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ICRA Rating Feature

Rating Methodology for Entities in the Indian Textiles Industry – Fabric Making

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 (Fabric) sector remains materially similar.

ICRA's Risk Analysis Framework

The broad list of rating factors that ICRA assesses while analysing fabric-manufacturing/weaving entities is covered in this methodology note. While these do not necessarily represent an exhaustive set of factors, they provide an overall perspective to lenders, investors and other market participants on the rating considerations that are usually considered the most important by ICRA. 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 fabric industry is highly fragmented, dominated by a large number of small scale units in the unorganised sector due to the Government's earlier policy of promoting the small scale sector through tax and fiscal incentives and favourable labour policies. The extent of fragmentation is evident in the organised sector's share of only ~4% of the total domestic fabric production.

Fabric manufacturing is capital intensive and requires significant investment in plant and machinery. A typical modern fabric-manufacturing (weaving) unit with ~100 looms will have a capital cost of ~Rs. 70 crore to ~Rs. 90 crore, depending on the nature of expansion, i.e. greenfield or brownfield. The high fixed capital intensity is also reflected in average operating income/gross block of ~1.5-1.7 times for fabric manufacturers. In addition, fabric manufacturing operations are working capital intensive with a gross operating cycle (receivable + inventory turnover period) of ~4 to 5 months.

Business Risk Analysis

○ Scale and capacity utilisation levels

Given the intense competition and limited product differentiation, larger capacities in fabric manufacturing offer benefits of economies of scale, thereby resulting in a better cost structure. Further, larger entities operating through multiple units are able to better manage risks associated with manpower issues such as strikes, labour unrests etc.

Further, with access to various fiscal incentives, such as capital and interest subsidy from Central and state governments and given the capital-intensive nature of operations, the tendency of entities in the industry to leverage is high, resulting in sizeable interest and repayment burden. Because of the high leverage, a fabric manufacturer's ability to consistently operate at high capacity utilisation levels and rapidly ramp-up production from a newly commissioned unit is of utmost importance. Besides ensuring comfortable debt coverage metrics, the ability to operate at healthy capacity utilisation levels is crucial for reducing capital costs per unit of production.

The production level of fabric units with a similar weaving capacity (in terms of looms) can vary significantly based on the specification or quality of fabric manufactured (in terms of gram per square meter (gsm), picks per inch[1] etc). Accordingly, ICRA uses the capacity derived at the average gsm/picks per inch of fabric being produced by the entity as reference for calculating capacity utilisation levels. The ability to consistently operate at high utilisation levels is a function of various parameters, like the level of modernisation, regular availability of power and order book position, and is a positive attribute.

○ Level of integration

Fabric units can have backward integration into spinning and forward integration into garmenting, apart from adding value through fabric processing like fabric dyeing, printing, finishing etc. However, given the high degree of fragmentation and the small scale of operations of the industry players, the backward/forward integration is mostly limited to a few large mills.

With backward and forward integrated operations, an entity is able to capture a larger share of value addition, leading to higher profitability. In addition, captive yarn availability for in-house consumption (weaving) and in-house consumption of fabric for garmenting result in savings from transportation, packing and selling costs.

While integration is a positive, it poses challenges as well, particularly with respect to backward integration into cotton yarn spinning. Profit margins, in the case of fabric manufacturing, are typically steady because of limited raw material stocking compared to that in spinning, which mitigates the impact of volatilities in raw material price while profit margins for spinning, specifically cotton yarn spinning[2], are susceptible to fluctuation in cotton prices leading to risk of inventory loss. Hence, the overall profit of an integrated fabric manufacturer is exposed to the risk of inventory loss in times of declining cotton prices, whereas non-integrated fabric manufacturers, in such times, would benefit from the procurement of lower cost yarn from

[1] Picks per inch is the number of weft threads per inch of woven fabric. The higher the picks per inch, the finer the fabric is.
[2] While man-made fibres are available throughout the year and can, accordingly, be stocked based on the millers' order book position, seasonality of cotton (as it is available from October until March) requires the mills to stock cotton to meet the fibre requirements during the non-harvest period as well. Hence, cotton fibre-based mills typically have higher peak working capital requirements than mills based on man-made fibre, and are, thus, more exposed to risk of inventory loss on account of volatilities in raw material prices.

the market. The profit margins, however, are protected for those players who keep cotton stocking aligned with their order book. Hence, a balanced level of backward integration, which matches the requirement for fabric manufacturing, along with a cotton stocking policy which is in line with the order book position are considered positive rating attributes.

