ICRA

RATING METHODOLOGY

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ICRA Rating Feature

Rating Methodology for Entities in Footwear Industry

This rating methodology outlines ICRA's approach to assess the credit quality of entities in the footwear industry, and supersedes ICRA's earlier methodology note on the sector, published in December 2016. While this revised version incorporates a few modifications, ICRA's overall approach towards rating entities in the sector remains materially similar.

This rating methodology aims to help entities, investors and other interested market participants understand ICRA's approach to analysing quantitative and qualitative risk characteristics that are likely to affect ratings of entities in the footwear sector. This methodology does not include an exhaustive treatment of all the factors that are reflected in ratings but enables the reader to understand the rating considerations that are usually the most important.

Overview

The Indian footwear industry is highly fragmented with almost 15,000 small and medium enterprises operating largely in the unorganised segment and with limited presence of the organised segment. The Indian footwear industry holds a crucial place in the Indian economy for its potential for employment, especially for the economically weaker sections, and for foreign exchange earnings. India is the second largest producer of footwear globally, accounting for 9% of the global annual production. The country annually produces ~2.2 billion pairs, of which ~90% are consumed internally while the remaining are exported, primarily to the European nations. India's annual footwear consumption of ~2.0 billion pair is the third largest globally after China and the USA and has recorded a healthy growth over the last decade driven by the rise in income levels, growing fashion consciousness and increasing discretionary spending. Despite just ~10% share of exports in India's total production volumes, the share of exports is almost one third in value terms due to higher average selling price (ASP) for exported footwear (mainly leather footwear) compared to the ASP for footwear consumed in the domestic market (mainly non-leather footwear). This rating methodology highlights the quantitative and qualitative risk factors that are likely to influence the rating outcomes for entities in the footwear industry, including, but not restricted to:

- **Industry Risk Assessment**
  - Raw material availability and prices
  - Competition from other countries with low cost of production
  - Regulatory risk
- **Business Risk Assessment**
  - Scale
  - Level of integration and capital intensity
  - Diversification – products, customers and geography
  - Brand strength
  - Cost-structure analysis and efficiency drivers
- **Event Risk**
- **Management Risk**
- **Parentage**
- **Financial Risk Assessment**
  - Profitability
  - Capitalisation and coverage indicators
  - Working capital intensity of operations
  - Foreign currency-related risks
  - Tenure mismatches, liquidity and financial flexibility

- Accounting quality
- Contingent liabilities/off-balance sheet exposures

Industry Risk Assessment

Competition from other countries with low cost of production

Indian footwear companies face competition from other countries with low cost of production. The Government of India has progressively increased import duty on footwear in September 2018 (current import duty is 25%) to safeguard the domestic footwear manufacturers. Currently, China controls the world export market. Chinese exports primarily to USA, which is the biggest footwear importer globally having a share of one out of every four pairs traded internationally. However, China's share in world exports has reduced over the years. Although India has not benefitted from this, other low-cost countries like Vietnam, Cambodia, Indonesia have increased their exports in the same period. India thus faces intense competition from all countries that have increased their export volumes in the recent past.

Raw material availability and prices

Leather hide/skin, plastic polymers and rubber are the main raw materials used in footwear manufacturing, and a large part of these raw materials are imported. India has among the largest livestock population in the world. However, the restrictions on abattoirs and slaughter of animals in certain pockets have led to lower raw material supply for leather footwear as well as lesser exports of leather products. Also, the country is still dependent on imports for good quality leather from developed countries. Raw material availability has been impacted by the recent regulatory interventions on the sector. A case in point being that the Government of Uttar Pradesh (UP) has clamped down on the unlicensed and mechanised slaughterhouses. Further, in order to reduce pollution in the river Ganga, multiple leather tanneries have been closed down and restrictions have been placed on many others by the National Green Tribunal (NGT) and the Central Pollution Control Board (CPCB) for alleged violation of the environmental and pollution norms in the Kanpur region, which has one of the biggest concentration of tanneries in the country. This in turn has adversely impacted leather supply. The dependence on imports is also high for plastic polymers and rubber, which have limited availability in India. The prices of these materials too have been volatile due to the corresponding volatility in commodity prices and currency rates.

