

Mr. Naseer Ahmed
Chairman and Managing Director
Scotts Garments Limited
481-B, Peenya Industrial Area,
Peenya IV Phase,
Bangalore, Karnataka – 560 058

August 29, 2012

Confidential

Dear Sir,

IPO Grading

Please refer to our letter dated August 21st, 2012 on the above subject.

2. The rationale for the grading is attached as an **Annexure - I**. Kindly note that the rationale would be published in the forthcoming issue of our quarterly journal, 'CAREVIEW'.

3. A write-up on the above grading is proposed to be issued to the press shortly. A draft of the press release is enclosed for your perusal as **Annexure - II**.

If you have any further clarifications, you are welcome to approach us.

Thanking you,

Yours faithfully,



[Karthik Raj K]
Senior Manager

Encl: As above

Annexure I
Grading Rationale
Scotts Garments Limited

Grading Assigned

| Particulars | Number of equity shares | Grading ¹ | Remarks |
|-------------|----------------------------------|---|----------|
| IPO Grade | 1,22,46,084 shares of Rs.10 each | CARE IPO Grade 3 (Grade Three) | Assigned |

CARE has assigned a '**CARE IPO Grade 3**' to the proposed IPO of Scotts Garments Limited (SGL). '**CARE IPO Grade 3**' indicates **average fundamentals**. CARE assigns IPO grades on a scale of Grade 5 to Grade 1, with Grade 5 indicating strong fundamentals and Grade 1 indicating poor fundamentals. CARE's IPO grading is an opinion on the fundamentals of the issuer. The grade assigned to any individual issue represents a relative assessment of the 'fundamentals' of the issuer.

SGL proposes an initial public offering of 1,22,46,084 equity shares of face value of Rs.10, each through 100% book building process, representing 31.41% of the post issue paid-up equity share capital of the company.

Grading Rationale

The grading takes into account the experienced promoter and management team, company's long and good operational track record, established and long-standing relation with reputed clients spread across global markets, stable income growth, relatively stable margins and strong return on the network.

The grading assigned is constrained by SGL's customer and business concentration risk with 50-60% of the revenue being derived from a single client and significant share of the revenue derived from Europe which is faced with extended economic downturn, working capital intensive nature of the operation owing to high inventory days, project implementation risk on account of the significant capex in next one year.

Background

Originally incorporated as M/s. Scotts Garments, a partnership firm on December 01, 1992, SGL commenced business in 1994 with Mr Naseer Ahmed, Ms Refath Jehan Begum and Mr Saifulla Sayed as partners. In 2002, Scotts Garments was converted into a private limited company as Scotts Garments Private Limited (SGPL). In 2007, SGPL was converted into a

¹ Complete definition of the grading assigned is available at www.careratings.com and in other CARE Publications

public limited company. Later in 2009, SGL acquired Arora Fashions Ltd which was engaged in the manufacturing and exports of the readymade garments integrated with dyeing facility. SGL is primarily engaged in the manufacture and export of readymade garments (RMG). A Government-approved export house having in-house manufacturing facility for woven and knitted garments that includes Shirts (Cotton, Denim) Tops, Skirts, Trouser (Cotton, Denim), Shorts, Cargos, T-Shirts (Basic and Embroidered), Sweats and Jerseys supported by additional facilities such as embroidery, printing, dyeing and washing. The company presently (as on August 2012) has an installed capacity to make 151.92 lakh pieces per annum of knitted garments and 101.86 lakh pieces per annum of woven garments annually spread across the units located in Karnataka and Tamil Nadu.

Management

SGL is promoted by Mr Naseer Ahmed, Managing Director of the company. He is also presently a Member of the Legislative Council (Karnataka) and a former minister of state for small-scale industries of Karnataka from October 1990 to November 1992. He has over 19 years of experience in the textile industry. He is also the Vice Chairman of Bombay Rayon Fashions Ltd. The management team at SGL comprises highly qualified and experienced professionals with an average experience of 19 years in the line of business. The day-to-day operations of the company are looked after by Mr Naseer, who is adequately supported by a group of professionals having rich business experience.

Operations

Established export base and long-standing relationship with clients

SGL primarily focuses on the export of manufactured readymade garments and derives more than 91% of the revenue from export market, with the European region contributing to approximately 76% of the total export sales in FY12 (refers to the period April 2011 to March 2012). SGL enjoys long-standing relationship with several reputed clients across several global markets. Significant share (56% of total sales) of SGL's sales is derived from *Best Seller, a leading retailer*, which sells its products through more than 2,800 chain stores in Europe, Middle East, Asia and Canada. The company's established export market and client base has helped it report strong growth in the income and maintain a relatively stable margin in the past three years, a period in which the market witnessed volatile raw material prices and sharp exchange rate fluctuations.

Customer and business concentration risk

With 50%-60% of the sales being derived from a single client *Best Seller*, SGL faces customer concentration risk. In addition, top five clients accounted for 78% of the company's

2014

income in FY12 (67% in FY11), which makes its earnings highly vulnerable to the risks of deteriorating financial health of the clients. Furthermore, significant share of the revenue is derived from Europe which is faced with extended economic downturn.