○ Diversification – products, customers, sales channels and geographies

For a fabric unit, diversification relates not only to fibre content and type of yarn (spun vs filament), but also to the gsm range, pick range, width, variety and finishing of the fabric manufactured. This apart, diversification can also be achieved in the customer profile (concentration towards top customers), sales channels (dealers vs direct sales) and geographies (domestic vs exports).

Products: The ability to manufacture a diversified product range is a positive attribute, as it improves the flexibility to shift the product offerings and retain pricing power in a commoditised product segment like fabric.

Customers: While entities focusing on the business to consumer (B2C) model have a diversified customer base by virtue of their nature of operations, a diversified customer profile for an entity operating under the business to business (B2B) model is a positive attribute. A diversified customer profile protects an entity from the vagaries of any adverse development at the customer end, as any reduction in demand from a particular large customer can impact sales. In the event of dependence of sales on a particular customer, there will also be receivables concentration. Accordingly, decline in sales from the customer can also jeopardise the receivables position of the entity.

Sales Channels: Dealers play an important intermediary role for fabric units like order aggregation, customer service and, sometimes also financing by making faster payments to units. Dealers also add value by sharing the fabric player's credit risk. As a result, sometimes, even direct sales are routed by the entities through dealers for client servicing, getting faster payments and managing credit risk. Nevertheless, ICRA notes that entities with niche product offerings or consistency in quality and delivery are able to establish direct relationships or get nominated by garment manufacturers/brands. Direct relationships typically act as positive attributes and result in better profitability by saving on dealer commissions.

Geographies: ICRA assesses an entity's geographical mix both in terms of the share of exports in overall sales, as well as the entity's concentration towards a particular overseas market. Diversity in exports to multiple countries can protect against adverse outcomes, which may arise by way of trade restrictions (such as imposition of import duty) or a decline in demand in a particular importing country, or reduction/removal of export incentives for exports to a particular country.

○ Customer profile

For fabric manufacturers, the customer profile is an indication of their operational strength as well as the likelihood of stretched payments/bad debts. Supply to large and reputed garment manufacturers/apparel brands with regular repeat orders underscores the manufacturer's adherence to international best practices for manufacturing and various compliances as well as consistency in product quality and delivery.

Because of these attributes and relationships that are developed over the years with a customer, an entity is likely to continue to get regular and repeat orders. In addition, these attributes also reflect the competitiveness of the entity and its ability to add other reputed customers to scale up the business. Entities that mostly supply to the unorganised sector and local brands generally do not enjoy much competitive advantage or an enduring relationship with customers, and the orders are mostly on a per transaction basis with limited long-term visibility on future orders.

Moreover, sales to reputed and strong customers provide comfort on timely payments, which is a positive attribute as it reduces the working capital cycle of the manufacturer, resulting in superior return indicators.

○ Brand strength

In addition to sales to garment manufacturers, fabric is also directly sold to customers who prefer customised stitching over ready-made garments. Thus, entities focusing on the B2C model, which are able to establish their brand in the markets by virtue of their designs, quality, product range and other requisites, are able to command superior pricing power, higher realisations and, thus, higher profit margins compared to entities which are mostly present in the unbranded commoditised segment.

For strong brands, the demand is relatively less price elastic, which provides the flexibility to pass on the increase in input costs to maintain profit margins. Moreover, given the premium pricing, strong brands have the cushion to lower their prices during economic downturns to sustain demand, both from existing as well as latent customers who were earlier restricted by the higher prices.

○ Cost-structure analysis and efficiency drivers

The fabric industry is raw material intensive with yarn cost accounting for ~55% of total revenue, followed by manufacturing expenses (like repairs, store & consumables etc) accounting for ~7% and power cost accounting for ~6% of revenue. Manpower cost, selling expenses (packing costs, outward freight, discounts etc) and general and administrative expenses further form ~5%, ~3% and ~2% of total revenue, respectively. Given the cost-intensive nature of the product, the ability to control costs at all levels becomes critical for the overall profitability of an entity.

Raw material costs: Yarn cost tends to vary as per the domestic and international demand-supply scenario for the fibre. The susceptibility of a fabric maker's profitability to fluctuations in raw material prices is generally low because of limited yarn stocking undertaken by the units, as yarn is readily available throughout the year. Moreover, manufacturing is generally undertaken against confirmed orders with pricing taking into account the prevailing prices of yarn, which limits the exposure to raw material price risks. Nevertheless, the vulnerability to raw material price fluctuation increases if the entity accepts long-term fixed price orders without adequate yarn stocking to cover for the orders or undertakes excess stocking of yarn in relation to the order book position. Profit margins, in these scenarios, can be impacted by an increase or decrease in yarn prices.

