortage, and cotton imports have climbed by 59.8% in quantity and 68.1% in USD terms, for FY21 vis-à-vis preceding year.
- Given favorable weather conditions, cotton production in Pakistan posted strong growth in FY22, with cotton crop for Jul-Nov'22 (Rabi) season being 81% higher than SPLY. Nevertheless, the upward momentum in cotton pricing continued in FY22, with prices as of November 2022 hovering at ~Rs. 16,000 per mound.
- The margins of textile operators have broadly depicted improvement despite the uptick in raw material costs, given that the same was offset by exchange rate movement. Nevertheless, higher raw material pricing has increased the working capital requirements for textile operators, which is likely to weigh on the liquidity of textile players. VIS expects the order book for the industry to remain adequate in the ongoing year along with transfer orders of neighboring countries, easing our business risk concerns.

Post De-merger, growth in topline during FY21 attributable to uptick in exports quantum, rupee devaluation and ease in global macroeconomic conditions. Going forward, sales are expected to escalate on account of significant orders in hand in lieu of growing demand.

After reporting a decline of 14% in FY20 due to de-merger, sales revenue of the company rose by 20.7% in FY21 due to an uptick in quantum of export sales, rupee devaluation and ease in global macroeconomic conditions. Sales mix of the company indicates that export sales constitutes 99% (FY20: 96%) of the total topline of the company. The company has a diversified product range; however, denim pants and shorts comprise more than 60% net sales of the company.

Sales Mix	FY20	FY21
Pants	50%	45%

Shorts	27%	32%
Jackets	18%	14%
Skirts	5%	0%
Shirts	0%	9%
Blouse	0%	0%
Total	**100%**	**100%**

Country wise concentration is considered to be on the higher side with top 5 countries constituted around 86% (FY21: 78%, FY20: 68%) of sales in HY2022. USA contributes a major portion of 65% (FY21: 48%, FY20: 38%). As per management, the company plans to increase the USA clientele based on better buying power, going forward. Client wise concentration also continues to remain on the highest side as top 10 clients accounted for 99% (FY21: 97%, FY20: 98%) of gross sales in HY2022. Single client concentration is elevated with GAP comprising 61% (FY21: 49%, FY20: 47%) in HY2022. However, long-term contractual relationship association with reputed international brands spanning more than a decade mitigates client concentration risk. Going forward, management is projecting healthy growth in revenues on account of significant orders in hand in lieu of growing demand.

Geographic Sales Mix	FY20	FY21	HY22
USA	38%	48%	65%
Spain	12%	10%	6%
Czech Republic	8%	8%	5%
Denmark	6%	8%	3%
Germany	5%	4%	7%
Total of Top 5 countries	**68%**	**78%**	**86%**

Profitability profile supported by improving margins on a timeline basis.

Gross margin (GMs) of the company has depicted improvement and was reported at 13.8% during FY21 (FY20: 12.0%), as compared to a decline in FY20 due to de-merger. The improvement in margins in FY21 was mainly attributable to better average selling prices, and lower power costs due to installation of solar power. In the period 9MFY22, gross margin further increased to 14.4% due to economies of scale and inventory gains.

Finance charges for the period increased in FY21 owing to expansion-led elevated debt levels. Overall profitability profile was supported by dividend income on short-term investments (mutual funds) in the outgoing year. Distribution costs were reported lower in FY21 on account of decrease in freight charges. Despite higher tax expense due to reversions in tax credits, the company reported significant increase in net profit in FY21. During 9MFY22, the company depicted further increase in net profit on account of lower operating expenses. Going forward, profitability profile is expected to improve in view of reaping benefits of backward integration and capacity expansion in the weaving segment. Ratings remain dependent on maintaining projected profitability levels amidst rising interest rates environment.

Despite improvement in overall profitability in FY21, cash flow coverage of outstanding obligations depicted a downtick due to prominent debt drawdown in the outgoing year. Improvement in liquidity coverages through enhanced projected profitability is considered important from ratings perspective.

