RATING REPORT

Cotton Web Limited

REPORT DATE:
January 01, 2024

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	Positive		Stable	
Rating Action	Maintained		*Initial*	
Rating Date	*January 01, 2024*		*October 11, 2022*	

COMPANY INFORMATION	
Incorporated in 1998	**External Auditors:** A.F. Ferguson & Co. Chartered Accountant
Public Unlisted Company	**Board Chairman:** Mr. Ibrahim Shamsi
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Mr. Waseem Akhtar Khan
Mr. Ibrahim Shamsi – 50.0%	
Mr. Waseem Akhtar Khan – 31.5%	
Mr. Mahwish Malik – 8.0%	
Mr. Daniyal Farid Malik – 6.5%	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Industrial Corporates *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*

Cotton Web Limited

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.

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 the CEO:
Mr. Waseem Akhtar Khan is also one of the founding members of Cotton Web Limited and holds engineering and business degrees from

RATING RATIONALE

Corporate Profile

Incorporated in 1998, Cotton Web Limited (CWL) was founded by its three major shareholders who also serve on the Board of Directors. Among them, two individuals actively participate in the management of the company's operations. The business was originally established as an AoP under the Partnership Act, later becoming a private limited company in 2002 and finally transitioning into a public unlisted company in 2015. CWL specializes in the production and export of denim garments, with its primary product lineup comprising denim fashion wear such as jeans and skirts. Furthermore, the management is planning product line diversification, with an emphasis on expanding into cotton apparel and chinos. The Company also owns a wholly owned subsidiary namely Cotton Web UK which is a Design Office based in UK.

The primary source of power supply is derived from gas generators, with coal and the LESCO gridline serving as backup sources during the winter season when gas availability may be limited. Additionally, 10% of the total energy demand is sourced from solar power.

Operational Performance

The Company has incurred Rs. 339m of capital expenditure during FY23 pertaining to capacity enhancement and Balancing, Modernization and Replacement (BMR). As a result, CWL's installed capacity has augmented by ~15.3%; however, production levels has declined due to the global recessionary trend prevalent in the market, resulting in significant drop in utilization levels in FY23. However, utilization levels have recovered to approximately 90% during 4M'FY24 due to the rebound in the global export market.

Table: Capacity & Production Data (Units in millions)

	FY21	FY22	FY23
Installed Capacity – (pcs)	9.2	10.8	12.4
Actual Production – (pcs)	8.7	10.0	9.7
Capacity Utilization	***95%***	***93%***	***78%***

Rating Drivers

Business risk remain elevated amid weak macroeconomic environment, 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 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[1]. Contributing around 8.5% to the country's gross domestic product (GDP), with an estimated market size of

[1] https://www.brecorder.com/news/40179021

UET and LUMS, respectively. With over 22 years of experience in business development and corporate management, he serves on the board of Softwood Textiles Pvt. Limited and Media Logic Pakistan Pvt. Limited as well.

around Rs. 4.0tr, textile sector has maintained an average share of about 60% in national exports over the years.

Table 1: Pakistan Export Statistics (USD in 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, was complemented by government import tax reductions and subsidized covid-related financing programs such Temporary Economic Refinance Facility (TERF), spurred robust export growth during FY22. 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 10% year-on-year decline in Pakistan's textile exports in FY23, totaling USD 16.7b (FY22: USD 18.5b). As per the data from Pakistan Bureau of Statistics (PBS), High Value-Added Segments made up over 82.2% (FY22: 80.7%) of the total textile exports in FY23.

Flash floods in Sindh and Southern Punjab monsoon wreaked havoc on the cotton crop last year. This catastrophe led to a historic low production level of 4 million bales of cotton in 2022, compared to a 12 million bales annual demand. Consequently, local cotton prices reached 12-year high of over Rs. 22,000 per 40kg during the year as well as import of raw cotton rose by ~20% in USD terms during FY22, as compare to the preceding year. This situation led to higher working capital requirements, adversely affecting profit margins and liquidity profile of textile entities, particularly spinners, weavers, and dyeing companies. Supported by favorable weather and timely government intervention, cotton production in the country is estimated to increase to 12.7 million bales during the current season (FY24). 4.0 million bales have already been produced during Q1FY24, marking an impressive 80.0% increase compared to the same period last year.

