

An Analysis of Business Opportunities within Afghanistan's Carpet Sector



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Overview of the Afghan Carpet Sector

Afghanistan's thriving carpets and textiles trade is a legacy of the country's rich commercial history and diverse culture. World-renowned for their intricate designs, Afghan carpets reflect the heritage of cottage-based craftsmanship passed through generations of families. Afghanistan produces several types of handmade carpets, including felted wool carpets (namads), flat non-pile fabric woven carpets (kilims), and pile and knotted carpets made from wool, silk, and cotton. Although carpet weaving by far dominates this sector, other textile items of cotton, wool, silk and cashmere are also made in Afghanistan. The manufacture of carpets is largely accomplished by a huge network of weavers working on individual carpets throughout Afghanistan's countryside. As testament to the meticulous nature of the art, one large carpet typically takes six to nine months to weave. Numerous dealers or traders contract upfront with the weavers, or purchase the carpets prior to final finishing for eventual sale to retail and wholesale customers on a global basis. In their role, the traders perform a variety of functions related to production and sale.

According to the Afghanistan Carpet Exporters Guild (ACEG), over one million Afghans work in the production of carpets, with millions more working in compatible industries such as wool production, cutting/washing and design. Because of this, the carpet sector has become a major focus for Afghanistan's government and private sector support organizations. For example, Afghanistan's Ministry of Commerce formed a carpet consortium in 2005 in order to utilize the combined strength of carpet producers to create visibility in the marketplace. The Afghanistan Investment Support Agency (AISA) and the Afghanistan Export Promotion Agency (AEPA) work to promote internal and external investment into the sector. On the private sector side, organizations such as the Afghan Women's Business Federation (AWBF) and the Center for International Private Enterprise (CIPE) facilitated the launch of a socially conscious brand called AfghanMark as part of a growing carpet consortium of thirteen companies and more than 23,000 weavers.

While one cannot argue that both the government and private sector are focused on the carpet sector as a potential growth industry in Afghanistan, one must also understand that no consistent strategy exists to coordinate investment within the sector or to consistently market Afghan carpets around the world. Many activities are ongoing, but most are done with little coordination or synergy, which creates activity but little long term progress. Even so, there are many opportunities for successful investment in Afghanistan's carpet sector for those companies and/or individuals with the resources, technical expertise, and long-term commitment to remain in the market.

This document is an analysis that can be used by potential investors within Afghanistan's carpet sector as a guide to achieving the best possible return on investment. It must be said that this is only a preliminary guide. Each investor will need significant assistance on the ground in Afghanistan to identify facilities, build support with the private sector and government, analyze the project's cost versus benefit, and to coordinate the logistics necessary to mitigate risk.

Section One: Organizational Plan

Description of Venture

A. Profile of Opportunities within the Carpet Sector:

1. Production: As stated above, the Afghan Carpet Exporters Guild reports that there are over one million Afghans currently involved in the production of carpets. Upwards of 95% of this production is done within the home on free-standing looms provided by carpet export companies that provide the weavers with a loom, raw materials, and designs. In some cases, the weaver "buys" the loom over time through the payment of a portion of his/her wages to the supplier. Traditionally, carpet weaving has been a cottage industry in Afghanistan, with generations of weavers being trained by older family members. Production times depend on the size, quality and material used to make the carpet. For instance, a ten sq/meter high quality carpet would most likely take 3-4 weavers ten months to produce. In light of this, Afghanistan's carpet production is extremely labor intensive and has not benefited from consistent quality standards, because production is scattered throughout the countryside. It is evident because of cultural and logistical restrictions that a majority of the production of hand made carpets will always take place in the home. However, an increasing number of investors have expressed interest in the establishment of "model" factories to accomplish three goals.
 - a. Integrating all phases of carpet production in order to produce designs and colors demanded by the global market while at the same time ensuring consistent quality.
 - b. Developing a central location where carpets can be produced, inspected, finished and shipped.
 - c. Developing a model that may eventually overcome the cultural paradigms and transition more production into a factory setting where it can be easily monitored and where amenities can be provided for workers.
2. Cutting/Washing: Cutting and washing of hand-made carpets is as integral to overall production process as is weaving. Currently, the capacity to cut and wash carpets within Afghanistan is minuscule, which results in the transfer of more than 80% of the country's production to Pakistan, where the carpets are finished and shipped under a "Made in

Pakistan” label. While monetary investment is one factor in the lack of cutting and washing facilities in Afghanistan, the following are just as significant:

