This methodology document stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology document on this subject.

RATING METHODOLOGY

March 2018

ICRA Rating Feature

Rating Methodology for Entities in the Indian Textiles Industry – Apparels

This rating methodology updates and supersedes ICRA's earlier methodology note on the sector, published in November 2015. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the Textiles (Apparels) sector remains materially similar.

ICRA's Risk Analysis Framework

The broad list of rating factors that ICRA assesses while analysing apparel manufacturing/ retailing entities is covered in this methodology note. While these do not necessarily represent an exhaustive set of factors, they provide an overall perspective to the lenders, investors and other market participants on the rating considerations that are usually considered the most important. For analytical convenience, the key factors are grouped under the following heads—Business risk analysis, Financial risk analysis, Management quality and other considerations.

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Sector Background

The Indian apparel manufacturing industry is highly fragmented and is characterised by a large number of small-scale units. This in turn is attributable to the Government's earlier policy of reserving the sector for the small-scale units, which had a specified cap on investments in plant and machinery (the sector was fully de-reserved from CY2005). Given the intense competition in both the domestic and export markets that limits pricing power, differentiation can be achieved on the basis of design capabilities, offering of consistent quality products as per the delivery schedule and ability to supply large orders across different products or smaller orders for customised products.

While apparel manufacturing is a manual process, consistent product quality can be achieved by a well-defined process flow and stringent quality control. Modernised stitching and ancillary operations such as fabric cutting, embroidery etc. also improves the quality of the apparels, besides offering better productivity with lower wastage and reduced labour intensity, thereby resulting in better cost structure and profitability. In addition, the modern layout of the manufacturing unit improves the material flow across various sections of the unit leading to lower wastage, quicker process flow and hence improved productivity.

Business Risk Analysis

o Scale

Scale of operations is an important determinant of the operating leverage an entity enjoys with respect to its industry peers. For apparel retailing entities, in addition to the number of outlets, factors like mix of formats, expansion plans, sales per square feet, same store sales growth, debt per retail outlet, among others, are important considerations. Generally, a large revenue base leads to economies of scale in terms of cost efficiencies in procurement and administrative functions, thereby supporting the margins of the retailer. Further, other factors remaining similar, a large scale apparel retailer is more likely to exhibit higher operational stability and financial flexibility.

For apparel-manufacturing entities, large capacities offer flexibility to supply larger orders (while retaining the flexibility to supply smaller orders) across multiple products, hence improving the ability to deal directly (rather than dealing through buying houses/aggregators) with large reputed domestic and international customers. Large-scale operations are also characterised by more diversified operations in terms of customer base as well as geographies, which is difficult to achieve at a smaller scale.

However, given the labour intensity of the sector, large units can also face challenges related to manpower issues, such as strikes, labour unrests etc. As a result, ICRA notes that the large players operate through multiple manufacturing units to mitigate risks associated with these issues, especially in the backdrop of stringent timelines for product delivery and penalties for delayed deliveries.

o Level of integration

An apparel player can manufacture the apparels in-house, outsource the manufacturing or adopt a mix of both. The manufacturing units, in turn, can plan a backward integration into fabric manufacturing, fabric processing or yarn spinning. However, given the high capital intensity in the other stages of the textile value chain vis-a-vis apparels, backward integration is limited to only a few large entities.

With backward integrated operations, an entity is able to capture a larger share of the value addition, leading to higher profitability. In addition, captive availability of fabric/yarn can also provide better control on quality, apart from savings in other costs such as transportation, packing, and sales commissions.