Regulatory risk

The regulatory risk to the industry emanates from changes in duty drawback rates, import duties, environment norms, changes in labour policies, including those in minimum wages and any potential adjustment in taxation of the sector, as seen in multiple changes in GST rates. The Government has in the past revised the duty drawback rates and the minimum wages. Changes have been made recently in the form of an incentive package for the sector to increase investments and employment. The increase in import duty has improved the competitive position of the domestic footwear players, while the interventions in the form of lower duty drawback and stricter enforcement of pollution control norms have adversely impacted the leather footwear exporters. Regulatory actions have also impacted the availability of raw material, as mentioned in the section above.

Business Risk Assessment

Scale

Scale of operations for footwear companies is measured in terms of revenues and sales volumes. A larger scale of operations also helps in cost and manufacturing process efficiencies, supports diversification across products, propagates the setting up of a wider dealer and distribution network, leading to better reach and geographic presence.

While analysing the revenues, factors driving the revenue growth are analysed to see volume and value growth drivers. An improvement in the product mix in favour of higher value products and development of innovative products can lead to an increase in the average selling price (ASP). Besides this, the increase in ASP is due to the pass-on effect of an increase in raw material prices and overheads and foreign currency fluctuations. These apart, the share of various Government incentives in the revenues are analysed (especially for footwear exporters) as a high share of the incentives indicates high susceptibility of the profits to continuance of the incentives. The Government incentives are mainly for footwear exporters in the form of the duty drawback scheme, whereby these get rebates to compensate/adjust for duty or taxes paid on any imported/excisable materials and input services used in the manufacture of footwear for export purposes.

The Indian footwear industry is highly fragmented and is characterised by a large number of small-scale units, which in turn is attributable to the Government's earlier policy of reserving the sector for the small-scale units which had specified cap on investments in plant and machinery. The reservation policy was withdrawn in CY2001 and several larger players have emerged thereafter. However, the unorganised sector still accounts for the lion's share of the footwear market.

There are more than 15,000 small- and medium-scale footwear manufacturing units in India, which tend to have a small setup and largely operate as fabricators. These keep the cost of production low by having small manufacturing set up, involvement of mainly family members and limited investments in capital assets and branding initiatives. Their small scale and limited investments constrain their ability to make consistent quality products and take large orders, especially from export clients. Large manufacturing units with contemporary plant and machinery and modernised tannery facilities complying with global environmental requirements can supply larger orders across various products and hence deal directly (rather than dealing through buying houses/aggregators) with large reputed domestic and international customers.

However, given the labour intensity of the sector, large units can also pose manpower-related issues such as strikes, labour unrests, etc. As a result, ICRA notes that the large players operate through multiple manufacturing units to mitigate the risks associated with these issues, especially in the backdrop of stringent timelines for product delivery and penalties for delayed deliveries. Also, a few companies outsource production work to third-party vendors to mitigate manpower-related risks as well as to reduce their fixed and working capital requirements.

Diversification – Products, Customers and Geography

The sales diversification can be measured in terms of:

a) Product (share of higher value-added products versus lower value-added products)
b) Customer (concentration towards top customers)
c) Geography (share of sales in domestic versus exports markets; regional versus national presence for branded footwear players)

a) Product

Footwear categories largely include rubber, plastic, textile and leather footwear as well as end-user classification: men, women and kids' footwear. Leather footwear has higher value addition than other product categories and hence, commands premium pricing and higher gross profit margins as well. Low-priced rubber and plastic footwear have almost 80% share in India's consumption of ~2.1 billion pairs and hence, are manufactured in large quantities. The companies that manufacture footwear under various product categories are able to sell more products to existing customers and be present across various price points. This helps them to grow at a faster pace than companies focused on any single product category. Also, the impact of changes in consumption pattern in particular segment(s) can be offset through the performance in other segment(s), giving more leverage to the company to sustain and improve its performance.

b) Customer

Companies having diversified customer profile have low risk of any adverse development at one customer end which can impact sales. Customer concentration can also result in receivable concentration and hence a weakening of financial position of the customer could also risk the receivable position. These attributes also improve the competitiveness of the manufacturer and its ability to add other reputed customers to scale up. Supply to large and reputed customers with regular repeat orders is considered a credit positive as it reflects in the manufacturer's adherence to the best practices for manufacturing and compliances. A business-to-consumer (B2C) player, by its very nature, has higher customer diversity.

b) Geography

Export sales to a diversified set of countries can protect against adverse outcomes, which may arise by way of trade restrictions (such as increase in import duty imposed by the destination country) or decline in demand in the importing country, or reduction/removal of export incentives for exports to any particular country. A diversified sales network imparts the flexibility to the manufacturer to sell its production in different markets. Indian footwear export companies rank low on geographic diversification as the majority of these have high exposure to countries in the European Union and the UK.