The industry is facing business risk due to 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.

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 along with advisory from the IMF led to the reduction or withdrawal of many of these fiscal supports. This along with contractionary monetary policy and political uncertainties in the country are the key business risk factors facing by the industry. In the long run, improvement in value addition, investment in technology and optimization of energy cost would define the future prospects of textile exports.

Double-digit growth attained amidst declining volumes, attributed to rupee devaluation; sales mix reflects high client concentration

The Company achieved double-digit growth in its topline for three consecutive fiscal year, reaching Rs. 17.0b (FY22: Rs. 13.4b) in FY23. The YoY increase of ~27.5% is primarily attributable to devaluation of PKR while volumes has declined by 9.1% during FY23. The management anticipates that net sales will surpass the Rs. 20b mark in FY24, thereby sustaining its upward trajectory in sales.

Nearly entire portion of revenue is emanating from export sales. Geographic sales diversification is moderate with the US (~34.7%), France (~22.8%), Spain (~8.9%) and Netherland (~8.2%) being the major export destinations. Top-10 client concentration is also deemed high, accounting for ~95.5% of the total sales. However, comfort is drawn from strong relationships with these clients including Levis and Kiabi.

Improved margins amid rupee devaluation while net margins fell yet remains aligned with peers

Gross margins continue to improve over the timeline and reported at ~18.5% in FY23 owing to the devaluation of the rupee. However, net margins have dipped due to high finance cost which has increased owing to higher benchmark rate and increased debt levels. in FY23 to ~5.4%, though it remained aligned with peer average. Raw material is sourced from local vendors which are usually nominated by the customers while average price of the raw material has increased by ~39.7% during FY23. Both administrative and distribution cost remains in line with topline growth. Management anticipates a decline in margins for FY24, primarily attributed to the expected pricing challenges resulting from reduced demand in the international market.

Steady Funds Flow from Operations (FFO) and surge in debt levels prompted deterioration of cash-flow and debt servicing coverage indicators while liquidity profile remains satisfactory

While Funds Flow from Operations (FFO) roughly remained at the similar levels at Rs. 1.16b in FY23 vis-à-vis Rs. 1.11b in FY22 while debt quantum has increased, resulting in decline of cash flow coverages as depicted by FFO to Total Debt and FFO to Long-term Debt of 0.32x (FY22: 0.40x) and 1.44x (FY22: 1.81x) in FY23.Similarly, debt servicing coverage ratio has also declined to 2.37x (FY22: 4.37x) in FY23 on account of higher interest charges and principal repayment.

Liquidity profile is satisfactory with current ratio consistently reported over 1.2x while coverage of short-term borrowings in relation to trade debts and inventory remains sufficient. Net cash cycle has increased in FY23 due to higher inventory holding and receivable outstanding days. Aging of receivable remains strong with more than ~96% of the receivables remain within due date.

Escalating debt levels have resulted in elevated leverage ratios, surpassing industry peers

Excluding the revaluation surplus, the equity base surged by ~23.0 % in the last fiscal year, hitting Rs. 4.1b at end-FY23, primarily driven by strong earnings and high-profit retention. The management issued bonus shares in FY23 as reflected in the higher paid-up capital at period end. The company paid dividends amounting to Rs. 166m (FY22: 133m) with a payout ratio of ~18.0% (FY22: 14.7%) in FY23. Total interest-bearing liabilities increased to Rs. 3.6b (June'22: Rs. 2.8b) as of Jun'23 with ~83.8% constituted short-term debt. Both gearing and leverage has increased slightly in FY23 and stands above peers.

Environment, Social and Governance

CWL's ESG initiatives encompass several key areas. In environmental protection, the Company has established a wastewater treatment plant, with a recycling plant in progress while air quality monitoring also is in place. Its energy efforts include a 0.75 MW solar plant, LED lighting installation, energy meters, and equipment upgrades, reducing electricity usage. It also efficiently treat and recycle 100% of hazardous waste and collaborate with certified parties and has planted 5K trees with Environmental Protection Agency (EPA) and Punjab Forest Department.

