

# Denim Industry

## SECTOR UPDATE

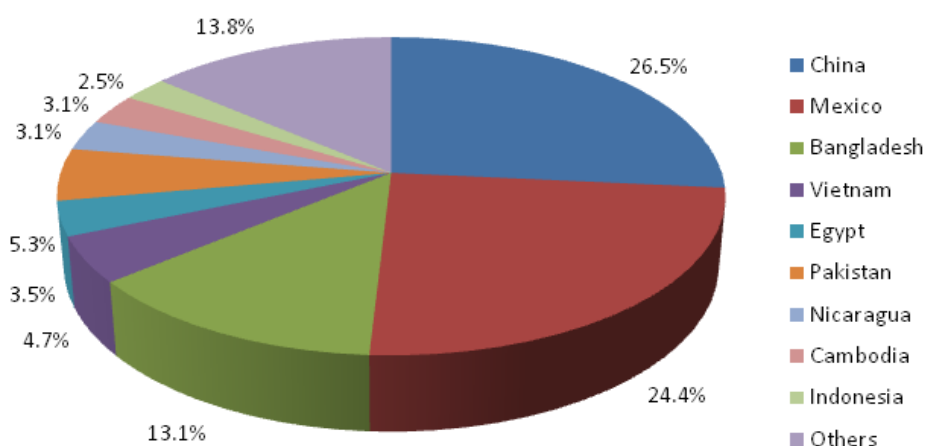
March, 2018

### Global Denim Sector

Global denim market is estimated to grow at about 6.4% annually from \$57 billion in 2016 (US accounts for 24% of this size) to \$75 billion in 2021. USA is one of the top consumers of denim jeans with an estimated demand of 450m pieces per year, followed by European Union (EU). US's top three suppliers of denim jeans include China, Mexico and Bangladesh. Largest supplier of denim garments to EU is Bangladesh followed by China. Demand growth for the next six years is expected to largely emanate from Asia (12%), Latin America (15%), North America (10%), Europe (4%), Mexico and China.

Top denim fabric importing countries include Bangladesh and Mexico. Top denim fabric exporting countries include China, Pakistan, Turkey, Hong Kong, Italy, India, Spain and Brazil. Supply growth of denim fabric is expected to supersede the increase in demand due to sizeable capacities coming online around the globe posing pressure on bargaining power of fabric and garments manufacturers.

US Denim Apparel Market



Denim Exports to EU

EUR (m)	2010	2011	2012	2013	2014	2015
<b>WORLD</b>	<b>3,530</b>	<b>3,746</b>	<b>3,703</b>	<b>3,767</b>	<b>4,090</b>	<b>4,651</b>
Bangladesh	445	592	725	809	939	1,176
Turkey	733	788	793	810	873	968
Pakistan	307	377	389	436	574	751
China	1,113	1,021	840	712	658	677
Tunisia	321	347	289	337	351	312

### Bangladesh

Bangladesh is recognized as one of the most significant centers for denim apparel production around the globe. It ranks as the second largest denim garments exporter after China. Bangladesh currently imports almost half of its fabric requirements from India, Pakistan and China. However, growing consumption of denim and expected increase in global demand has created opportunity for Bangladesh to enhance the productivity and efficiency of its denim mills thereby reducing its reliance on imported denim fabric. Overall denim capacity is witnessing significant increase and will impact players who are currently exporting to Bangladesh. On garments front, industry players are increasing capacity in order

to maintain current market share in global trade and to boost total denim exports to \$7b by 2021. The country enjoys advantage in terms of one of the lowest cost of doing business with expenses being lower by around one-third as compared to Pakistan. The future of the denim industry appears to be bright for Bangladesh's economy on the back of competitive pricing, low labor cost and focus on product innovation.

### India

Despite declining denim apparel exports, the denim sector in India is growing at a consistent CAGR of 13% to 15% per year led by escalating local demand. India's share in global denim jeans trade account for 2.5% with 10% share in global denim manufacturing capacities. The Indian denim industry enjoys the advantage of suitable cotton, induction of state-of-the-art production plants and large local market where increasing consumption of denim products is being witnessed. Indian denim industry is primarily aiming to increase its share in exports, which currently stands at around one-third of total production. The total denim fabric capacity of the country stands at 1.2b meters/annum reporting utilization levels of 75%, of which only 28% is exported. Although the urban and rural Indian markets contribute to the overall share of denim, the average number of denim items owned by Indian consumers is much lower (0.3) in comparison to other markets like the US (9), the UK (8) and Brazil (7). This demonstrates the huge potential that still remains untapped in the domestic market.

### China

Statistics reveal that Chinese denim exports are following a declining trend owing to increase in labor cost in Xintang-Hub of Textile Manufacturers in China- thereby making their denim products expensive compared to other regional players. However, demand growth is expected to remain healthy due to sizeable millennial generation who reside in middle-class cities. Additionally, the same is evident from denim jeans sales growth of 5% registered during 2016 valued at \$11.8b. Chinese per capita ownership of denim garments stand at 7 items slightly lower than U.S (9) and Mexico (12).