- a. Access to Land: Access to land is a difficult issue for investors in any sector of Afghanistan’s economy, as land titles are convoluted at best and in many cases do not exist. Without access to clear-titled land, investors are hesitant to make an investment in facilities that depend on fixed assets and infrastructure such as carpet washing and finishing.
 - b. Income: In recent times, there has been little incentive for carpet producers to invest in their own cutting and washing facilities, as they can earn a significant income by sending their unfinished carpets to Pakistan. The producers have no money in sunk costs, while at the same time benefiting from quickly turning their inventories into profit by selling to Pakistani wholesalers. In short, there is little financial incentive for Afghan producers to invest in finishing facilities.
 - c. Access to Credit: Cutting and washing facilities require several acres of land that has water, drainage and transportation infrastructure on site. Because Afghan financial institutions do not value land as collateral it is difficult for potential investors to gain access to credit. This being the case, the potential investor, in a majority of cases, is faced with accepting 100% of the risk of such an investment. It thus becomes easier and arguably more economical to sell unfinished carpets to Pakistani wholesalers rather than to make an investment in a finishing facility.
3. Transportation: The transporting of carpets to foreign markets is a key issue in the growth of Afghanistan’s carpet sector. Currently, a large majority of Afghan carpets, upwards of 80%, are shipped by truck to Pakistan for finishing and transport. Thus, the Afghan producer’s basic responsibility from a transportation standpoint is to coordinate shipment between Afghanistan and Pakistan. A few producers are shipping carpets by air freight from Kabul (KIA) through Dubai (DXB) to buyers in Europe and North America, but this is the exception rather than the rule. Air freight is an expensive transportation option and a majority of carpet producers do not have access to markets outside Afghanistan anyway. For investors that can produce sufficient volume to warrant air cargo shipments, whether commercial or charter, this is the most viable option in moving product outside the country since there is no rail system and transportation by road is fraught with challenges. Transportation by sea is possible only if the carpets can be moved in mass to the port of Karachi, Pakistan or to Dubai, UAE. The major problem with ocean transportation, of course, is the length of time it takes for the carpets to arrive at their destination in Europe or North America.
 4. Retail Operations: Relatively few Afghan carpet producers have retail operations outside Afghanistan. There are many reasons for this, but the

most prevalent one is simply the lack of contacts and capacity to initiate direct connections to foreign buyers. Without these direct connections, it is easier and arguably more profitable to sell carpets to buyers in Pakistan or on the local market to foreigners that are visiting Afghanistan. The potential for investors lies in the integration of all facets of the carpet industry to achieve the end state of retail sales. This may or may not mean the establishment of a stand-alone retail presence in targeted countries. In fact, for most investors it will most likely mean the production of carpets in Afghanistan for sale to wholesale buyers in Europe and North America.

B. Analysis of Carpet Sector's Strengths, Weaknesses, Opportunities and Threats: As part of its analysis of Afghanistan's carpet sector, the Afghan Women's Business Federation (AWBF) conducted research in conjunction with On the Frontier (OTF) Group to assess the strengths, weaknesses, opportunities and threats facing Afghanistan's carpet industry. The following is a synopsis of this assessment:

a. Strengths:

- Globally acknowledged as one of Afghanistan's most viable and visible products.
- Large supply of skilled labor in parts of the country where carpet weaving has been traditionally important.
- Hand-made process makes Afghan carpets one-of-a-kind heirlooms.

b. Weaknesses:

- Home production makes monitoring and quality standards difficult.
- Limited existence of cutting and washing (finishing) facilities promotes shipment of unfinished carpets to Pakistan.
- Transportation is expensive and options are limited.

c. Opportunities

- Investment in production and finishing facilities could dramatically increase the visibility and sale of Afghan carpets on the global market.
- Creation of a "socially conscious" carpet brand could change the business model within Afghanistan's carpet industry and increase foreign support/desire for Afghan carpets.
- Investment in production and finishing could lead to investment in other sectors such as raw materials (wool) and transportation.

d. Threats

- Competition from neighboring countries has dramatically increased and Afghanistan has lost much of its market niche due to years of war.
- Hand-made carpets, while unique, have certain quality irregularities that make them unappealing for some European and North American customers. This includes inconsistencies in the dyeing, weaving and shape (due to the conditions under which the carpets are weaved).
- Afghanistan's wool industry was decimated by war, which has limited the availability of high quality wool. This could have negative implications on quality and texture, as well as increasing the price of carpets due to the use of imported wool (Belgique) or payment of a higher price for domestic wool.

Products

A. Product Differentiation:

2. Production Material: Carpets are constructed from the knotting of threads around longitudinal threads (or warps) and held in place by latitudinal threads (the weft).¹ In Afghanistan, there is considerable choice of which materials can be used for the knotted threads, warps and wefts. Most common are carpets made of wool, though silk and cotton are produced as well. The carpet's quality, especially in the case of wools, is based on the quality of the raw material that is used.
3. Dyes: Traditionally, natural dyes have been used in the production of Afghan carpets but in recent years an increasing number of producers have begun using semi-fast chemical dyes. These dyes have similar properties to vegetable dyes and allow for softening and mellowing with age. Vegetable dyes are now primarily used in the production of one type of carpet, Chobrans.
4. Design: As a general rule, the design of a carpet depends on where it is made. In the north of Afghanistan, in the areas around Mazar e Sharif, Turkmen carpets are traditional and are characterized by geometric patterns associated with particular tribes. Increasingly, designs have been created overseas that have impacted the traditional patterns of Afghan carpets, so it is no longer as difficult to differentiate particular designs. The following are among the most traditional designs by region:²

¹ Pain, Adam and Moharram Ali. "Understanding Markets in Afghanistan: A Case Study of Carpets", March 2003.

