RATING REPORT

Artistic Garments Industries (AGI Denim) (Private) Limited

REPORT DATE:
September 21, 2023

RATING ANALYSTS:
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RATING DETAILS

Rating Category	Latest Rating		Previous Rating	
	Long-term	Short-term	Long-term	Short-term
Entity	A	A-2	A	A-2
Rating Outlook	Stable		Stable	
Rating Action	Reaffirmed		Initial	
Rating Date	*Sep 21, 2023*		*July 20, 2022*	

COMPANY INFORMATION

Incorporated in 1988	**External Auditors:** Kreston Hyder Bhimji & CO., 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: Industrial Corporates (May 2023)
https://docs.vis.com.pk/docs/CorporateMethodology.pdf

APPLICABLE RATING SCALE(S)

VIS Issue/Issuer Rating Scale: *https://docs.vis.com.pk/docs/VISRatingScales.pdf*

Artistic Garment Industries 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. The company began its operations from January 2022. It is registered as a private limited company.

The company has 10 units situated in Korangi, 5 units in Malir and 4 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 2007 and 2017, respectively

RATING RATIONALE

Corporate Profile

Artistic Garment Industries (AGI Denim) (Private) Limited is a complete end-to-end enterprise focused on the production and export of denim fabric, yarn, and an extensive array of ready-made denim garments. With a 35-year operating track record, the company undertakes all stages of the production cycle, including spinning, weaving, dyeing, and finishing, supported by a workforce of over 13,000 employees. With its production base and headquarters in Karachi, the company expands global outreach via marketing offices in the USA, Turkey, Denmark, and Bangladesh.

Average energy demand of 30 MW is primarily fulfilled by gas generators, supplemented by the national-grid line, with diesel and furnace oil generators serving as backup. Each unit has its own dedicated KE line, and recently, management invested Rs.1.2b in the construction of grid stations.

Environmental, Social, & Governance (ESG) Initiatives

The company has LEED accreditation for its spinning unit and forthcoming garment unit. It takes pride in owning one of Pakistan's top LEED Gold certified buildings with SGS approved in-house labs. The company adheres to the Recycled 100 claim standard and meets key global safety and quality standards in its manufacturing methods. Production facilities possess both ISO14001 and SA8000 certifications, meeting global quality criteria. In addition, the organization recycles a substantial 600,000 gallons of water per day.

Backward integration through establishment of a spinning unit and recent capacity expansion initiatives in denim garment and fabric divisions

Spinning – In FY21, the company strategically pursued backward integration by establishing a spinning unit with 30,000 spindles. This facility began commercial operations in Oct'21, yielding a daily yarn production capacity of 120K lbs. The project incurred a total cost of Rs. 8.2b, financed through a debt-to-equity ratio of 54:46. At present, the unit can meet around 75-80% of the internal yarn demand, with the rest met through a mix of local and imported procurement.

Denim Fabric – The company has recently set up a new denim unit (II), equipped with 84 new air-jet looms, at a total cost of Rs. 3.9b. Two-thirds of the funding came from internal capital generation, and the rest was financed through debt. This addition has led to a ~24% increase in the installed capacity of the fabric segment, which now houses a total of 304 looms. Around half of denim production, in terms of volume, is used for in-house garment manufacturing.

Denim Garments – The company intends to launch a new garment unit (XIV) by the conclusion of 2023. This project involves a total investment of Rs. 3b, which will be entirely financed through internal cash flows. The construction of this new unit will entail a ground plus five-story building, along with the installation of machinery.

Management invested almost Rs. 1b in efficiency enhancement initiatives to optimize production processes, including machinery upgrades/replacements, bottleneck reduction in garments and fabric segments, a fiber dyeing project, import of wood boilers, and solar installation. Notably, ~90% of the debt undertaken for capacity expansion and efficiency enhancements is sourced through LTFF & TERF.

Operating Performance

The company currently manages 13 garment units, each equipped with cutting and stitching capabilities, along with one washing unit and three units dedicated to finishing services. Besides, there are two denim-weaving units and a recently inaugurated spinning division. Since starting in Oct'21, spinning operations had low utilization in FY22 but showed considerable improvement this fiscal year. Meanwhile, denim fabric and garment production remained steady despite global demand dips. Garment utilization levels stayed consistent, while fabric division utilization declined due to increased installed capacity.

Table: Capacity & Production Data (Units in millions)

	FY21	FY22	FY23
Spinning			
Installed capacity – Lbs	-	43.2	43.2
Actual production – Lbs	-	23.5	34.2
Capacity Utilization	-	***54%***	***79%***
Denim Fabric			
Installed Capacity – Meters	30.3	37.5	37.5
Actual Production – Meters	29.6	31.7	30.2
Capacity Utilization	***97%***	***85%***	***81%***
Denim Garments			
Installed capacity – Pieces	25.8	25.8	25.8
Actual production – Pieces	22.1	22.4	21.4
Capacity Utilization	***85%***	***87%***	***83%***

Key Rating Drivers

Business risk profile is constrained by current weak macroeconomic environment both globally and locally, high-interest rates, inflationary pressures, rising raw material costs, ongoing energy crisis in the country, and a global slump in demand. All these factors pose a challenge to the sector over the medium term in terms of margins sustainability and future growth.