While backward integration is a positive, ICRA observes that it is largely restricted to fabric weaving and processing and not as much in yarn spinning. This in turn can be explained by larger quality control requirements in the weaving and processing stages and abundant availability of quality yarn in the domestic market. While some of the spinning entities have forward integration into apparel manufacturing, however, given the large scale of their spinning operations, the extent of such forward integration is limited with apparel manufacturing consuming only a small percentage of their yarn production.

o Level of capital intensity

Apparel entities with an asset-light business model, involving outsourcing of manufacturing, have lower fixed capital requirements (investment in building and plant & machinery) as well as lower working capital requirements in comparison to those entities which have entire manufacturing in-house, as the need for stocking raw materials/work-in progress gets eliminated. As a result, such entities are better equipped to face the demand slowdown because of lower fixed overheads. On the positive side, during an upturn in demand, with outsourcing systems in place, the operations can be scaled up with increased outsourcing / adding new suppliers to cater to the demand, without missing out on market opportunities.

Moreover, apparels can be retailed either through multi-brand outlets (MBOs[1]) or exclusive brand outlets (EBOs[2]). In contrast to the owned-EBO distribution model, entities retailing through MBOs and franchisee-managed EBOs require limited fixed capital investments, in-store interiors and fixtures besides limited fixed overheads such as rentals, employee salaries, electricity charges etc. They are accordingly able to withstand downturns better, scale up easily during demand upturns and also command higher returns on investment. However, if the franchisee-managed EBOs have an arrangement of minimum guaranteed returns, the said benefits get offset to a large extent.

- **Diversification – customers, sales channels and geographies**

Sales diversification can be measured in terms of:

a) Customers,
b) Sales channels; and
c) Geographies

a) Customers

A diversified customer profile protects an entity from the vagaries of adverse developments at any one large customer's end, as any reduction in demand from that particular customer can impact sales. By virtue of sales concentration to a single-location large customer, the ability to achieve geographic diversification is also limited. Customer concentration may also result in receivables concentration and hence a weakening of the financial position of the customer could also jeopardise the receivables position.

b) Sales channels

For manufacturers*:* Apparel manufacturers typically source their orders directly from customers or buying houses/aggregators. A diversified sales channel with dealers/ buying houses and/or a diversified customer base is a positive attribute. Dealers/buying houses play an important role as intermediaries in the industry by adding value by order aggregation, customer service and, in some instances, also financing by making faster payments to manufacturers vis-à-vis payment realisations directly from customers. Further, dealers/buying houses also add value by way of sharing credit risk of the customers, whose financial profile may not be known to the manufacturer. However, sourcing orders through dealers/ buying houses also results in limited bargaining power for manufacturers as buying houses can source from different suppliers on the basis of the lowest pricing.

Ability to source orders directly from customers, on the other hand, reflects favourably on the ability of the manufacturer to deliver the products in a timely manner and with consistent quality. It also provides an opportunity to the manufacturer to cater to repeat orders unlike orders sourced through buying houses where the discretion to give the purchase order lies with the buying house.

For apparel retailers*:* Apparel retailers typically use a combination of both sales channels for retailing their products, i.e. MBOs and EBOs. While the MBO-route provides greater and faster geographical reach with low fixed capital investments; the EBO-route provides greater opportunity for brand building, engaging directly with customers and also expanding the product portfolio.

However, entity-managed EBOs require substantial capital investment in store interiors and fixtures, besides substantial fixed overheads such as rentals, employee salaries etc. If, on the other hand, the EBOs are franchisee-managed, while there is no capital investment and fixed overheads, there may be a requirement to provide minimum guaranteed returns to the franchisees, depending on the terms of the franchisee agreement.

[1] Outlets which retail products of a number of different brands
[2] Outlets which retail products of only one brand; EBOs can be managed by branded apparel players or by the franchisees

Thus, given the trade-off between the two sales channels, a healthy mix of both the channels, depending on the brand positioning, is considered a positive attribute as too much dependence on EBOs can result in substantial upfront investment while the sales may not scale up commensurately.

c) Geographies

For manufacturers, apart from diversification in the form of export sales, ICRA also considers the concentration towards a particular export market in its geographic risk assessment. Exports to a diversified set of countries can protect against adverse outcomes that may arise by way of trade restrictions (such as increases in import duty imposed by the destination country) or a decline in demand in the importing country, or reductions/removals of export incentives for exports to a particular country.