² Ibid

Table One: Types of Afghan carpet designs

Bokhara	Any rug in the Tekke design			
Mauri	Mauri after the Merv oasis from where the weave originated			
Mauri Zair Sha	From the Herat region to a design created in the 1950s			
Mauri Shakh	Group of distinctive Tekke designs from Marmazit near Balkh			
Kizil Atak	A design from near Shebergang			
Alti Bolagh	Near Andhoy in North Afghanistan			
Jangalarik	East of Aq Cha			
Afghan Ersari	From the region of Andkhoy, Farukh, Taghan and Chakseh			
Kazan	Aq Chah and Dali tribes from Konduz			
Waziri	Confederation of weaving groups			
Daulatabad	Prayer rugs			

5. Structure: A carpet's structure is determined by the way in which the loops of wool (or other raw material) are knotted around the warp strings and anchored in place by the weft string. Different styles of carpets, such as Turkmen, may have different knot patterns. A key element in the structure is the knot count. The more counts per unit area, the finer the weave and consequently the more exquisite the carpet. The following table provides detail on the types of wool and number of knots used to differentiate qualities of weave:³

Table Two: Knot range for different wool types

Knots/sq m	Knots/10 cm	Knots/sq inch	Local Wool	Pakistan	Chobrang	Belgique
40,000	20	25				
90,000	30	60			Course	
100,000	32	65	Course			
110,000	33	70		Course		
164,000	40	106			Fine	
171,000	41	110	Fine			Course
200,000	45	130		Fine		
230,000	48	150				
250,000	50	160				Fine
300,000	55	194				
320,000	57	296				
460,000	68	300				
1,000,000	100	650				

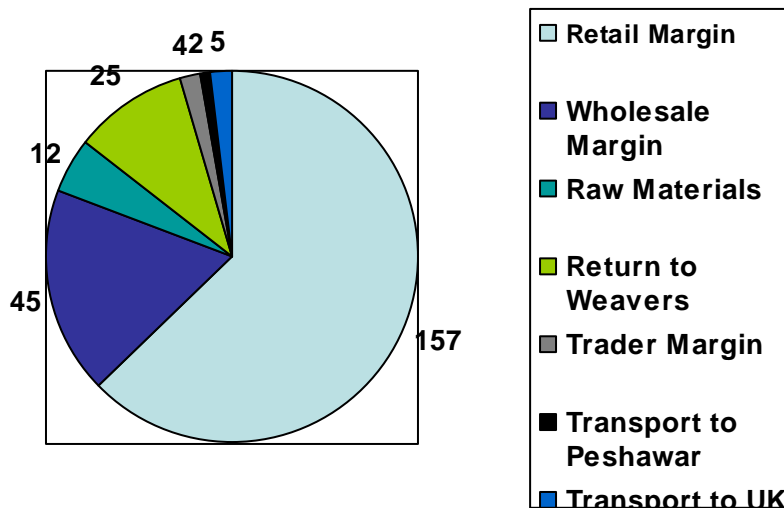
- B. Raw Materials: Traditionally, karakul wool has been used in the production of Afghan carpets. For the most part it is hand spun to the highest wool qualities.

³ Ibid

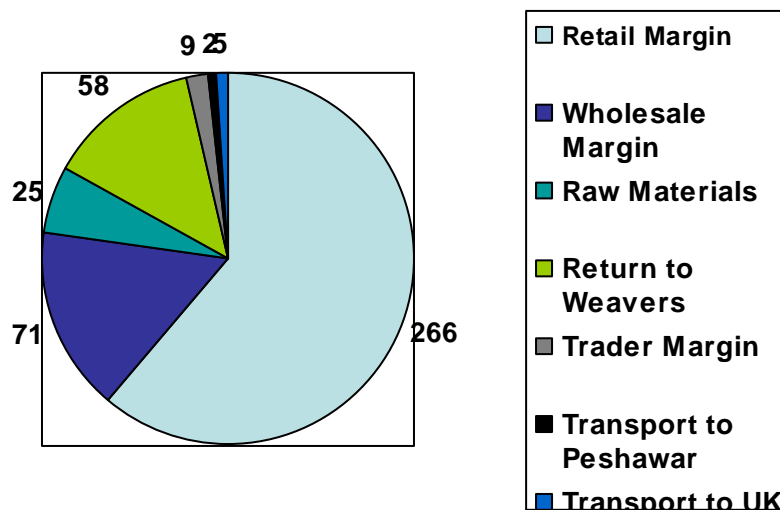
- However, in recent years, there has been a trend toward machine spun wool, as it is easier to establish a quality standard and is less labor intensive. Because of the difficulties facing Afghanistan's wool industry, many producers began buying wool from Pakistan, which for the most part is low quality. Many of Afghanistan's finest carpets are now made with wool produced in Belgium (Belgique). Table one provides more information on the quality of wool being used to weave Afghan carpets.
- C. Competitors: Afghan carpet producers face an increasing number of competitors in the global marketplace. Competition has become even more challenging over the last twenty-five years as Afghanistan lost its market niche and began moving a majority of its carpets through Pakistan for finishing. By law, these carpets were exported as Pakistani products, though they were made by Afghans. This eroded the country's visibility. In addition, during the years when Afghanistan was unable to adopt new weaving techniques and designs, competing countries such as Turkey, Saudi Arabia, Pakistan, and Iran made great strides in developing a market niche. The term "Persian" carpets became a designating label for carpets manufactured throughout the region, which helped the countries that were prepared to export and hurt those, like Afghanistan, that had restricted market access. In addition, many of Afghanistan's competitors began to use machine weaving techniques versus hand weaving, as well as chemical dyes and finishing techniques that dramatically increased the overall quality of the carpets. Afghanistan failed to adopt such techniques and therefore became even more uncompetitive. Since 2001, the Afghan government and international organizations have made the re-establishment of Afghan carpets on the global market a priority. However, lack of technology, infrastructure and market access has continued to impede progress in this area.
- D. International Markets: The leading importer of carpets in the world is the European Union, which buys about 63% of total world imports. The major importers within the EU were Germany, Italy and the United Kingdom, accounting for more than 45% of the total exports. Competing for these markets are six main producing countries-the Islamic Republic of Iran (24.7%), India (21.3%), China (13.9%), Nepal (8.4%), Pakistan (8.3%), and Turkey (7.1%). While Afghanistan does not make a significant sales impact on the EU market, it should be noted that this competition reflects a different type of carpet than provided by Afghan producers, as most of them are machine woven and chemical dyed. This also does not take into account the United States, which is a huge market for carpets in its own right. In the United States especially there is a niche market for higher end hand-made carpets that are sold as heirlooms as much as for home décor. The baseline is that Afghanistan will have continued difficulty competing head-to-head with the countries noted above in the low to mid-range home décor carpet sales. Instead, Afghan producers should focus on niche markets that demand high-quality, moderately priced, heirloom quality carpets.
- E. Pricing: Based on data collected by the Afghanistan Research and Evaluation Unit (AREU) on the transport and processing of carpets to Peshawar, their export to the UK and the final retail price of Afghan carpets in the UK, it is clear that the major mark up occurs in the UK and is undertaken at the wholesale and retail

