RATING REPORT

Cotton Web Limited

REPORT DATE:
October 11, 2022

RATING ANALYSTS:

Asfia Aziz
asfia.aziz@vis.com.pk

Muhammad Taha
m.taha@vis.com.pk

RATING DETAILS		
Rating Category	**Initial Rating**	
	Long-term	**Short-term**
Entity	A-	A-2
Rating Outlook	Stable	
Rating Action	Initial	
Rating Date	*October 11, 2022*	

COMPANY INFORMATION	
Incorporated in 1998 as an AoP	**External auditors:** A.F. Ferguson & Co. Chartered Accountants
Public Unlisted Company	**Chairman:** Ibrahim Shamsi
Key Shareholders (with stake 5% or more):	**CEO:** Waseem Akhtar Khan
Ibrahim Shamsi – 50%	
Waseem Akhtar Khan – 31%	
Daniyal Farid Malik – 19%	

APPLICABLE METHODOLOGY(IES)

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

OVERVIEW OF THE INSTITUTION

Cotton Web Limited was established in 1998 as an Association of Persons (AoP) under the partnership act. It was then converted into a Private Limited Company in 2003 and was converted into a public unlisted company in 2015. Principal activity of the company is the manufacturing and export of denim garments. Registered office and production facilities of the entity are located in Lahore.

Profile of Chairman:

Mr. Ibrahim Shamsi is among the founding members of Cotton Web Ltd. He completed his graduation from Government College University Lahore and MBA from LUMS. He has over 26 years of experience in business development and corporate management, and serves as a board member for companies such as Adamjee Insurance Ltd, MCB Islamic bank and Siddiqsons Ltd.

Profile of CEO:

Mr. Waseem Akhtar Khan is also one of the founding members of Cotton Web Limited and holds engineering and business degrees from UET and LUMS, respectively. With over 22 years of experience in business development and

RATING RATIONALE

Established in 1998, Cotton Web Limited (CWL) is engaged in the manufacturing and export of denim garments. Initially the business was set up as an AoP under the Partnership Act, and was later incorporated as a private limited company in 2002. Eventually, it was converted into a public unlisted company in 2015. Three major shareholders (who are also on the Board of Directors) and founding members of the entity are lifelong friends, with two of them playing an active role in managing the affairs of the business. While gaining extensive experience, the company has grown significantly over the years. Product portfolio mainly consists of denim fashion wear, including jeans and skirts. The company has international presence with a Design Office operating in the UK by the name of Cotton Web UK (100% owned subsidiary of CWL). The company has direct relationships with the clients in the USA as well as in Europe.

Power requirement is met via mix of solar panels and electricity supply from the grid (WAPDA). Four operating facilities and Head Office of the company are located in Lahore.

With a double-digit growth in demand from the key customers, installed capacity of the company have increased over time. During FY20-22, CWL has incurred cumulative capital expenditure to the tune of Rs. 1.95b which was financed through a mix of debt financing and internal cash generation. Capacity utilization levels have remained on the higher side. In line with rising demand, over the next financial year, management projects capex amounting around Rs. 500m which is expected to be financed in debt: equity ratio of 40:60.

	FY20	FY21	FY22
Installed capacity - Pieces	7,575,443	9,172,800	10,779,950
Actual Production - Pieces	6,595,891	8,708,841	9,984,628
Capacity Utilization	87%	95%	93%

Business risk profile is supported by industry wide growth in exports over the last year; however, recent floods across the country have adversely affected the cotton crop. Consequently, margins of textile operators may be effected with projected elevated cotton cost. Comfort may be drawn from higher likelihood of selling prices being adjusted against rising input costs.

Surge in textile exports has continued in FY22 as COVID-19 related restriction are lifted across the globe. Over the year, businesses in Pakistan earned $19.3b from the export of textile and apparel products, an increase of 21% year-on-year. Category wise, knitwear was the commodity that contributed the most, followed by ready-made garments and bed wear. The margins of textile companies have broadly depicted improvement despite the uptick in raw material costs, given that the same was offset by exchange rate movement.

However, floods in Sindh and Southern Punjab regions during the recent monsoon season have resulted in serious damage to the cotton crop. According to an estimate, around 45% of the crop has been washed bearing a total value of more than $2.5b. Consequently, price of cotton in the country *corporate management, he serves on the board of Softwood Textiles Pvt. Limited and Media Logic Pakistan Pvt. Limited as well.*

also surged by more than 30%. The Government has communicated its decision to facilitate textile players in importing raw material to overcome the domestic shortfall. Nevertheless, in addition to having an impact on profit margins, higher raw material pricing is expected to increase the working capital requirements for the companies in the sector, which is likely to weigh negatively on the liquidity profile of textile operators.

Growing topline in lieu of increasing demand from key players. Although client concentration is on the higher side, comfort is drawn from strong association with them since the past six years.

CWL's revenue have grown at a CAGR of 33% over the past two years.. Growth has been attributable to a blend of higher average selling price and a rise in the quantity of pieces sold in line with consistent capacity enhancements. Increasing revenue base is contributed by an organic growth from existing clients as well as consistent new client additions. Moreover, continuous emphasis on R&D and efficiency related measures help to strengthen the entity's competitive position.

99.96% of sales comprise exports. With regard to pricing, optimization of sales mix over time has benefited the company while also reducing operational risk. Around 65% of the products sold as categorized as basic, 25% as semi-fashion, and the remaining as high-end fashion. Going forward, management plans to focus towards value addition. In terms of geographic sales distribution, 66% of the revenue is provided by USA (45%) and France (21%), followed by other European countries.