For apparel retailers, a national presence protects against the decline in demand in a particular state/region because of unforeseen events such as changes in weather conditions, economic slowdown, increase in competition because of entry of new players etc. Further, a wide product portfolio, which caters to demand across seasons, is a credit positive as it minimises the seasonality in sales.

- **Customer profile**

For apparel manufactures, customer profile is an indication of their operational strength as well as timeliness in receipt of their payments. Supply to large and reputed customers with regular repeat orders underscores the manufacturer's adherence to best practices for manufacturing and various compliances as well as consistency in quality and delivery of the products. Because of these attributes and relationship developed over the years with the customer, the manufacturer is likely to continue to get regular orders from existing ones. In addition, these attributes also reflect the competitiveness of the manufacturer and the ability to add other reputed customers to scale up the business.

- **Brand strength**

For branded apparel retailers, brand strength manifests itself in the form of pricing power and the ability to grow. Strong brands have superior recognition, recall and identity in their respective target market segments. This strength is developed over a period of time and can be based on attributes such as product quality, styling, variety and pricing.

Strong and established brands enjoy a premium pricing over others and also have better pricing power. In addition, because of the strength of the brand, the demand is relatively less price elastic, which provides flexibility to pass on the increase in the input costs to maintain the profit margins. Moreover, given the premium pricing, strong brands have the cushion to offer discounts during economic downturns to sustain the demand from existing customers and potential customers who were earlier reluctant to buy because of higher prices.

Further, strength of a brand determines its ability to expand, both geographically and in terms of product portfolio. Geographical expansion is facilitated by the latent demand which was earlier not fulfilled because of limited accessibility to the brand's products. Besides expansion through own stores, strong brands provide the flexibility to expand faster and by committing lower capital investment by entering into tie-ups with third parties (franchisees for exclusive stores; and multi-brand outlets) as the latter will be keen to get associated with a strong brand that could drive growth.

In addition, the brand strength can also be leveraged for expansion of the product portfolio and to cater to a larger market as the acceptability of the new products from an existing strong brand is better as compared to new products from weaker brands.

To assess the brand strength, the revenue growth is analysed for volume and value trends and sustained growth in these parameters along with profitability levels vis-à-vis other industry players. Fluctuating sales with low profitability reflects relatively weaker brand strength, whereas steadily growing sales with stable or improving margins reflect a relatively stronger brand strength.

- **Arrangement with channel partners and inventory management**

The apparel industry is working capital intensive, primarily on account of the high inventory levels. The inventory levels for the entities engaged in apparel manufacturing are on account of the long manufacturing cycle, which involves multiple processing stages, starting from order-backed fabric stocking, processing and stitching to finished apparels in transit to port/customers or awaiting shipment, pending the completion of the entire lot size.

For an apparel retailer, the inventory is because of the requirement to stock apparels for multiple designs, colours and sizes in the stores which typically averages ~three to four months of store sales, stock apparels in warehouses to ensure good fill rates in the stores and inventory on account of season leftovers. For an apparel retailer having in-house apparel manufacturing, the inventory levels are even higher and thus pose higher working capital requirements compared to entities which are engaged in only manufacturing/ retailing. Given the fast-changing fashion trends, apparels can face fast obsolescence and witness a sharp decline in their realisable value, if not sold within the marketing season they were manufactured for. Accordingly, inventory management is most critical for the profitability of an apparel retailer.

When the apparels are retailed through entity-managed EBOs, the apparel inventory remains with the entity till it is sold to the final customers. However, in case of retailing through distribution partners, i.e. MBOs and franchisee-managed EBOs, the entity enters into either/or mix of the sale or return (SOR) model or an outright sale model with their distribution partners.

Under the SOR model, while the sale is recognised when the entity transfers the inventory to the channel partner, the unsold inventory with the channel partners at the end of the season is taken back by the entity and is reflected as sales returns. Accordingly, ICRA analyses the past trend in the proportion of sales returns and provisioning made in the current financial year for potential sales return in the subsequent financial year.