level. The return to the producer can be up to 15% for those who are independent producers (in the case of Pakistani and Belgique carpets) but under conditions of wage labor, this percentage may be cut by half. Chobrang producers may be better paid than producers that work with other wools, but they achieve overall a smaller percentage of the sale price. The trader margin on the other hand is greatest with Chobrang carpets. The following tables provide an illustrative example of shares in the final retail price of carpets (U.S. \$ per/sq m) by stage in the commodity chain in relation to final retail price in the UK by wool type.⁴

Graph 1: Pakistani Wool Carpets

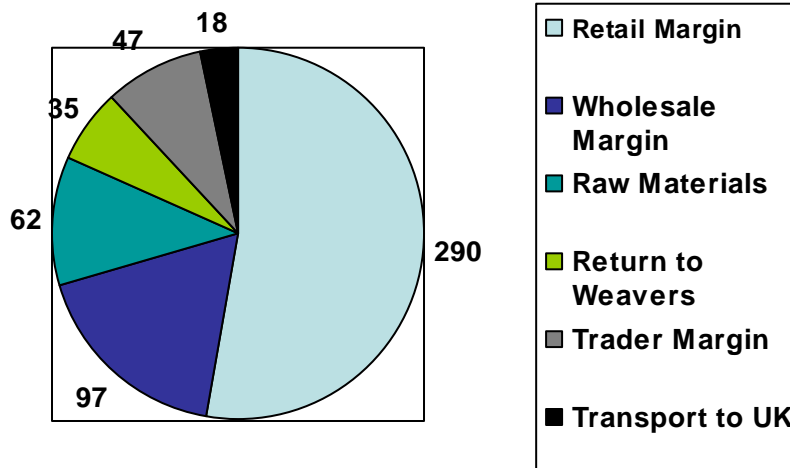


Graph 2: Belgique Wool Carpets



⁴ Ibid

Graph 3: Chobrang Wool Carpets



Location

A. Factory Location: As stated above, more than 95% of Afghanistan’s current carpet production is done in homes, on one or two looms with a number of family members participating. There is growing interest, however, if the development of “model” factories that allow for proper quality oversight, process-oriented integration of different facets of the commodity chain, and simplify the logistics necessary for production, finishing and transportation. While integration of all the value chain processes is tempting, the reality is that it may not be the best approach in Afghanistan. For instance, a large majority of carpet production takes place in the north of the country, in places such as Mazar e Sharif, Andkhoy, Aq Chah, Shiberghan, and Maimana. There is also significant production in and around Herat and in pockets around Bamyán and Kabul. This being the case, the optimal location for a carpet production facility is in the north, most likely in Mazar e Sharif since it has the labor force, infrastructure, access to land and transportation network necessary for success. Herat would also be a location worthy of consideration. In both of these areas, the Afghan government and international donors have land and facilities available to provide assistance to investors. The areas where production flourishes, however, is not optimal for the location of finishing facilities, as these facilities require warm, dry weather that is not inherent to northern Afghanistan.