### **Demand Drivers**

With increasing disposable income and inclination towards western fashion trends, emerging economies are shifting their purchasing patterns towards denim jeans as a part of their casual wear. Higher quality, durability, comfort level, low maintenance, and easy availability are the main reasons for growing demand for denim products amongst the youth. Despite rising acceptance of denim products across all age groups, demand for men is forecasted to surpass that for women. Evolution of e-commerce has increased accessibility thereby improving distribution channel and facilitating consumption.

### **Denim Production Process**

#### Spinning Division

1. Cotton bales pass through the blow room where its cleaning is done.
2. Cotton then passes through the carding machine where opening, cleaning and straightening of fiber's entanglement is performed. The end product of this process is called sliver (untwisted rope).
3. Sliver passes through the drawing process where further straightening is done.
4. Sliver is drafted with twists to enable it to transfer it in ring.
5. Final yarn is made as per required counts and is wounded on bobbin tubes.
6. Final package of yarn is made through clearing of faults and winding on cones. It is further sent to the weaving division.

#### Weaving Division (Denim Fabric)

1. Yarn procured from the spinning division undergoes the process of ball warping whereby multiple ends of yarn are collected into a twisted rope for dyeing.
2. Wet rope passes through rope dyeing process.
3. Dyed ropes pass through the re-beaming process where they are converted into threads to be wound into a single beam.
4. Threads are then sized, where a protective adhesive coat is applied on the yarn to attain maximum weaving efficiency.
5. Threads are then weaved using air-jet and rapier looms, and then finishing is done to improve its appearance.
6. Denim fabric is then inspected and is ready to be exported in roll form.

### Cut to Pack Garments Process Flow

1. Denim fabric is cut as per client's requirements.
2. Sorting and bundling is performed.
3. Bundles are transferred to the stitching department.
4. Garments are then sent to dispatch area where accessories are attached.
5. Then the batch moves to the washing area.
6. The garments are then dried, graded, finished, inspected, packaged, and are ready for shipment.

### **Domestic Textile Sector**

After remaining flat during FY17, textile exports have showed healthy growth of 8% during 5MFY18. Increase in exports has been driven by growth in the value added segment where readymade garment, knit and bed wear segment has depicted a growth of 15%, 12% and 7%, respectively during 5MFY18. Growth in value added exports has been driven by incentives under the textile package: 1) increased rebates on total FOB exports value of yarn (4%), fiber (5%), home textiles (6%), and garments (7%); 2) removal of sales tax on imports of cotton and textile machinery; and 3) elimination of custom duty on man-made fiber. However, exports of cotton yarn and cotton cloth remained constant during 5MFY18 after declining in FY17. Increase in exports of cotton yarn and cotton cloth has remained limited due to weaker demand from China. Growth in denim fabric and garment exports has consistently outpaced local textile players over the last five years. Going forward, significant rupee depreciation and full year impact of textile package (particularly rebate from GoP in case of 10% growth in exports) is expected to bode well for competitiveness and profitability of textile exporters. This is expected to be partly offset by significant increase in cotton prices during the ongoing fiscal year. Impact on margins may vary depending on average price and inventory carried by different players.

### **Denim Industry- Pakistan**

Domestic denim sector's market size hovers around 10-15% of total textile exports of Pakistan, with denim fabric: garments product mix of 30:70. Major markets for fabric exports include Bangladesh, Turkey, Egypt and nominated sales to local players. Prime markets for denim garments comprise US and Europe.

### Denim Fabric

Historically, local cotton was considered most suitable for manufacturing of denim fabric due to its low staple length catering to lesser course count requirement; however, given the weakening in quality of cotton crop, reliance on imported cotton of local players has increased. The industry comprises few large players and multiple smaller players. Domestic denim fabric producing capacity is estimated at around 500m sq. meters annually, approximately three-fourth of which is catered by tier 1 and tier 2 players. Most of the tier-1 and tier-2 players are operating at over 80% capacity utilization. The determinant which governs player size is the number of looms installed and the speed of the same. Tier wise classification is presented below:

<b>Tier 1 (Looms &gt;250)</b>
• Artistic Milliners (Private) Limited
• Soorty Enterprises (Private) Limited
• U.S. Denim Mills
<b>Tier 2 (Looms 150-200)</b>
• Rajby Textiles (Private) Limited
• Naveena Exports Limited
• Artistic Denim Mills
• Kassim Denim Mills
• Siddiqsons Limited
<b>Tier 3 (Looms &lt;=150)</b>
• Denim International
• Classic Denim
• Pak Denim Limited
• Rana Tex
• Karim Denim Mills