In the outright sale model, the apparels once sold to the channel partners are not taken back. High proportion of sales on an outright sale basis keeps the inventory levels under control as there are no unexpected returns at the end of the season; however, the outright sale model is analysed for the pace of debtor collection, as sometimes, the entities tend to extend a longer credit period, if the sales at the end of channel partner are slow.

ICRA also notes that in the case of the outright sale model, large unsold inventories at MBOs/franchise managed EBOs can impact the future sales of the entity and thus the policy on inventory liquidation through discount sharing with channel partners is also compared with other players. The ability to minimise the obsolete inventory on a consistent basis through efficient inventory management is a credit positive as it not only reduces the working capital requirement but also reduces the risk of inventory loss because of obsolescence.

In case the finished goods inventory is significantly higher than that of other players, ICRA also analyzes the inventory ageing and valuation. The analysis includes evaluation of the absolute quantity of apparel from past seasons and the average value per piece of such inventory.

In addition, ICRA also evaluates the management's strategy and plans on inventory levels, both within the manufacturing and retailing process, through improvement in the manufacturing process, as well as in the supply chain. On an average, for the last five years, for more than 100 apparel entities (manufacturers and apparel retailers) rated by ICRA, the overall inventory levels have remained close to ~100 days.

Apart from the overall inventory, the inventory mix in terms of raw material, finished goods and work-in process are also benchmarked in relation to industry average. The raw material and finished goods for the apparel entities form ~30~40 days each, whereas the work-in process typically stands at ~20 days, depending on the level of integration and product range.

- **Revenue composition and sales realisation**

While analysing the revenues, factors driving the revenue growth also analysed to see volume/value growth drivers. These apart, the share of various Government incentives in the revenues are also analysed (especially for apparel exporters) as a high share of incentives in revenues indicates high susceptibility of profits to the continuance of such incentives.

- **Cost-structure analysis and efficiency drivers**

The apparel manufacturing industry is raw material and labour intensive with the fabric (raw material) cost accounting for ~60% of the total revenues and manpower cost accounting for ~8~9% of the total revenues. Other manufacturing expenses (like repairs, store & consumables etc), general and administrative expenses, selling expenses (packing costs, outward freight, discounts etc) and power costs further form ~8~9%, ~6%, ~5% and ~1% of the total revenues respectively. All the above costs, together, account for ~88~89% of the total revenues. Given the cost-intensive nature of the industry, the ability to control the costs at all levels becomes critical for the overall profitability of the entity.

Raw Material/ Fabric Costs: The fabric cost is a function of yarn prices and typically tends to vary as per the domestic as well as international demand-supply scenario for the fibre. While the susceptibility to fluctuations in raw material prices is generally low as apparel manufacturing is undertaken against confirmed orders (with apparel pricing taking into account the prevailing prices of fabric) it is to some extent also dependent on the fabric stocking policy of the apparel manufacturer. Stocking/ booking of fabric to fully cover the confirmed orders of apparels protects the profit margins of the apparel manufacturer in case of any adverse movement in the fabric prices because of upward movement in yarn/fibre prices. Conversely, excess fabric stocking in relation to the apparel order book position results in exposure to any downward movement in fabric prices. For an apparel retailer, the retail selling price of the apparels is also fixed depending on the fabric and other input cost prices; and ability to pass on cost increases is critical for profitability.

Manpower Costs: Apparel manufacturing is the most labour-intensive segment in the entire textile value chain, which is also reflected in the manpower cost being the second highest cost component in the apparel industry after the fabric cost. Availability of adequate skilled labour at competitive cost is thus a positive factor. Manufacturing units located in the garmenting hubs of Delhi - National Capital Region (NCR), Ludhiana (Punjab), Bangalore (Karnataka), Tirupur (Tamil Nadu) and Mumbai (Maharashtra) have better access to skilled labour compared to that in other locations.