While the north is the logical choice for the location of a carpet manufacturing facility, it is important to note that only a small percentage of overall production is likely to be produced in a factory setting. The main reason for this is that it is not the culture of Afghans to produce carpets in a factory setting and therefore this approach will likely take time to germinate. Carpet experts estimate that only 25% of a company’s overall production could come from a factory setting, while the remaining 75% would come from home-based looms. The importance of the factory concept, however, is that a) it will change the cultural paradigm over time,

- b) it will provide a monitoring and evaluation system that will transcend the factory floor and proliferate among the home-based producers, and c) it will provide much needed structure to the carpet industry by starting the process of value-chain integration.
- B. Finishing Facility Location: As stated above, carpet finishing requires warm dry weather that for the most part is available in southern Afghanistan. Jalalabad is an especially good location for cutting and washing due to its close proximity to Peshawar, its weather, its relatively stable security, and its access to land/facilities. The likely scenario for factory-based carpet production in Afghanistan is that a company would have a production facility in the north and a finishing facility in the south. This of course will require an adequate transportation system between the two locations. At present, it takes at least two days to transport carpets from Mazar e Sharif to Jalalabad, provided the weather cooperates.

It is possible to cut and wash carpets at the production facility site, even if this site is in north Afghanistan. However, this would most likely require the cutting and washing to be done indoors, with drying done by heaters instead of the sun. This changes the texture and sheen of the carpet and is not considered optimal for the quality of carpets Afghanistan must produce to be competitive in the global marketplace.

Any company considering an investment in the carpet finishing industry should understand that a) very few facilities of this type exist at present, which provides an opportunity for potential investors and b) an opportunity exists to sign contracts with other Afghan producers to wash and finish their carpets in addition to handling the carpets produced by the investor's company. With this in mind, there may be more of an opportunity for return on investment in the carpet finishing industry than in production.

A carpet finishing location requires a reasonably large piece of property (2-4 acres), proper drainage and waste water treatment, as well as access to water. The investment needed for cutting and washing equipment is minimal. Even though chemicals are used in the washing process, environmental impact is minimal, since the solutions are detergent-based and can be treated in a waste water facility.

- C. Cost: Cost for development of a carpet production facility and/or finishing facility will depend on the specific needs of the investor. Factors that will impact cost will include a) size, availability and location of property, b) whether or not the property is provided gratis or is leased, c) infrastructure costs, d) personnel costs, e) utility costs and d) taxes and overhead. These costs can only be accurately tabulated after proper due diligence has been conducted.
- D. Legal Issues: While there is risk associated with investment in any post-conflict country, it can be mitigated through a thorough understanding of the appropriate laws that pertain to investment. One of the best sources for information in this

regard is the Afghanistan International Chamber of Commerce’ “Legal Guide to Doing Business”, which is available on its website, <http://www.aicconline.org>.

The first decision that an investor must make is what kind of company to establish. The following table provides an overview of options based on current Afghan law:

Type of Company	Suitable for Small Entrepreneurs in Afghanistan?
Corporation	<input checked="" type="checkbox"/> No – It is too complicated and expensive to establish a corporation for small entrepreneurs. Only big companies register as a corporation.
Limited Companies	<input checked="" type="checkbox"/> Yes – Although it is more complicated to establish a limited company than a sole proprietorship or partnership, it is less difficult than a corporation while investors are protected from liabilities when the company cannot pay its debts.
Partnerships	<input checked="" type="checkbox"/> Yes – Partnerships are useful when investors want to establish a company together with close relatives who all bring capital into the company. Since partners are normally liable for the debts of the company, they need to have good working relationships.
Sole Proprietorship	<input checked="" type="checkbox"/> Yes – This is the least expensive and easiest way to register as an entrepreneur in Afghanistan. It only takes one person to register the business with the municipality as a sole proprietor and begin the business.

The sole proprietorship is by far the most popular company model in Afghanistan, though partnerships are becoming more important. More information on the requirements for creating a company in Afghanistan is available from the Afghanistan Investment Support Agency (AISA). AISA’s contact information is as follows:

Opposite Ministry of Foreign Affairs, Kabul-Afghanistan
 Phone: +93 (0) 20-210 3404
 Fax: +93 (0) 20-210 3404
 Email: invest@aisa.org.af
<http://www.aisa.org.af>

Once an investor contacts AISA, it will be asked to fill out the [Investment Application Form](#) and the [Application form for tax identification number](#) as provided by the [Ministry of Finance](#).

Depending on the size of the investment, the investor will pay a licensing fee of USD 100 to USD 1,000. The remaining details will be handled by an assigned AISA manager, including the successful registration of investment documents in

the Commercial Court and the announcement of business details in an Afghan newspaper.