Pakistan's export proceeds have oscillated in the range of USD 22-25b during the past decade (FY11-FY21), however, in FY22 exports broke the threshold, clocking in at USD 32.4b. Textile sector contributes nearly one-fourth to industrial value-added segment and provides employment to about 40% of the industrial labor force. Contributing around 8.5% to the country's GDP, with an estimated market size of around Rs. 4.0tr, textile sector has maintained an average share of about 60% in national exports over the years.

Table: Pakistan Export Statistics (in USD millions)

	FY20	FY21	FY22	FY23
Pakistan Total Exports	22,536	25,639	32,450	27,911
Textile Exports	12,851	14,492	18,525	16,710
PKR/USD Average rate	158.0	160.0	177.5	248.0

Source: SBP

The lingering effects of Covid-19 pandemic continue to shape the Pakistan's textile industry. Initially, as lockdowns lifted, the industry capitalized on opportunities, securing production contracts with Western countries. This redirection of substantial volumes to Pakistan, complemented by government import tax reductions and subsidized covid-related financing programs such TERF, spurred robust export growth during FY20-22. However, a subsequent phase presented new challenges. Global interest rate hikes aimed at curbing post-pandemic inflation, coupled with geopolitical unrest such as the Ukraine conflict, led to supply chain disruptions and energy crisis. These factors led to a global demand slowdown in major textile economies, reflected in a ~15% year-on-year decline in Pakistan's textile exports in FY23, totaling USD 16.5b (FY22: USD 19.3b). Knitwear, Readymade, and Bed wear segments remain key contributors, making up over 60% of the textile exports.

Table: Textile Export Details (in USD millions)

	FY20	FY21	FY22	FY23	YoY FY23
High Value-Added Segment	**9,669**	**12,427**	**15,611**	**13,576**	**-13%**
- Knitwear	2,794	3,815	5,121	4,437	-13%
- Readymade Garments	2,552	3,033	3,905	3,492	-11%
- Bed wear	2,151	2,772	3,293	2,692	-18%
- Towels	711	938	1,111	1,000	-10%
- Made-up Articles	591	756	849	693	-18%
- Art, Silk & Synthetic Textile	315	370	460	412	-10%
- Others	555	743	872	851	-2%
Low to medium Value-Added Segment	**2,858**	**2,972**	**3,719**	**2,926**	**-21%**
- Cotton Cloth	1,830	1,921	2,438	2,022	-17%
- Cotton Yarn	984	1,017	1,207	844	-30%
- Others	43	34	74	60	-20%
Total	**12,527**	**15,399**	**19,330**	**16,502**	**-15%**

Source: PBS

Flash floods in Sindh and Southern Punjab from last year's monsoon wreaked havoc on the cotton crop, washing away roughly 45% worth over USD 2.5b. This catastrophe led to a historic low yield of 4 million bales in 2022, compared to a 12 million bales annual demand. Local cotton prices subsequently reached a 12-year high of over Rs. 22,000 per maund during the year, and imports rose by ~20% in USD terms for FY22, vis-à-vis preceding year. This situation heightened working capital needs, adversely affecting profit margins and liquidity profile for textile entities, particularly spinners, weavers, and dyeing companies. On a positive note, the production target for the current season is set at 12.7 million bales, supported by favorable weather and timely government intervention.

Table: Cotton Prices Trend (In Rs.)

	June'19	June'20	June'21	June'22	June'23
Per Maund	8,770	8,860	13,000	17,380	17,735
YoY % Change	*26%*	*1%*	*32%*	*34%*	*2%*

The industry faces medium-term risks due to the current weak macroeconomic environment both globally and locally, high-interest rates, inflationary pressures, rising raw material costs, ongoing energy crisis in the country, and a global slump in demand, primarily from North America and Europe. Additionally, the potential expiration of Pakistan's GSP plus status in December 2023 could be impactful. This status, allowing duty-free access to the EU for over 6,300 tariff lines, fosters beneficial trade. Its loss could lead to reduced trade revenues and create market uncertainties.

Previously, the sector also enjoyed incentives provided by the government through a five-year textile policy (2020-25), including preferential energy rates, low-interest financing schemes, and timely payments of various refunds, easing liquidity constraints for local players. However, the prevailing economic instability led to the reduction or withdrawal of many of these supports. This along with contractionary monetary policy and political uncertainties in the country are the key present business risk factors. In the long run, improvement in value addition, investment in technology and optimization of energy cost would define the future prospects of textile exports.