Financial Risk Analysis

While ICRA believes that a strong business profile drives strong financial profile in the long-term, financial profile of an entity is also governed by the risk appetite and growth plans of the management. Accordingly, while assessing the financial risk profile, apart from the past and the current financial position, ICRA also takes note of the growth plans of the entity and its likely impact on the financial position in future. Suitable adjustments in reported financials are also made to make them comparable for meaningful peer comparison. The various financial metrics assessed by ICRA could be divided into four categories viz., Profitability, Leverage, Coverage and Liquidity. This document provides a brief summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the note titled, “Approach for Financial Ratio Analysis” published on ICRA’s website. Some of the key metrics analyzed are described below:

o Profitability

The profit margins in terms of ratios like OPBDITA/OI (Operating profits before depreciation, interest and amortization / Operating Income) and PAT/OI (Profit After Tax / OI) are analyzed. In addition, for an apparel exporter, the share of OPBDITA contributed by government incentives (such as export incentives) is also analyzed as high share of incentives indicates vulnerability of the OPBDITA and OPBDITA margin on the sustenance and level of the export incentives.

These apart, the above-mentioned profit margins are also seen in relation to the overall return on capital. Higher OPBDITA margin because of backward integration (requiring more capital) is also seen in relation to the return on capital employed (RoCE[3]). While the entity may have an OPBDITA margin similar to or better than the industry average, in case the RoCE is lower, then the reasons for the same are analysed, which can be lower fixed asset turnover or a longer working capital cycle than industry average.

For more than 100 apparel manufacturers/exporters rated by ICRA, the OPBDITA margins have averaged ~9% with net profit margins of ~3% over the past five years. The RoCE has averaged at ~14% levels with fixed asset turnover (Operating income/Gross Block) of ~300% during the same period. As can be seen, the RoCE of ~14% is moderate. However, most of the apparel manufacturers enjoyed interest subsidies of ~5% under Technology Upgradation Fund Scheme (TUFS) of the Government of India on the bank debt availed for setting up of the manufacturing unit till December 2015. Accordingly, the average cost of capital for apparel manufacturers used to be lower. While interest subsidy has been discontinued under the Amended TUFS launched by the Government of India and effective from January 2016 onwards, the apparel manufacturers continue to have access to capital subsidies for eligible benchmarked machinery at a higher rate of 15% (with a cap of Rs. 30 crore), vis-à-vis 10% under the earlier scheme. In addition, some

[3] RoCE is defined as profit before interest and taxes / average capital employed for the year

manufacturing companies have access to capital/ interest subsidies under the various state government schemes which keep the effective financing costs low.

o Working capital management, liquidity and inventory valuation

The apparel sales are seasonal with most of the sales in second half of the year during festival season in both the domestic and export markets, and the sale of higher value winter wear apparels. While the working capital requirements also vary with seasonality, obligations which are fixed in nature such as term loan interest and repayments, employee salaries, lease rentals etc. have to be met throughout the year. This makes it necessary to maintain adequate liquidity to meet the fixed obligations in a timely manner.

In addition to inventory-holding requirements, the level of working capital is also driven by the receivables position, which on an average has remained at ~65 days for more than 100 entities rated by ICRA. Apart from the overall receivable position, the receivable ageing analysis (its comparison with eligibility for drawing power) and receivable concentration towards few entities are also analysed to assess the quality of receivables. For export receivables, the credit risk mitigants such as Letter of Credit (LC) or export credit risk insurance are also taken as comfort factors.

Given the working capital intensive nature of operations, seasonality in sales and the fixed nature of expenses, the liquidity analysis is critical to ensure the obligations are met in a timely manner. The liquidity profile of entities is assessed based on their ability to generate cash from internal resources and have access to committed sources of external financing, in relation to cash obligations such as debt repayments and investments over the near term. Higher the cushion available between the resources available and the obligations, better the liquidity profile of an entity. Further, ICRA compares fund-based working capital limit utilisation with sanctioned fund-based working capital limits or drawing power, whichever is lower, and assesses the cushion therein. Since drawing power is also driven by inventory valuation (higher valuation leading to higher drawing power), hence it is also seen in relation to the realisable value of inventory, especially for old unsold stock from season leftovers, as detailed earlier.

o Leverage and debt coverage indicators

Entities that pursue an aggressive financial policy, including heavy reliance on debt financing, are likely to be more vulnerable to cyclical downturns than entities that employ a lesser degree of financial leverage in their business.