Any investors should be aware of the following when dealing with the Afghanistan Investment Support Agency:

1. The investor should personally visit AISA office to complete the process of license acquisition. Otherwise, an authorized representative of the investor should be present in AISA for this task.
2. Foreign investors should certify their legal identity through Ministry of Foreign Affairs in Kabul, Afghanistan. A passport is acceptable for verification of a foreign citizen's identity.
3. The investor must have a specific work address. Postal address (POB) is not acceptable and work address should be that stated in the rental agreement or relevant document(s) to verify the work address.
4. AISA will provide the tax identification form to be completed by the investor and will be responsible for acquiring the tax number for the investor from the Ministry of Finance.
5. Activities and operations of the investor should be clear. Moreover, the investor should carry details regarding the amount/quantity of investment, number of workers for the organization and names of top level officials of the organization.
6. The applicant should take care that the commercial name/title that they wish to use is not one already in use. Although the license will be issued after proper consideration given to the business name, the investor will be directly responsible for using a commercial name.
7. The organizations' legal entity will be based on the structure of business e.g. sole proprietorship, partnership, corporation, limited corporation, or foreign company. Relevant documents should be attached to the application to prove this.
8. For public information summary of the information given in the investment application form will be published in one of the newspapers in Kabul city or the city in which the company may operate.
9. The applicant is expected to provide all correct information on the application form, since incorrect information will disqualify the applicant from obtaining the license. Furthermore, if incorrectness of the provided information is proved after the issuance of license, the investors' license will be immediately terminated and the right of investment will be lost. All information that will be required including information concerning Govt. tax payments, bank loans and ability of paying for losses shall be based on courts decisions or within legal forum.

10. In accordance with “Law on Private Investment in Afghanistan” the investor (A Registered Enterprise) must immediately notify AISA if there has been a change in its ownership or capital structure, or if an investor contributes additional capital to its investment.
11. The holders of the small business licenses do not qualify for industrial lands, nor can they apply for a business passport from the Ministry of Interior.

While foreigners cannot own property in Afghanistan, they can enter into a long term lease. For investors in the carpet sector there are several options as far as access to land and facilities is concerned. The first is the development of a green field site within or contiguous to one of the USAID or World Bank-funded industrial parks. USAID has funded development of industrial parks in Mazar e Sharif, Kandahar and Kabul, while the World Bank is developing a park in Jalalabad. AISA is responsible for overseeing the industrial parks and after initial expression of interest companies are ranked and short listed based on criteria such as: compatibility with industrial estate, stability of the company, type of product, job creation potential, investment amount proposed, space requirements, and availability of plots. Short listed investors are then invited to submit a formal competitive offer for the land price or lease rate. Each bid must be accompanied by the marked-up purchase agreement or lease agreement. The highest bidders are selected and negotiations of the lease or sale agreement begin immediately. The companies may use this period of time to complete their project. Once the agreement is signed, the investors can make their final financial arrangements and begin procurement of the plant, building works and other plot or building site.

Another option is through the privatization of State Owned Enterprises (SOEs). The Afghan government has a plethora of SOEs that are designated for privatization over the next several years. Privatization is a slow and bureaucracy profound. However, for investors that have the patience, there are good opportunities within the SOEs. For more information on privatization, investors can log on to Emerging Markets Group’s privatization and land titling website at <http://www.ltera.org>.

A third option for investors, especially those in the carpet sector, is direct negotiation with the Afghan Government. Both the Ministry of Commerce and the Ministry of Agriculture have expressed interest in providing carpet sector investors with access to land, whether it is in the form of green field sites or existing facilities owned by the Afghan government.

Tax incentives for investment were rescinded by Executive Order of President Karzai on June 21, 2004. Subsequently, the following tax regime was put in place:

Corporate Income Tax

Corporate income tax is a flat tax of 20% of net taxable income. Net taxable income is computed by deducting all ordinary and necessary business expenses from gross income. Corporate rates apply to legal entities such as corporations and limited liability companies.

Personal Income Tax

Resident natural persons are taxed on income from all sources world wide including but not limited to wages, salaries, rents, etc. The annual tax rates are 0% (up to \$3,000), 10%, (\$3,000 to \$24,000) and 15% (for amounts over \$24,000). As a general rule, foreigners are exempt from paying personal income tax in Afghanistan.

Wage Withholding

Employers with two or more employees are required to withhold tax from their employees' salaries based on the above rate. Employers file an annual wage and tax withholding statement with the Ministry of Finance. Employees attach a copy with their tax return.

Business Receipts Tax

A business receipts tax is imposed on gross receipts of all types of income of corporations and limited liability companies, except for rents, royalties, commissions, fees, interest, dividends, and similar income, which are taxed at 5%.

A 10% tax is imposed on gross receipts for businesses with over 100,000 Afs income per month on service providers in the following sectors:

Equipment

- A. Equipment Needs/Production: Looms comprise the major equipment cost for the production of carpets. Depending on the size of the loom, they can cost in the range of \$800 to \$4,600 each. Used looms that are found throughout Afghanistan can be purchased for considerably less money, though the consistency necessary in a manufacturing operation will no doubt warrant the purchase of high quality looms. In addition, there will be additional costs for generators and other equipment needed to operate the factory unless it is located in an industrial park.
- B. Equipment Needs/Finishing: The equipment needs for a finishing operation are relatively small. The cost of washing equipment is low and it is readily available in Peshawar and other locations. The same is true for cutting machines. Tumblers needed to dry the carpets are also readily available and cost in the neighborhood of \$8,000 each.