Stable income and satisfactory profitability

SGL's financial risk profile is characterised by stable income growth, relatively stable PBILDT margin and strong return on networth (RoNW). Income from operations grew at a compounded annual growth rate (CAGR) of 11.83% during FY10-FY12. PBILDT margins remained stable in the range of 14%-16% during the period under consideration. Income growth and profits moderated in FY12 impacted by slower recovery in company's major market of Europe. However, one time income of Rs.59.5crore earned from sale of investment helped SGL report strong growth in PAT in FY12. RoNW for the period ended March 2012 stood at 42%. While the sharp improvement may be attributed to the one time income, the company's RoNW has generally remained strong over the past years as well.

Working capital intensive operation owing to high inventory holding

The company's operation is working capital intensive as evidenced in the working capital cycle of 167 days in FY12 (127 days in FY11) primarily owing to high inventory holding days. Long delivery time and need for placing advance orders in case of denim fabrics and variety of garments being produced has generally resulted in high inventory holding. It is observed that the working capital cycle has been increasing over the last three years and supporting its elongated working capital cycle, the company's reliance on working capital borrowings has also been persistently high.

Corporate Governance

SGL has complied with Clause 49 of the Listing Agreement in respect of Corporate Governance, especially with respect to broad basing of Board, constituting the Committees such as Audit Committee, Remuneration Committee and Shareholders/Investors Grievance Committee. The audit committee and remuneration committee were formed in January 2008 and the Shareholders'/Investors grievances committee was formed in May 2010.

The Board of Directors of SGL has an optimum combination of executive and non-executive directors. The Board has seven directors out of which five are Independent Directors in accordance with the requirement of clause 49 of the Listing agreement.

Litigations

There are no litigations pending against SGL and its directors as on August 2012.

IPO Details

Size of the issue

The offer comprises an offer for sale of 1,22,46,084 shares of Rs.10 each through 100% book building process. The issue would constitute 31.41% of the post issue paid-up capital of the company.

Terms of the issue

The offer comprises an offer to the public of 1,22,46,084 equity shares of Rs.10 each.

Purpose of the issue

The Objects of the Issue is to raise resources to part finance:

- Setting up a unit for trouser manufacturing at Doddaballapur, Karnataka and Knitting and Fabric Processing unit at Kolhapur, Maharashtra
- Margin Money for working capital of Doddaballapur and Kolhapur unit
- General corporate purpose
- Meet the issue expenses

The total project cost is Rs.319.94 crore.

| Sr. No. | Object | Total Estimated Cost (Rs.crore) |
|---------|--|---------------------------------|
| 1 | Setting up a unit for trouser manufacturing at Doddaballapur, Karnataka and Knitting and Fabric Processing unit at Kolhapur, Maharashtra | |
| | Land & Site Development | 13.16 |
| | Building and Civil Works | 72.86 |
| | Machineries and Equipments | 172.04 |
| | Miscellaneous Fixed Assets | 26.12 |
| | Preliminary and pre Operative | 12.90 |
| | Provisions for Contingencies | 11.69 |
| 2 | Margin Money for Working Capital | 11.17 |
| 3 | Issue Expenses and General corporate purpose | [.] |
| | Total | [.] |

Of the above, Rs.175 crore will be funded from IPO proceeds.

Project Details

SGL is presently undertaking project involving setting up a trouser manufacturing unit at Doddaballapur, Karnataka. The total estimated cost of trouser manufacturing project (with a capacity of 90 lakh pieces per annum) at Doddaballapur is Rs.92.56 crore proposed to be funded with a debt equity ratio of 1.8:1. As on July 31, 2012, SGL had incurred Rs.75.49 crore (funded by term loan of Rs.43.12 crore and the balance from internal accruals).

Although the laser processing section of the unit is operational, complete operationalisation

of the unit is expected by October 2012 as against the scheduled completion by November 2011. The delay was primarily attributable to the subdued industry scenario and delay in the proposed IPO. The repayment for the above term loan (Rs.6.48 crore due in FY13) will start from September 2012.

Apart from above project, SGL is undertaking an independent garment (woven and knit) unit in Kolar, Karnataka. The unit in Kolar is being executed at an estimated total cost of Rs.78 crore to be funded by term debt of Rs.62 crore and internal accruals of Rs.16 crore. Till August 9, 2012, SGL had incurred Rs.35 crore (funded by term loan of Rs.25 crore and the balance from internal accruals). The company expects the project to start commercial operation by the end of October 2012 as against the scheduled completion date of April 2012. The unit is proposed to have a capacity to produce 30,000 pieces per day (90 lakh pieces per annum).

In addition to the above, company has proposed a Knitting and Fabric processing unit at Kolhapur, Maharashtra, at an estimated cost of Rs.227.38 crore. The same is proposed to be funded with a term debt of Rs.90 crore and remaining through equity. The project scheduled to be implemented over the next one year and achieve commercial operation by July 2013 is expected to give SGL the benefits of backward integration. Timely infusion of equity (funds raised from IPO) remains critical for timely implementation of the Kolhapur project. The unit which initially was planned to be set-up at Doddaballapur was shifted to Kolhapur owing to the benefits derived from the availability of land at competitive price, additional state subsidy and reimbursement of power cost by State Government of Maharashtra.