As detailed earlier, the fixed capital intensity is driven by the business model adopted by the entity, whereas the working capital intensity is generally high, thereby keeping the funding requirements high. As a result, the overall leverage can vary from player to player. For entities with in-house manufacturing, central (under TUFS) and state governments provide various incentives such as capital as well interest subsidies on the bank term loans for setting up of the manufacturing units, thereby reducing the cost of debt funding.

Low leverage improves the financial flexibility of the entity during any downturn, besides keeping the fixed financing expenses low. Moreover, the tenure of the term debt is a key driver for the debt coverage as entities with longer tenure debt and similar levels of leverage will be more comfortably placed compared to entities with shorter tenure debt.

Some of the key indicators observed by ICRA include –

- Leverage indicators
  Total Debt/Tangible Net Worth (TD/TNW), Total Outside Liabilities/Tangible Net Worth (TOL/TNW), Total Debt/OPBDITA, Net Cash Accruals/ TD
- Debt coverage ratios
  Interest Coverage, Debt Service Coverage Ratio (DSCR)
- Liquidity ratios
  Current Ratio

While the leverage for the sector as reflected in average TD/TNW of ~1.3x during the last five years appears to be moderate, however, because of low profitability, the leverage as reflected in Total Debt/OPBDITA of ~4x is high. Further, given that most of the debt is for working capital funding, (~60% of total debt in ICRA's sample set is working capital), which results in lower scheduled repayments for term liabilities, the other debt coverage indicators such as interest coverage of ~3x, DSCR of ~2x appears to be relatively better. On an average during the last five years, for the ICRA rated sample set of more than 100 apparel entities, other financial indicators such as Net Working Capital Intensity of Operations had been ~30%, current ratio of ~1.2x and Net Cash accruals/Total debt of ~14%.

o Sufficiency of funding availability

As the apparel manufacturing/ retailing industry is working capital intensive, the working capital requirements increase with the revenue growth. While an entity may have DSCR >1 over the projected period; however, despite a satisfactory DSCR, the entities which are targeting high growth may find themselves stretched on liquidity as their incremental funding requirements may be much higher than the cash generation. In such cases, ICRA analyses the sufficiency of the cash accruals (after meeting the scheduled repayment) to fund the targeted growth. The funding requirements can partially be met through additional debt, however, even in such a scenario the lenders seek at least margin funding from the borrowers. Hence if the projected levels of cash accruals (after repayments) are lower than the margin funding requirement for capital expenditure (capacity expansion, opening of retail stores, warehouse etc.) and enhanced working capital requirements, then despite a satisfactory projected DSCR, the entity may find itself stretched on liquidity. In such a situation, the alternate financial flexibility of the entity to fund its growth requirements is seen as an important factor.

o Access to fiscal incentives

To support the capital investments in the sector, various fiscal incentives are available from the Central and state governments on the term debt, which can reduce the overall cost of borrowings and improve the debt coverage ratios for the same levels of operating profitability and debt. However, such fiscal incentives on term debt are available only for the manufacturing sector and not for retailing. Based on ICRA's analysis, for apparel manufacturers and retailers in ICRA's rated sample set, the working capital borrowings account for ~60% of the total debt, reflecting high working capital intensity of the sector. Given the working capital intensity and to improve the export competitiveness in international markets, cheaper working capital finance for exporters and fiscal incentives such as interest subvention may be available for the apparel exporters.