- C. Raw Materials Cost: Presently, raw materials costs comprise between 5%-18% of carpet costs, depending on the quality of the wool. Belgique wool is much more expensive than Afghan or Pakistani wool. It should be noted, however, that traditionally Afghan karakul wool has been much higher quality than Pakistani wool.
- D. Labor Costs: Because carpet weaving is a labor intensive industry, labor costs represent a significant percentage of the overall production cost. Currently labor costs are extremely low for home-based weavers that produce their project for a carpet merchant. According to a recent study by On the Frontier, a top quality weaver will produce about 1 sq/m per month and for a three meter carpet, which takes three months to weave and sells within Afghanistan for \$250, the weaver will make approximately \$25. It should be noted that in most cases the weaver makes the same amount even if the carpet is exported and sold for a higher price. Recently, organizations such as the Afghan Women's Business Federation (AWBF) have attempted to change the economic model of carpet weaving by establishing socially conscious programs that attempt to provide a higher stake of the revenue to weavers. In AWBF's case, it created a socially conscious brand, AfghanMark that is now being sold by retail outlets in New York City. This brand includes thirteen carpet companies or consortiums that employ 23,000 weavers. Each participating company must offer its weavers a reasonable wage plus a 10% commission on the carpets final sale price, access to health care and access to education.

Any investor interested in opening a carpet production facility in Afghanistan should consider partnering with a program such as AfghanMark, as the investor can take advantage of the marketing opportunities it offers. In addition, the investor should plan to offer educational, health care and child care opportunities on the factory site as this will enhance the ability to recruit workers. In summary, wage rates should continue to rise as these socially conscious programs become more prominent. It is clear that producers can raise wages for the weavers without sacrificing profit (on carpets that are exported to the EU and North America) if they also control the wholesale and retail operations. This is important in that almost 62% of the profit margin on exported carpets is at retail end.

Management/Personnel

- A. Labor Force: As stated earlier in this report, the Afghanistan Carpet Exporters Guild (ACEG) estimates that there are over one million Afghans involved in carpet production. This does not count the number involved in finishing and related industries such as wool production. Most of the labor force is centered in northern Afghanistan, in the Mazar e Sharif, Andkhoy areas, as well as near Herat. Other pockets of labor exist in Bamyan and in areas outside Kabul. During the war years, a large number of Afghanistan's carpet weavers fled to Pakistan and today thousands of Afghan weavers are working in Peshawar manufacturing carpets that are exported as "Made in Pakistan". According to

Mazhar Amir, who runs a carpet factory in Peshawar, a large majority of the weavers would like to return to Afghanistan given the opportunity to do so.

B. Labor Regulations: Afghanistan's labor regulations are consistent with those of its neighboring countries. The following are the major elements of the current employment legislation:

1. Average hours of ordinary work during the year shall not exceed 40 hours per week.
2. Working hours on Thursday shall not exceed 5 hours per week;
3. Young adults between 15 and 18 years old, shall not work more than 35 hours of work per week;
4. For adolescents who are not yet 15 years old, working hours shall not exceed 30 hours per week;
5. For those workers who perform hazardous and underground work, the hours of work shall not exceed 35 hours per week;
6. The working hours of a night shift will be one hour less than the day shift.
7. The breaks for prayers and meals not exceeding one hour shall not be included in the hours of work. A worker is entitled to 20 days annual leave with pay and if less than 18 years of age, 30 days annual leave with pay.

Additional information is contained in the Afghanistan International Chamber of Commerce' "Legal Guide to Doing Business", which is attached in the appendix of this analysis but is also available at <http://www.aicconline.org>.

Section Two: Marketing

Target Market

- A. Potential Customers: It is assumed that investors in the carpet sector are interested primarily in producing carpets for export. There are over \$1.4 billion in carpet sales on the world market each year, with exports from Afghanistan officially reported at \$4.5 million (although because of inconsistent reporting this could be as high at \$10 million). The United States is the single largest purchaser of carpets on the world market, with approximately \$500 million in annual sales. Germany is second with approximately \$260 million in annual sales. As a block, the European Union is the largest purchaser of carpets. Afghanistan currently captures less than 1% of world carpet sales.⁵
- B. Direct Sales versus Sales through Retail Partners: It is well known in the carpet industry that the greatest profit is derived by the individual that is closest to the end buyer, which is the retailer. Currently, three sales models exist in Afghanistan. The first, which is widely used by Afghan producers, is the sale of carpets to Pakistani wholesalers that finish them and export them as "Made in Pakistan". While this provides a steady income to the Afghan merchants, they are on the lowest end of the profit chain. The second model, which was widely

⁵ The OTF Group Carpet Sector Study, February 2005.

promoted by Arzu Rugs (a USAID funded project), is direct sales. In Arzu's case, the direct sales occurred either through its e-commerce site at <http://www.arzurugs.com> or at various shows and exhibitions it hosted throughout the year. Arzu passed a portion of the profits back to its weavers in Afghanistan, so the profit margin for individual weavers did rise. The difficulty with this model is that it generates relatively low sales volume while requiring significant expenditure for warehoused inventory. The third model is the traditional retail model where a producer either has his own retail outlet in the United States or United Kingdom (such as Nomad Rugs in Kabul) or exports directly to one or more retail outlets outside Afghanistan.