Production yields: Production yields, in terms of final fabric production and yarn loss, determine production efficiencies. While fabric production is a function of the type of fabric manufactured, the level of modernisation of the manufacturing unit also governs it to an extent. The minimisation of yarn loss improves overall revenues and the contribution margin of the fabric units.

Power costs: The cost of grid power can vary from state to state. The lack of regular power from the grid may require the mills to operate on captive power to achieve high utilisation of manufacturing capacities. However, captive power costs can vary depending on the source, viz. coal, liquid fuel, solar or wind. In effect, the overall power costs for fabric units can vary significantly depending on the location of the unit and the source of power. Units, which have the flexibility to source power through open access, can benefit in scenarios of lower prices in the merchant power markets.

Manpower costs: The manpower cost for a unit is governed by its level of modernisation, with manpower costs, as a proportion of revenues, being lower in modern units. However, at the same time, new units also have associated capital costs (such as interest and depreciation/repayments), which are not there for older units. It may be noted that the paucity of labour in certain locations or situations might affect capacity utilisation levels and, hence, might negatively impact the ratings.

Contribution analysis: In line with the approach followed typically for profitability assessment of entities manufacturing commoditised products, ICRA assesses the trend in realisations, key cost drivers and their impact on the contribution level per unit of fabric sales. The analysis facilitates the assessment of key cost and realisation drivers and the movement in these factors. Subsequently, the entity's ability to pass on increases in key costs to customers is assessed by looking at the track record of retaining or improving gross/net contribution levels.

Sales realisations are also compared with industry trends, the reasons for variance vis-à-vis industry trends are analysed and the factors which can sustain or impact these trends are looked into. Revenues derived from related parties/Group entities are assessed for arms-length transactions and, accordingly, the profitability levels are seen in relation to the nature of these transactions.

Extent of modernisation of manufacturing facilities: A modernised unit offers lower down-time, better quality fabric, better production yields with lower manpower deployment, contributing further to a better cost structure and, hence, profitability. Since modern machinery improves the ability to offer better and consistent quality fabric, it improves the ability of players to supply value-added fabric to apparel brands, both in domestic and export markets, which results in better sales realisations and profitability. Players with old machinery generally supply commoditised fabric to the domestic unbranded apparel segment, which results in lower sales realisation as well as lower profitability.

○ Inventory Management

Fabric-manufacturing entities are required to stock yarn as well as fabrics. While yarn is stocked to cover confirmed orders, fabric stocks include material in transit to distributors/customers or awaiting shipment pending the completion of the entire lot size. On an average, for the past five years, inventory levels have remained close to ~2.5-3 months for the ~100 fabric entities rated by ICRA.

In case inventory levels for an entity are significantly higher than that of peers, ICRA analyses the inventory mix in terms of raw material, finished goods and work-in-process, which can vary depending on the level of integration and product range.

Financial Risk Analysis

While ICRA believes that a strong business profile drives a strong financial profile in the long term, the financial profile of an entity is also governed by management's risk appetite and growth plans. 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 analysed are described below:

○ Profitability

Profit margins in terms of ratios like operating profits before depreciation, interest and amortisation/operating income (OPBDITA/OI) and profit after tax/OI (PAT/OI) are seen in relation to changes in the contribution margins. A mere decline in profit margins with stable per unit contribution or OPBDITA (Rs./kg or Rs./MT) is not necessarily seen negatively, as the same could be because of a higher realisation base.

These apart, the profit margins are also seen in relation to the degree of backward or forward integration (which requires more capital) and, hence, in relation to the overall return on capital employed (RoCE[3]).

For instance, an entity with operating profitability similar to or better than the industry average may have a lower RoCE because of factors such as backward/forward integration, lower fixed asset turnover or a longer working capital cycle than the industry average. For the ~100 fabric entities rated by ICRA during the past five years, the average OPBDITA margins have remained at ~11% with net profit margins of ~3%. The RoCE has averaged at the ~14% level with fixed asset turnover (operating income/gross block) of ~190%. Although the RoCE is moderate, the same compares favourably with the average cost of capital given that most of the domestic weaving mills enjoy interest/capital subsidies under the Technology Upgradation Fund Scheme (TUFS) of the Government of India (interest subsidies discontinued for new loans for weaving entities with effect from January 2016) and/or interest subsidy benefits from state governments under their respective textile policies.

○ Working capital management, liquidity, inventory valuation and cash flows

In addition to inventory holding requirements, the level of working capital for fabric-making entities is also driven by the receivable position, which, on an average, has remained ~1.5 to 2 months for the fabric entities rated by ICRA[4]. The overall receivable position is analysed for its aging (which determines its eligibility for drawing power estimation) and concentration. Receivable concentration towards a few entities with weaker credit profiles could be an area of concern. For export receivables, credit risk mitigants such as export credit risk insurance cover or letter of credit (LC)-backed receivables are taken as comfort factors.