To address climate-related risks, CWL's HSSE department is actively perusing measures like an Oxygen Analyzer, treated water reuse, and refrigerant replacements. It also priorities workplace safety with a formal HSSE policy in place. It also support free education for employees, and over 90 students from various cadres have received assistance in the past two years. Lastly, all board directors have received training in Directors' Roles and Responsibilities, with ongoing enrollment for the remaining director. These actions underscore CWL commitment to ESG principles.

Cotton Web Limited Appendix I

FINANCIAL SUMMARY				*(amounts in PKR millions)*
BALANCE SHEET	**FY20**	**FY21**	**FY22**	**FY23**
Property Plant and Equipment	2,373.6	2,204.9	3,014.0	3,451.6
Stock-in-Trade	1,231.7	1,582.5	2,329.7	3,039.8
Trade Debts	625.5	910.4	1,611.5	2,281.5
Cash & Bank Balances	55.0	259.3	150.5	96.8
Total Assets	**5,282.2**	**6,385.5**	**8,432.8**	**10,572.3**
Trade and Other Payables	1,283.5	1,391.5	1,855.0	2,425.5
Long Term Debt *(including current maturity)*	510.9	522.7	611.5	579.8
Short Term Debt	842.4	1,511.7	2,167.8	2,998.1
Total Debt	1,353.3	2,034.4	2,779.3	3,577.9
Total Liabilities	**2,709.9**	**3,508.7**	**4,778.4**	**6,162.9**
Paid Up Capital	697.1	697.1	1,897.1	2,997.1
Total Equity *(without surplus revaluation)*	**2,058.3**	**2,522.3**	**3,303.5**	**4,062.0**
INCOME STATEMENT				
Net Sales	7,519.6	9,278.3	13,385.8	17,062.0
Gross Profit	1,066.2	1,392.7	2,320.4	3,161.1
Profit Before Tax	**277.4**	**558.2**	**1,082.5**	**1,139.4**
Profit After Tax	**204.7**	**468.8**	**904.7**	**922.3**
RATIO ANALYSIS				
Gross Margin (%)	14.2%	15.0%	17.3%	18.5%
Net Margin (%)	2.7%	5.1%	6.8%	5.4%
Current Ratio (x)	1.20	1.30	1.22	1.22
FFO	216.9	549.3	1,105.1	1,156.0
FFO to Total Debt (%)	16.0%	27.0%	39.8%	32.3%
FFO to Long Term Debt (%)	42.5%	105.1%	180.7%	199.4%
Debt Servicing Coverage Ratio (x)	2.00	3.06	4.37	2.37
ROAA (%)	4.1%	8.0%	12.2%	9.7%
ROAE (%)	10.0%	20.5%	31.1%	25.0%
Gearing (x)	0.66	0.81	0.84	0.88
Leverage (x)	1.32	1.39	1.45	1.52
(Stock in trade + Trade debt)/Short term Borrowing (x)	220%	165%	182%	177%

<table>
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<tr><td>Name of Rated Entity</td><td colspan="5">Cotton Web Limited</td></tr>
<tr><td>Sector</td><td colspan="5">Textile</td></tr>
<tr><td>Type of Relationship</td><td colspan="5">Solicited</td></tr>
<tr><td>Purpose of Rating</td><td colspan="5">Entity Ratings</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>01-01-2024</td><td>A-</td><td>A-2</td><td>Positive</td><td>Maintained</td></tr>
<tr><td>11-10-2022</td><td>A-</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="3">Due Diligence Meeting Conducted</td><td colspan="2">Name</td><td colspan="2">Designation</td><td>Date</td></tr>
<tr><td colspan="2">Mr. Abdul Basit Sultan</td><td colspan="2">CFO</td><td rowspan="2">24th November, 2023</td></tr>
<tr><td colspan="2">Mr. Umar Tarar</td><td colspan="2">Asst. GM</td></tr>
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