Prospects

The operating environment for the textile players is expected to remain challenging in the near term due to uncertainty over demand growth, volatility in raw-material prices and persistent increases in other operating costs coupled with the stress on liquidity. Going forward, the ability of the company to diversify its clientele and market, completion of ongoing projects without any further delay and timely infusion of equity funds for the proposed capex would be critical to its prospects.

10/11/12

Financial Performance

(Rs. Crore)

| <i>For the period ended / as at March 31,</i> | <i>2010</i> | <i>2011</i> | <i>2012</i> |
|---|-----------------|-----------------|-----------------|
| | <i>(12m, A)</i> | <i>(12m, A)</i> | <i>(12m, A)</i> |
| Working Results | | | |
| Net Sales | 430.17 | 495.28 | 500.25 |
| Total Income | 433.85 | 501.83 | 505.27 |
| PBILDT | 71.74 | 74.78 | 76.76 |
| Interest and Finance Charges | 16.45 | 14.91 | 19.95 |
| Depreciation | 12.40 | 14.52 | 14.42 |
| PAT (After Deferred Tax)* | 20.37 | 27.55 | 76.66 |
| Adjusted PAT | 20.37 | 27.55 | #17.17 |
| Gross Cash Accruals | 45.13 | 48.44 | 102.79 |
| Financial Position | | | |
| Equity Share Capital | 26.74 | 26.74 | 26.74 |
| Tangible net worth | 109.11 | 139.91 | 225.17 |
| Total Capital Employed | 161.14 | 195.23 | 300.68 |
| Ratios | | | |
| Growth (%) | | | |
| Growth in Total income (%) | 18.89 | 15.67 | 0.69 |
| Growth in PAT [after D.Tax] (%) | -25.16 | 35.27 | 178.23 |
| Profitability (%) | | | |
| PBILDT / Total operating Income (%) | 16.54 | 14.90 | 15.19 |
| PAT / Total Income (%) | 4.69 | 5.49 | #3.40 |
| ROCE (%) | 22.07 | 17.50 | 13.93 |
| RONW (%) | 21.59 | 22.13 | 42.00 |
| EPS | 7.62 | 10.30 | 28.67 |
| Solvency (times) | | | |
| Long-term Debt Equity ratio | 0.48 | 0.40 | 0.34 |
| Overall Gearing Ratio | 1.74 | 1.78 | 1.24 |
| Interest Coverage | 4.36 | 5.01 | 3.85 |
| Total Debt/ Gross Cash Accruals | 4.21 | 5.16 | # 6.47 |
| Liquidity | | | |
| Current Ratio | 1.14 | 1.10 | 1.19 |
| Quick Ratio | 0.64 | 0.50 | 0.45 |
| Turnover | | | |
| Average Collection Period (Days) | 76 | 63 | 60 |
| Average Creditors (Days) | 56 | 55 | 58 |
| Average Inventory (Days) | 98 | 120 | 164 |
| Operating cycle (Days) | 118 | 127 | 167 |

Adjusted for one-time income from sale of investment of Rs.59.5 crore

*After deducting goodwill written off

Disclaimer

CARE's IPO grading is a onetime assessment and the analysis draws heavily from the information provided by the issuer as well as information obtained from sources believed by CARE to be accurate and reliable. However, CARE, does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. CARE's IPO grading does not take cognizance of the price of the security and it is not a recommendation to buy, sell or hold shares/securities. It is also not a comment on the offer price or the listed price of the scrip. It does not imply that CARE performs an audit function or forensic exercise to detect fraud. It is also not a forecast of the future market performance and the earnings prospects of the issuer; also it does not indicate compliance/violation of various statutory requirements. CARE shall not be liable for any losses incurred by users from any use of the IPO grading.

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Annexure II
Press Release

CARE assigns 'CARE IPO Grade 3' to the proposed Initial Public Offering of Scotts Garments Limited

Grading

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|-------------|----------------------------------|---------------------------------------|----------|
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Company Profile

Incorporated in 1992, SGL is primarily engaged in the manufacture and export of readymade garments (RMG). A government-approved export house having in-house manufacturing facility for woven and knitted garments that includes shirts (cotton, denim) tops, skirts, trouser (cotton, denim), shorts, cargos, t-shirts (basic and embroidered), sweats and jerseys supported by additional facilities such as embroidery, printing, dyeing and washing.

The company presently (as on August 2012) has an installed capacity to make 151.92 lakh pieces per annum of knitted garments and 101.86 lakh pieces per annum of woven garments annually spread across the facilities located in Karnataka and Tamil Nadu.

SGL reported PAT of Rs.76.66 crore on total income of Rs.505.28 crore in FY12 (refers to the period April 2011 to March 2012).

Analyst Contact

Name: Karthik Raj K

Tel: 080-22117140

Mobile: 9980562244

Email: karthik.raj@careratings.com

²Complete definitions of the ratings assigned are available at www.careratings.com and other CARE publications

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