Customer concentration is on the higher side, as two customers account for around 70% of total sales (Top 10: 95%). However, comfort is drawn from strong relationships with clients. Key customers including Levi's and Kiabi share their detailed expansion plans for the next two years with CWL so that necessary capacity enhancements can be made to allocate capacities to them. At every point in time, CWL has revenue/order visibility for the next six to seven months. Further support is gathered from strong financial profile of these two customers with minimal recovery risk. As per management, even if there is a deferment of order, they make payments in advance to mitigate liquidity stress on CWL. Although CWL has grown its scope of business with these customers, other clients have been maintained as well.

Going forward, management plans to focus towards value-added products and expand the product portfolio. This, coupled with higher demand from existing customers is expected to ensure volumetric growth in sales.

Improving profitability indicators on a timeline basis attributable to exchange rate movement, higher dollar based selling prices, volumetric growth, efficient raw material procurement, and optimizing energy costs through co-generation by installing solar panels.

Gross margins of the company increased on a timeline basis to 17.3% (FY21: 15.0%, FY20: 14.2%) in FY22. This was achieved because of higher dollar based selling prices, volumetric growth, efficient raw material procurement, and optimizing energy costs through co-generation by installing solar panels. Ratings incorporate efficient procurement strategy of the company with lower lead times evident from purchasing fabric from local vendors that are usually nominated by the customers. These include Siddiqsons Limited, Indigo Textile Pvt. Limited, and Sapphire Fibres Limited.

Distribution costs and administrative expenses went up in line with higher revenue. Other income also depicted a noticeable increase in FY22 mainly attributable to exchange gain earned during the year. Through cost optimizing efforts in line with revenue growth, overall net profitability profile of the company also indicated an upward momentum on a timeline basis with net margins reported at 6.8% (FY21: 5.1%, FY20: 2.7%). Given slight demand slow-down projected in the latter half of the ongoing year along with expected increase in raw material prices due to flooding in the country, gross and net margins are forecasted to stabilize at 15.1% and 5.2%, respectively.

Sufficient cash flow coverages.

Despite increasing quantum of debt on a timeline basis, funds from operations (FFO) provide sound coverage against outstanding obligations. In FY22, FFO to Total Debt, FFO to Long Term Debt and Debt Servicing Coverage ratio were reported higher at 38.9% (FY21: 27.0%, FY20: 16.0%), 180% (FY21: 105.1%, FY20: 42.5%) and 4.6x (FY21: 3.6x), respectively. Current ratio remained at an adequate level of 1.3x at end-June'22. Although quantum of trade debts in relation to sales revenue has seen to increase to 12% (FY21: 10%, FY20: 8%) at end-FY22, ageing profile of the same is considered satisfactory with 95% of trade debts not being over-due. Overall cash conversion cycle of the company has extended on account of reduced payable days with suppliers. Hence, short-term borrowings have been mobilized to manage working capital requirements. However, stock in trade and trade debts provided sufficient coverage against short-term debt. Timely receipt of loans, advances and other receivables on the balance sheet is considered important. These consist of advances to suppliers, prepayments, and dues from the subsidiary company (Cotton Web UK Limited).

Despite inclining debt levels, capitalization indicators have remained stable due to profit retention.

In line with an increasing bottom-line, equity base of the company went up at end-FY22 attributable to sufficient profit retention. The management issued bonus shares in FY22 as reflected in the higher paid-up capital at period end. Debt levels increased over time to finance expansion plans and to finance higher working capital needs. A major portion of debt portfolio is short-term in nature. The company operating in the export sector enjoys the benefit of concessionary rate financing with 48% of the total debt portfolio comprising ERF at end-June'22. With adequate profit retention, leverage and gearing ratios were reported at 1.44x (FY21:1.39x, FY20: 1.32x) and 0.86x (FY21: 0.81x, FY20: 0.66x), respectively at end-June'22. As per management, internal dividend payout policy stipulates disbursing 20-25% of the profits as dividends with a defined minimum profit level threshold. Although management plans BMR expansion in the next financial year for which additional debt will be drawn, capitalization indicators are expected to remain within manageable levels. Maintenance of the same in accordance with the benchmarks for the assigned ratings is considered important.

A well-established Corporate Governance Framework.

Even though, CWL is public unlisted company, corporate governance framework is well-defined. The company has a Board of Directors comprising seven members, including three independent directors. Three Board committees exist including Strategy Committee, Audit Committee, and

Human resource & Remuneration Committee. Financial Statements of the entity were audited by A.F. Ferguson & Co. Chartered Accountants.

The company also has a separate internal audit department in place, which reports to the Board Audit Committee. Broad objective of the department is to assess the effectiveness of the internal control systems with regard to the efficiency and effectiveness of operation; integrity and reliability of financial reporting; and compliance with internal polices, procedure, and applicable laws. Head of the Department is a fellow member of Institute of Chartered Accountants of Pakistan, with more than ten years of relevant experience.

On the IT front, the company uses Oracle E-Business Suite R12 as the integrated ERP system. Furthermore, various other software are used for security and other purposes. As for data, Dell EMC servers are used for storage and back up is stored at three different physical locations. By enabling the run time application on disaster recovery site, recovery point has been reduced to sixty minutes.

RATING SCALE & DEFINITION — Appendix I

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: JCR-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.jcrvis.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.jcrvis.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.

'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.jcrvis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when JCR-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 II
Name of Rated Entity	Cotton Web Limited
Sector	Textile
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	see 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.
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Due Diligence Meetings Conducted	see below

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
11-10-2022	A-	A-2	Stable	Initial

Due Diligence Meetings Conducted

Name	Designation	Date
Abdul Basit Sultan	Chief Financial Officer	30 August, 2022
Naeem Iqbal	General Manager Finance & Exports	30 August, 2022
Umar Tarar	Assistant General Manager Finance	30 August, 2022
Hashim Saeed	AVP Marketing & Sales	30 August, 2022