In absolute terms, Funds from Operations (FFO) increased by 43% on account of higher overall profitability during FY21. Despite improvement in profitability, Debt Service Coverage Ratio (DSCR), FFO/Long-Term Debt, and FFO/ Total Debt were all reported lower at 8.8x (FY20: 24.9x), 44% (FY20: 608%), and 18% (FY20: 38%) at end-June'21, respectively due to elevated debt levels to finance backward integration. Liquidity profile of the company is supported by short-term investments comprising exposure in mutual funds. Inventory and trade debts coverage for short-term debt obligations although being adequate, has declined in FY21 as a result of higher short term borrowings to meet working capital needs for procurement of raw material in relation to the orders on books. Current ratio was reported at 1.2x at end-June'21 and at 1.3x at end-Mar'22. Trade debts aging also remains comfortable with majority of receivables due within 60 days. Going forward, improvement in liquidity coverages through enhanced projected profitability is considered important from ratings perspective.

Elevated capitalization indicators to finance working capital requirements and expansion in the spinning and weaving segment. With gradual repayment of debt and retention of profits, leverage indicators are expected to improve over the rating horizon.

Equity base of the company was reported higher) at end-Mar'22 on account of profit retention and directors' loan. In FY21, short-term borrowing accounted for 60% (FY20: 94%) of the total debt. Quantum of total debt increased at end-Mar'22 to finance working capital requirements and expansions in the spinning and weaving segments. Around 90% of the total debt comprises ERF, LTFF and TERF facilities of SBP depicting comparatively lower interest rate risk. With SBP increasing interest rates for these loan categories as well, impact of higher finance charges will be seen going forward. With elevated debt levels, gearing and leverage ratios were reported higher at 1.2x (FY21: 1.3x; FY20: 0.5x) and 1.5x (FY21: 1.7x; FY20: 1.1x), respectively at end-Mar'22. With gradual repayment of debt and retention of profits, leverage indicators are expected to improve over the rating horizon.

Sound internal control and IT framework; however room for improvement exists in governance structure given family members (owners) being the directors of the company.

Given the company's ownership vested with family members, there is no formal Board structure in place. However, discussions with the senior management are convened on need basis. Room for improvement exists in formation of a formalized BoD with induction of external members in accordance to best practices.

AGI Denim has an independent internal audit department that conducts compliance of internal policies, timely preparation of reliable financial information, performs reliable financial reporting and emphasizes prevention and detection of fraud/error. The internal audit (IA) department follows a risk based audit approach with observations classified into 'high', 'medium' and 'low' risk categories. The company has defined internal audit Standard Operating Procedures (SOPs) for every process; employee are required to adhere to these SOPs.

On the Information Technology front, the company has deployed a completely integrated ERP system. AGI Denim is currently using Oracle Cloud Infrastructure, which constitutes modules for various administrative departments barring the production department. A customized solution is in place for the production department. The firm has also invested in one of the best Firewall Systems-Sophos. As per management, Research and Development (R&D) remains a forte of the company and the company continues to make sizeable investment to ensure continuous innovation.

ISSUE/ISSUER RATING SCALE & DEFINITIONS Annexure II

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.

REGULATORY DISCLOSURES	Appendix III
Name of Rated Entity	AGI Denim (Private) Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	see table below
Instrument Structure	N/A
Statement by the Rating Team	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.
Probability of Default	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.
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Due Diligence Meetings Conducted	see table below

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
20/07/2022	A	A-2	Stable	Initial

Due Diligence Meetings Conducted

S. No.	Name	Designation	Date
1	Mr. Ahmed Javed	Director	April 26, 2022
2	Mr. Abdul Rahim	CFO	April 26, 2022
3	Mr. Syed Sajjad Haider	Group Manager Financial Reporting & Company Secretary	April 26, 2022