- C. Exporting: Carpets are among roughly 73 different items that may be shipped to the United States duty free. In addition, the U.S. government supports the development of Reconstruction Opportunity Zones (ROZs) in Afghanistan. The concept of ROZs is that any products produced within these designated zones will be duty free to the United States. While these incentives certainly provide an advantage for carpet producers in Afghanistan, it should be noted that this will only provide an increased margin of about 3%.

There is massive potential to increase Afghan exports due to the unique nature of their carpets and global interest in supporting the Afghan carpet industry. Interest is beginning to decline, however, so it is imperative that carpet producers in Afghanistan establish and maintain a presence outside the country. According to the OTF Group's study in 2005, Afghanistan's current exports of \$10-40 million could grow from 2 to 5 times with proper marketing.

Competition

Competition for the approximately \$1.5 billion in annual carpet sales is increasing. Iran is the world's leading exporter of carpets, with over \$530 million in annual sales. Pakistan is second with just over \$200 million in exports, with India, China, Nepal and Turkey ranking 3-6 respectively. Afghanistan currently ranks in 21st position, though Afghan made carpets comprise a significant majority of Pakistan's exports.⁶

Section Three: Financial Overview

Summary of Financial Needs

The financial requirements for the development of carpet production and finishing facilities in Afghanistan will depend on the location, size and complexity of the enterprise. However, the following factors will largely determine the amount of the initial investment:

- A. Land: As stated earlier in this report, the Afghan government and private sector have been supportive of providing land, either at low

⁶ Ibid

cost or no cost, to potential investors. However, securing property of any kind will take time and will require the maintenance of an on-the-ground presence to facilitate the transfer of property. Since foreigners cannot own property, it is likely that land access will be in the form of a long term lease.

- B. Construction: Afghanistan's construction costs are considered low by global standards, while quality is for the most part good. Construction costs, of course, will be determined by the size of the facility, whether it is a green field (new construction) or renovation site, and the type of materials used for construction.
- C. Infrastructure: Location within an existing industrial park is optimal from an infrastructure standpoint since electricity, sanitary sewer and security are already in place. The demand for property within these parks currently far exceeds supply, although there are some available spaces in the Mazar e Sharif park. Locating off the industrial park, either contiguous to it or in a separate location, is an alternative but infrastructure costs will rise as the investor will be responsible for roads, power, site improvements and security.
- D. Taxes/Licenses: A brief analysis of Afghanistan's tax regime is noted above. This regime is encountering ongoing changes that make it difficult for investors to get a clear picture of the overall tax burden. The Afghanistan Investment Support Agency (AISA) works with investors to coordinate all the necessary business licenses.

Future Outlook for the Industry

The outlook for Afghanistan's carpet sector is positive as global sales will continue to expand and there is renewed focus on Afghan products. Over the next five years, the OTF Group estimates that carpet exports from Afghanistan could increase to over \$100 million if a) production capacity is increased, b) finishing operations are developed, c) a consistent marketing effort is launched and d) the government and private sector cooperate to develop a cohesive sectoral strategy. It is clear that investors are needed to enhance Afghanistan's ability to achieve its goals for the carpet sector. Likewise, it is evident that there is money to be made by investors that make a long-term commitment to the carpet sector.

Section Four: Summary and Conclusions

After analyzing Afghanistan's carpet industry, it is clear that investment opportunities exist. Certainly, these opportunities come complete with the risk associated with doing business in a post-conflict country, but for the size of the potential investment, the possible returns are high. There are three reasons for this:

1. The Afghan government and international donors perceive carpet production as one area where Afghanistan can make a relatively quick impact on the global market. All parties involved are very interested in assisting investors with the

- development of production and finishing facilities that will increase the quality, marketability and sale of Afghan carpets.
2. Unlike in many other sectors of its economy, Afghanistan has a massive skilled labor force in the area of carpet production. With the integration of new designs, weaving techniques and market access, this labor force can greatly increase the volume of production.
 3. Currently there is virtually no production capacity (in a factory setting) in Afghanistan's carpet industry. With this being the case, the establishment of a production facility can fill a niche that is needed in order for the sector to increase its market access. There are also few finishing facilities currently operational in Afghanistan, which provides an opportunity for investors.

Even in light of these natural advantages, investors in the carpet sector should consider the following as they consider their strategy in Afghanistan:

1. Investors may want to consider partnering with an Afghan individual or company as a minority stakeholder. Any investor considering a site in an industrial park is required to have an Afghan partner. This is especially important for investors that do not have a background in the carpet sector, as it will provide them the technical expertise necessary to increase the likelihood of success.
2. Investors should strongly consider having a representative on the ground in Afghanistan in order to address the many issues that will arise with government and private sector stakeholders.
3. While investment in the carpet sector is less resource-intensive than many others, investors should consider it to be a long-term commitment.
4. Because of significant cultural differences, doing business in Afghanistan is different than in most other areas of the world. Many investors find out too late that culture and religion play primary roles in every facet of society. Investors should not anticipate managing a production operation in Afghanistan the way they would in most other areas of the world, which is why it is important to have a local partner that understands the best way to conduct business operations within Afghan society.