### Denim Garments

Total domestic denim garments manufacturing capacity is estimated at around 15m-20m pieces per month. With sales entirely directed to the international market and being the final product in the value chain, this division spurs higher margins compared to the fabric segment. Given the increasing demand and in order to maintain market share, all of the major players are expanding capacities of garment division. Moreover, new players who have a strong foothold in non-denim segment are also entering the denim segment. Major players in this segment are the following:

• Artistic Milliners (Private) Limited
• Soorty Enterprises (Private) Limited
• US Apparels
• Rajby Industries
• Artistic Denim Mills
• Nishat Apparels
• Kassim Denim Mills
• Siddiqsons Denim City

### **Business Risks**

- Increasing international and local expansions by major players is expected to keep pricing power and margins of garment manufacturers under pressure. Despite growth in volumetric off-take, margins have witnessed a consistent declining trend for all major players. Given the additional capacities coming online, JCR-VIS expects margins of industry players to witness further pressure, going forward.
- Players within the denim segment who are vertically integrated, have diversified operations (geographical diversification in sales) and low concentration in sales tend to have better business risk profile vis-à-vis non-diversified players. Moreover, players with sizeable operations and market share benefit from higher economies of scale. Most of the large players in denim segment now have vertically integrated operations and have consistently increased their capacity over the last decade. Given the declining margins and increasing requirements from customers, smaller players will face a challenging operating environment unless they differentiate themselves through product innovation.
- Players that have sizeable denim fabric exports to Bangladesh will be impacted given the significant fabric capacities coming online in Bangladesh.
- Skewed nature of the industry towards denim jeans poses a significant challenge. There is a need to develop and market a larger collection of denim garments and accessories. Higher concentration towards one specific product opens doors to substitutes like jogging bottoms (yoga pants). Therefore, operations being concentrated with exposure entirely to denim jeans might significantly impact business risk profile in case of change in demand patterns or any other industry specific factors.
- Focus on innovation and product development and keeping abreast with fashion changes remains critical to denim market growth which has evolved significantly over time with products now including stretchable, skinny, ripped and jogger jeans.
- Increasing cost of sustainability initiatives in order to cater to the requirements of customers has resulted in rising cost of doing business for denim fabric and garment manufacturers.
- Procurement of raw material (cotton for players with spinning capacities) of premium quality at optimal price is critical to the profitability of denim players.
- Changes in duty structure in key export markets in order to protect local industry or other external factors may result in impact on company's sales. Moreover, weakening in law and order situation could also impact sales as company's capacity to attract orders may be impacted. In this regard, players with international presence through product development centers (for showcasing products and reducing lead times) are considered positively.
- Currently, GoP has provided incentives to the textile sector in the form of duty free import and export and loan facilities at lower rates. Any change in the same may hamper profitability of the textile players.

## Financial Analysis

Pakistani denim industry reflects significant fragmentation with a mix of integrated (those who have spinning, weaving and garments divisions) and non-integrated players. Financial profile of large integrated denim players have improved on a timeline basis with increase in equity base due to profit retention. Reinvesting the profits for enhancing capacities has resulted in low leverage capital structure for most large players. Sales of large integrated denim players in Pakistan have grown at a CAGR of 7% (despite declining prices) over the last three years with margins hovering at 3-year average of around 20% which are higher in comparison to integrated non-denim textile units. Gross margins vary across different companies and depend on the sales mix of denim fabric and garments whereby the companies focusing towards value-added segment report higher margins. Moreover, export markets also tend to have an impact on margins (Players with sales to US markets tend to have higher margins as compared to those in Spain). Other factors include size of operations and production efficiencies. Margins have observed a declining trend in the recent years owing to increasing competition, rising input prices and higher cost of doing business. JCR-VIS expects gross margins to remain under pressure as selling prices are expected to decline on account of increasing competition due to additional capacities coming online. Moreover, conservative debt structure along with utilization of export refinance borrowings resulting in lower finance cost also supports profitability levels. Going forward, growth in profitability during FY18 will be a function of increase in sales post completion of expansion projects of major players.

Liquidity profile of the industry remains healthy with strong cash flows in relation to outstanding obligations and strong debt servicing ability. Debt profile of companies is primarily short-term in nature and has been mobilized to fund working capital requirements. With majority payments being made upfront and higher time to collect receivables and fund inventory, working capital cycle of most denim manufacturers necessitates utilization of short term borrowing. Capitalization indicators are sound with low gearing levels and healthy internal capital generation. While gearing is expected to increase to fund expansions, the same is expected to remain within manageable levels. Key financial number and ratios for the denim players rated by JCR-VIS are as follows:

<b>JCR-VIS Rated Universe (3-yr average)</b>	
Average Sales (Rs. in m)	14,940
Average Gross Margins	22%
Average Gearing	0.43
Average FFO to Total Debt	57%
Average DSCR	6.29*
Average Equity (Rs. in m)	9,821
Average Long Term Debt	985
Average Short Term Debt	3,243
Average Total Debt	4,228

\* Average of players in the rated universe

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