Besides high working capital requirements, high term debt of players in the sector leading to sizeable repayment obligations necessitates the need for maintaining liquidity for ensuring the timely servicing of debt obligations. The liquidity profile of entities is assessed based on their ability to generate cash from internal resources and their 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

[3] RoCE is defined as profit before interest and taxes/average capital employed for the year
[4] For entities focusing on the B2B model

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. The sanction of sufficient working capital limits to fund peak-level working capital requirements provides comfort. The drawing power can be a function of inventory valuation and, hence, it is seen in relation to the realisable value, especially in a declining price scenario.

ICRA analyses the trends in the entity's funds flow from operations (FFO) after adjusting for working capital changes, the retained cash flows, and the free cash flows after meeting debt obligations and capital expenditure needs. Cash flow analysis also helps in understanding the external funding requirements that an entity might have to meet its maturing debt obligations. ICRA also draws up projections on the likely financial position of the entity based on the expected movements in operating performance factoring in capex and investment requirements as well as the upcoming debt obligations.

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.

Given the fixed capital as well as working capital intensive nature of the weaving business, funding requirements are typically high in the sector. Access to fiscal incentives from the Central as well as state governments, which provide for capital as well as interest subsidies, reduce the interest burden on weaving entities. Over the years, access to low-cost debt has incentivised weaving entities to operate at a high financial leverage, increasing their vulnerability to downturns. While interest subsidies under TUFS are not available to the new loan sanctions now (from January 2016 onwards), some of the weaving entities continue to get incentives from state governments, which, together with the presence of the older TUFS loans and capital subsidies on new loans, keeps their average cost of capital low.

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, working capital cycle, net working capital/operating income ((NWC/OI)

The high leverage for the sector is reflected in the past five-year average TD/TNW of about 2 times, interest coverage of about 3 times, TOL/TNW of about 2.5 times and total debt/OPBDITA of about 4 times for the weaving entities rated by ICRA.

Low leverage improves the financial flexibility of an entity during downturns, besides keeping the fixed financial expenses low. Moreover, the tenure of the term debt is a key driver for 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.

o Access to fiscal incentives

Fiscal incentives like interest/capital subsidies are available for setting up manufacturing facilities under TUFS as well as textile policies of some of the states. Given the capital-intensive nature of weaving operations and the resultant sizeable proportion of long-term borrowings in total (~60% typically), access to fiscal incentives can reduce the overall cost of borrowings and improve the debt coverage ratios for the same levels of operating profitability and debt.

o Foreign currency risks

Foreign exchange risk for fabric-manufacturing entities emanates by virtue of fabric export orders and the corresponding foreign currency receivables. With most of the costs being rupee denominated, the scope of natural hedge remains limited for fabric entities. To hedge these risks, an entity may choose to avail working capital loans like packing credit or bill discounting denominated in foreign currency, which should be equivalent to the pending export order value or forex receivable position. Alternatively, an entity could also fund its working capital by rupee-denominated working capital borrowings and could take forward

contracts 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 to the export orders and the forex receivable position to assess the unhedged 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.

- **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 refinancing 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.

- **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 by 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, the inventory valuation policy and the 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 entity's management to understand its business objectives, financial policies, plans and strategies, and views on past performance, besides the outlook on the (entity's) industry. Key factors that are considered to assess management quality include (but are 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 management provide insights into the operations of the entity and ongoing developments and further help understand management's commitment to the business and strategies. The information gained from the interactions with management is evaluated against the backdrop of the track record or the possibility of management deviating from their stated policies in times of stress.

Other Considerations

- **Project risk**

Being highly capital intensive and given the availability of various fiscal incentives for capital investments, capacity expansion has been a regular feature for industry participants. While an entity may have a DSCR >1 over the projected period, ICRA also assesses sufficiency of balance cash accruals (after meeting scheduled repayments) to fund the equity margin required for the planned capital expenditure. If the projected levels of cash accruals (after repayments) are lower than the equity funding requirement for capital expenditure and enhanced working capital requirements, then despite a reasonable projected DSCR, the entity may find itself stretched on liquidity. In such a situation, the financial flexibility of the entity to fund its growth requirements is seen as an important risk mitigant.

○ 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 is 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, the 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 fabric-manufacturing entities involves an assessment of the business strengths and weaknesses as reflected by their scale of operations, operating efficiencies owing to their presence in a highly competitive product segment and diversification in terms of product profile. The operational strengths are typically reflected in the financial performance. However, the financial risk profile of entities in the industry is also governed by their growth plans (given the high leveraging in the sector) and their ability to fund growth at a lower cost.

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