



## COTTON SPINNING INDUSTRY IN TAILSPIN AFTER RECENT FALL IN COTTON PRICES AND RISING INTEREST RATES

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After a brief but sharp upturn, the Indian cotton yarn industry is facing a challenging environment yet again. This time, due to the steep fall in cotton prices since April 2011 along with rising interest rates. Recent crash in cotton prices right after the end of peak supplies has questioned the practice of procuring raw material in bulk quantities during the season. During 2010-11, cotton prices more than doubled to Rs. 176<sup>1</sup> per kg in April 2011 from Rs. 74 per kg in March 2010 on the back of a combination of robust demand and constrained supply because of unfavourable climatic conditions in main producing countries like China, Pakistan and the United States. The spinning companies were able to pass on the soaring cotton prices to their customers on the back of strong demand for cotton yarn in domestic as well as international markets. Rising yarn prices coupled with utilisation of low-cost inventory procured from October 2009 to March 2010 enabled spinning mills to post an increase in their average operating profit margin to 17.5%<sup>2</sup> in 2010-11 from 14.5% in 2009-10.

The buoyancy in profitability was, however, deflated in Q4 of 2010-11 due to the ban on export of cotton yarn which lasted from 15 January 2011 until 31 March 2011. This burdened the spinning companies with surplus yarn inventory. The pile-up in inventory towards the end of March/April 2011 was also due to subdued demand in the domestic market following closure of dyeing units in Tirupur, which is a leading hub for hosiery exports, and levy of 10% excise duty on branded garments. Unsold stock squeezed the liquidity of spinners which in turn affected cotton purchases by mills and had a further cascading effect on cotton prices. The cotton prices started tumbling and are currently down by almost 50% from the peak of April 2011. Currently, spinners are loaded with high-cost cotton procured during the last season and a large stock of finished yarn that is waiting to be picked-up, which is likely to squeeze their profitability over the two-to-three quarters of 2011-12. The rising interest rates in the domestic markets are likely to aggravate the situation further. The highly leveraged capital structure along with rising interest rates exposes the industry to higher risk of defaults.

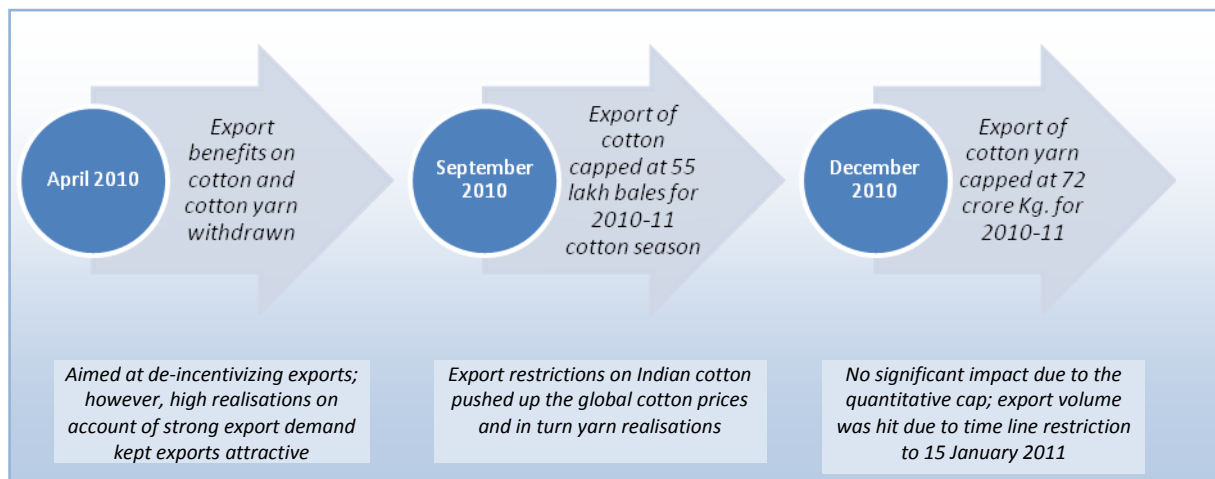
### BACKGROUND

After a countrywide protest by yarn consumers following the steep increase in the prices of cotton and cotton yarn, the Government of India (GoI) initiated several measures in order to ensure cotton availability for the domestic industry and easing of cotton yarn prices. For improving the yarn availability in the domestic market, GoI restricted yarn exports by withdrawing incentives like duty drawback (4.0%) & Duty Entitlement Pass Book Scheme (7.7%) in April 2010 and thereafter fixed the quantitative export quota of 72.0 crore kgs in December 2010 for the year 2010-11. Although the allocated quantum of yarn exports for 2010-11 was ~22% higher than actual export volume in 2009-10, the compression of export window up to 15 January 2011 notified on 1 December 2010 restricted the shipments. While there was no export of cotton yarn for over two-and-a-half months, the industry continued to produce yarn using high-cost cotton procured during this period in anticipation of strong realisations from the global markets after the removal of the export ban. As most of the spinning mills adopted this strategy, there was a huge pile-up of large unsold cotton yarn stock.