o Foreign currency risks

Foreign currency risks for the apparel industry emanate largely by virtue of the export orders and the corresponding foreign currency receivables. With most of the costs being rupee-denominated, the scope of a natural hedge remains limited for the apparel exporters. To hedge these risks, the entity may choose to avail of working capital borrowings in foreign currency, like packing credit in foreign currency/bill discounting denominated in foreign currency, which should be equivalent to the average export order value or forex receivable position. Alternatively, an entity could also fund its working capital by rupee working capital borrowings and a take forward position equivalent to the pending export order book and forex receivables. The outstanding forex position by way of forwards or working capital borrowings in foreign currency is compared with the export orders and the forex receivable position to assess the un-hedged exposure. The effectiveness of a hedge by way of comparison of the tenure of forward contracts vis-à-vis the shipment schedule of the export orders is also assessed.

Apart from the above financial parameters, off balance sheet exposures/ contingent liabilities and the likelihood of these liabilities getting crystallised is also taken into account while assessing the credit profile.

o Tenure mismatches, and risks relating to interest rates and refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an entity to significant re-financing risks, especially during periods of tight liquidity. The ratings factor in the existence of adequate buffers of liquid assets/bank lines to meet short-term obligations and the extent to which the entity could be impacted by interest rate movements on such borrowed funds.

o Debt-servicing track record

Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the entity's future debt servicing capability. ICRA factors in the entity's ability to honour its debt obligations even during periods of cyclical stress.

- **Contingent liabilities/Off balance sheet exposures**

The likelihood of devolvement of contingent liabilities/off-balance sheet exposures, and the financial implications of the same are evaluated.

- **Accounting Quality**

ICRA looks at the quality of accounting practices followed by the entity based on interactions with the statutory auditors as well as studying the Auditors' Report and other Notes to Accounts disclosed in the Annual Report. Some of the key factors looked at include - auditor qualifications with respect to internal control systems, debt servicing and asset liability mismatch; contingent liabilities and other off-balance sheet items and the method of revenue recognition, inventory valuation policy and depreciation policy of the entity in comparison with industry peers. Any deviation from the generally accepted accounting practices is noted and the financial statements of the entity are adjusted to reflect the impact of such deviations.

Management Quality

A discussion is held with the management of the entity to understand its business objectives, financial policies, plans and strategies, and views on past performance, besides the outlook on the (entity's) industry. The key factors considered to assess the management quality include (but not limited to):

- Management's experience in the line of business concerned
- Risk appetite of the management and risk mitigation plans
- Entity's policies on leveraging, interest risks and currency risks
- Entity's plans on new projects, acquisitions and expansions

Periodic interactions with the management provide insights into the operations of the entity and ongoing developments and further help understand the management's commitment to the business and strategies. The information gained from interactions with the management is evaluated against the backdrop of the track record or the possibility of the management deviating from its stated policies in times of stress.

Other Considerations

- **Parentage**

All debt ratings necessarily incorporate an assessment of the credit quality of the entity's parent entity (ies) or the promoter group, and the inter-linkages between the parent-subsidiary (ies) or the constituent group entities. Also of importance are the entity's possible cash outflows arising from the need to support weaker group entities. Some key factors considered include:

- Experience of the promoter in the line of business concerned
- Commitment of the promoter to the business concerned
- Risk appetite of the promoter and risk mitigation plans
- Strength of the other entities belonging to the same group as the entity
- Ability and willingness of the group to support the entity through measures such as capital infusion, if required

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the entity's business and financial risks, its competitive strengths, it's likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt servicing obligations and other funding requirements. The credit profile of apparel manufacturing/ retailing players involves an assessment of the business strengths and weaknesses as reflected by their scale of operations, operating efficiencies owing to their presence in highly competitive product segment, diversification in terms of product and customer profile, level of integration and the brand strength. The operational strengths are typically reflected in the financial performance. However, the financial risk profile for the entity is also governed by its future growth plans (given the high leveraging in the sector and working capital intensive nature of operations) and their ability to fund the growth at a lower cost.

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