Despite falling export volumes, revenue growth continues, supported by consistent rupee depreciation and local yarn sales contribution. Geographic and client wise sales mix feature concentration.
Sales revenue has bounced back after a dip in FY20, registering robust double-digit annual growth for two successive fiscal years and reaching Rs. 43.6b (FY21: Rs. 32.4b) in FY22. The notable YoY growth of ~35% can be explained by a ~9% uptick in volumes, ~3% rise in dollar prices, and a significant ~23% rupee devaluation impact. While most revenue is generated from exports, the local sales ratio has seen an upturn this fiscal year, largely driven by a spike in yarn sales amidst regional shortages and attractive prices.

Nearly four-fifths of export revenue stems from garments sales including items like denim pants, shorts, jackets, skirts, shirts, and blouses, with the remainder from the fabric division. The recent trend has shown an increased focus on denim pants exports, while contributions from jackets, shorts, and shirts have dropped, likely influenced by economic recessions in the European markets. Over half of exports are shipped to the US, followed by Spain, Germany, Poland, and the Czech Republic. Management indicated a stronger focus on the US market, highlighted by the recent addition of high-profile clients. The garment segment has high client concentration, with the top ten clients contributing over 90% of revenues, whereas the fabric division has lower risk given the high granularity in revenues. Additionally, decade-long contractual relationships with reputable international brands serve to reduce risk.

Despite a global economic downturn affecting export volumes which declined by ~7%, FY23 revenue surpassed Rs. 55b, propelled by local yarn sales and consistent rupee depreciation. Going forward, management anticipates export growth due to the projected recovery in global demand.

Profitability margins have seen a marked improvement over the last three fiscal years.
Both gross and net margins have consistently shown improvement, which can be attributed to backward integration, capacity expansion, efficient energy usage, and the benefits of rupee devaluation. Currently, all cotton for yarn production is sourced locally while fabric production uses a 35:65 local to imported yarn mix, but plans are to shift this to a 65:35 ratio, reducing reliance on imported yarn.

The increase in administrative and distribution costs aligns with the inflation and sales growth trends, while finance charges have been kept in check despite higher benchmark rates and increased utilization of running finance. Additionally, the profitability profile received substantial support from exchange gains and dividend income this fiscal year. As per management, projected improvement in local cotton production is expected to lead to even lower costs, thus enhancing margins in the future.

Reflecting the profitability growth, a surge in cash flows has notably improved debt coverage metrics. Liquidity profile receives significant support from short-term investments.
Aligned with a strong profitability profile, funds from operations (FFO) have demonstrated sizeable growth over the review period. Consequently, there has been a notable improvement in cash-flow coverage indicators, with FFO to total debt and FFO to long-term debt ratios reaching 0.52x (FY22: 0.27x; FY21: 0.18x) and 1.33x (FY22: 0.67x; FY21: 0.44x),

respectively, as of 9M'FY23. Debt service coverage ratio (DSCR) also ameliorated, surging to 9.54x (FY22: 4.75x; FY21: 8.76x), standing out positively among peers.

The liquidity profile remains sound, as indicated by a current ratio exceeding 1.5x and strong coverage of short-term debt with trade debts and inventory. The liquidity status is further strengthened by sizeable investments in Islamic mutual funds. However, the cash conversion cycle has noted an upward trend, mainly due to higher inventory holding days since cotton is now also procured for spinning operations. The aging profile of trade debts is healthy, with only ~6% receivables outstanding beyond the 90-day period; no bad debt reported.

Capitalization benefited from all-out profit retention; leverage ratios now align with peers.

The equity base has more than doubled since FY20, reaching Rs. 21.9b at the end of 9M'FY23, largely due to robust earnings and all-out profit retention. Since the de-merger, no dividends have been distributed. Debt profile is a blend of short-term and long-term debt, with total interest-bearing liabilities slightly declining to Rs. 19.2b (FY22: Rs. 19.8b, FY21: Rs. 16.9b) at end-9M'FY23; ~61% constituted short-term debt. Aggregated running finance lines total Rs. 14b, entirely from the ERF facility, while long-term financing includes LTFF and TERF facilities. Gearing and leverage ratios have improved considerably this fiscal year, aligning with the peers. The gradual debt repayment and profit retention will further improve leverage indicators over time.

REGULATORY DISCLOSURES	**Appendix I**				
Name of Rated Entity	Artistic Garment Industries (AGI Denim) (Private) Limited				
Sector	Textile				
Type of Relationship	Solicited				
Purpose of Rating	Entity Ratings				
Rating History	**Rating Date**	**Medium to Long Term**	**Short Term**	**Rating Outlook**	**Rating Action**
	Rating Type: Entity				
	21/09/2023	A	A-2	Stable	Reaffirmed
	20/07/2022	A	A-2	Stable	Initial
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.				
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Due Diligence Meeting Conducted	**Name**	**Designation**	**Date**		
	Mr. Abdul Rahim	CFO	July 19, 2023		
	Mr. Syed Sajjad Haider	Manager Financial Reporting	July 19, 2023		