<sup>1</sup> J-34 variety of cotton; Source: Cotton Association of India, Emerging Textiles

<sup>2</sup> Based on a sample size of 12 listed companies in cotton spinning and ICRA Analysis

Chart 1: Policy Level Changes in CY2010

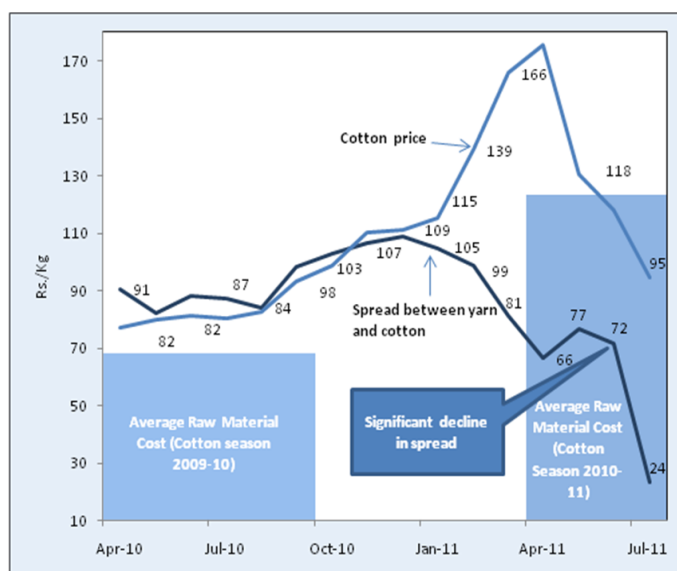


As anticipated, Gol lifted the restriction on cotton yarn exports effective 1 April 2011. In addition, it was listed under ‘free list’ category, implying that contracts for cotton yarn exports were required to be registered only with the Directorate General of Foreign Trade and that shipments could go ahead without verification by the Indian customs. As over 20% of cotton yarn production in India is exported, the government measure was considered to be a positive development for the industry. However, it did not benefit Indian spinners as expected because overseas customers had started sourcing cotton yarn from alternate global suppliers when the ban was enforced. Post removal of the export ban, the prices in export market crashed within one month, recording the sharpest fall of ~33% due to significant additional supply on account of accumulated stock and weak demand. As per industry sources, the capacity utilisation of most of the spinning mills dropped by upto one-third of optimal utilisation level of ~93-97% due to slowdown in demand and large finished goods inventory.

**OUTLOOK DURING 2011-12**

Due to the recent fall in yarn prices, the operating profit margin of spinners is expected to decline in 2011-12. As per ICRA analysis, the spinners may find it difficult to recover their cost, as the yarn would be produced utilising high priced cotton procured from October 2010 to March 2011. ICRA believes that the pressure on operating profit margins will be the highest in Q2, 2011-12, when most mills are likely to consume the highest priced cotton.

Chart 2<sup>3</sup>: Decline in spread between yarn and cotton



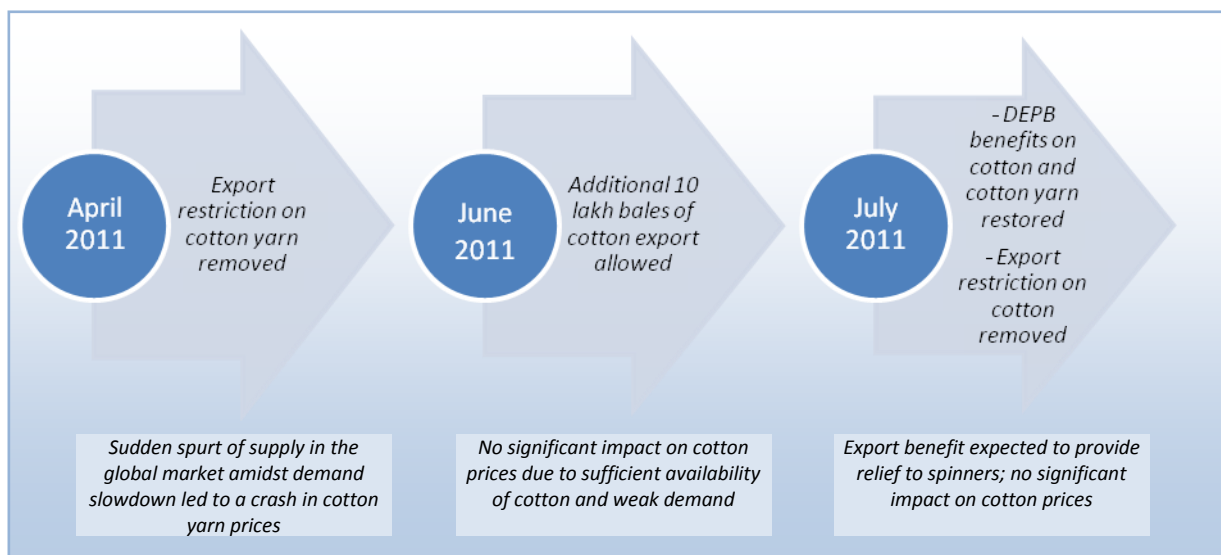
Due to the sharp drop in yarn prices since April 2011, in sync with the falling cotton prices, the spread between yarn and raw material has plummeted in a short span of less than twelve months on account of consumption of high-cost inventory procured in the period from October 2010 to March 2011. Considering that the average price of cotton from October 2010 to March 2011 was Rs. 123/kg<sup>4</sup>, the spread declined from a high of Rs. 109/kg in December 2010 to Rs. 24/kg in July 2011 given the average price of Rs. 147/kg for 30s carded knitting cotton yarn. As per ICRA analysis, the raw material cost of the yarn to be produced during Q2 and Q3 could be in the range of Rs. 137-145/kg, assuming an average yield of 85% to 90% for carded yarn. Hence, the prevailing market price may not be sufficient to recover the cost of production.

<sup>3</sup> Chart assumptions: Spread calculated between prevailing yarn prices and cost of cotton; For the period between October & March, the prevailing market prices were assumed for computing cost of cotton whereas for the period from April to September, the average price of cotton between preceding October & March was assumed as raw material cost

<sup>4</sup> Price of J-34 variety of cotton

ICRA expects no improvement in the situation until November/December 2011, as the mills may take that long to consume their current stock of cotton. Subsequently, fresh purchases of cotton are likely to be made at more reasonable rates upon arrival of fresh cotton in the market. ICRA expects the demand too to improve in the domestic market with the onset of festival season in H2, 2011-12 and in the export markets as well in order to fill the gradually depleting pipeline inventory. Moreover, the recent decision by GoI to reinstate the DEPB benefits on export of cotton yarn and cotton with retrospective effect from 1 April 2011 and 1 October 2010, respectively; and removal of quantitative cap on cotton exports, may arrest the downward pressure and help stabilise the prices of cotton and cotton yarn.

Chart 3: Policy level changes in CY2011



Global cotton production is expected to rise by 8%<sup>5</sup> to a record 26.9 million tonnes (mt) in 2011-12, driven by an expansion in plantings in most producing countries. Hence, assuming that the cotton prices do not increase in the short-to-medium term, ICRA expects the recent correction in cotton and cotton yarn prices to bring more stability in terms of demand and raw material availability. Although the operating profitability of cotton spinning companies is likely to remain under pressure in the short term, the competitive advantages of easy access to raw materials and cheap labour would continue to support the expansion of the cotton yarn spinning industry over the longer term.

The impact of short-term mismatch between consumption and production is expected to have an acute impact on spinning mills having high leverage on account of limited financial flexibility and rising interest cost. High leverage with a gearing of around two<sup>6</sup> times as on 31 March 2011 results in high payouts in the form of term loan instalments and interest, which coupled with subdued demand is expected to stress the financial profile of spinning mills further. Nevertheless, many spinning mills have plans for capacity additions in order to avail the benefit of additional fund allocation under the Technology Upgradation Fund Scheme (TUFS). As per ICRA analysis, over ten lakh spindles are scheduled to commence production over the next two years. Accordingly, to sustain a healthy balance sheet, the gradual improvement in spread between yarn and cotton price and optimum capacity utilisation will be critical factors for cotton spinning mills in the short-to-medium term. In ICRA's view, entities with stronger capital structure, efficient cotton procurement; diversified product mix and favourable economies of scale are better positioned to tide over the volatility in the market. At the same time, ICRA is also of the opinion that the regulatory risks for the sector have increased substantially with frequent policy level changes such as restrictions on export of cotton, cotton yarn and availability of export benefits.

<sup>5</sup> Source: International Cotton Advisory Committee

<sup>6</sup> Based on a sample size of 12 listed companies in cotton spinning and ICRA Analysis



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