For domestic branded footwear players, a national presence with a wide product portfolio, which caters to demand across seasons, is a credit positive as it minimises the seasonality in sales and protects against the decline in demand in a particular state/region due to unforeseen events, the economic slowdown or increase in competition, etc. Due to higher penetration of e-commerce, a new distribution channel has emerged, leveraging which, direct supply to customers across India has become much easier. However, this channel currently accounts for limited share of total footwear sales in the country.

Brand Strength

The majority of the exports from India are done under third-party labels and the presence of Indian brands is limited to export markets. For branded domestic footwear companies, strength of the brand(s) manifests in the form of pricing power and the ability to grow. For third-party manufacturers, the brand strength of their client(s) is assessed. The importance of a strong brand has also increased over a period of time, because many new competitors are entering the market, lured by the large consumer base in the country, increasing the competition. Strong brands have superior recognition, recall and identity in their respective target market segments. A consistently healthy spend on branding and sales promotion initiatives as a percentage of sales improves a brand's visibility, image and pricing power. This strength is developed over a period of time and can be based on attributes such as product quality, variety and pricing. This strength can be leveraged for expansion of the product portfolio and cater to a larger market as the acceptability of the new products from an existing strong brand will be better than new products from weaker brands. 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 are measured. Fluctuating sales with low or volatile profitability margins reflects relatively weaker brand strength, whereas steadily growing sales with stable/improving margins reflect a relatively stronger brand strength.

Project Risk

ICRA assesses the impact of any new or ongoing project of the company being analysed. The project is assessed for the planned capacity (vis-à-vis the existing capacities), total cost, funding pattern, and its overall impact on the credit risk profile of the company. Also, the experience and ability of the management to ensure the timely execution of projects within budgeted cost levels play a key role in determining the viability and returns from the project.

Management Risk

All debt ratings necessarily incorporate an assessment of the quality of the entity's management as well as the strengths/weaknesses arising from the entity being part of a Group. Also, of importance is the issuer's likely cash outflow arising from the possible need to support other Group entities, in case the entity is among the stronger ones. Usually, a detailed discussion is held with the entity's management to understand its business objectives, plans and strategies, and views on the past performance, besides the outlook on the industry in which it operates. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The entity's policies on leveraging, interest risks and currency risks
- The entity's plans on new projects, acquisitions, expansion, etc
- Strength of other companies belonging to the same Group as the entity
- The Group's ability and willingness to support the entity through measures such as capital infusion, if required

ICRA gives adequate weightage to various qualitative aspects resulting from management meetings. A detailed discussion is held with the management to understand their business strategy, growth plans as well as risk appetite, which may impact the issuer's future performance. Periodic interactions with management also help ICRA estimate the possibility of the management's tendency to deviate from its business philosophy. The management's ability to meet its committed performance and ensure stability in operations are key to the rating.

Parentage

Apart from standalone credit considerations, the likelihood of extraordinary support coming in from the parent to an entity or the support that an entity is likely to extend to the other Group companies is factored while assessing the credit profile of the entity. This process involves an assessment of the ability and willingness of the parent to extend support to the entity (and vice versa), in addition to evaluating the entity's own fundamental credit strength.

Financial Risk Assessment

Since the prime objective of the rating exercise is to assess the adequacy of the entity's debt servicing capability, ICRA draws up projections on the likely financial position of the entity under various scenarios. Besides, ICRA takes into account the commitments of the entity towards other Group entities, new ventures, and its investments in subsidiaries/SPVs. Accordingly, future cash flows are projected after taking into account the entity's capacity utilisation levels, capital expenditure programme, and the likely prices of input material, the growth it envisages, debt repayment schedule, its funding requirements, and the funding options available to it. These cash flows are then used to determine the entity's future debt servicing capability under various scenarios. In case of Groups consisting of entities with strong financial and operational linkages, various parameters such as capital structure, debt coverage indicators, and future funding requirements are assessed at the consolidated/Group level.

Profitability

Profitability metrics are a measure of an entity's efficiency and return on investments. It is imperative for most businesses to invest regularly in physical assets, product development, marketing, and human capital to sustain or improve their competitive position. Entities that have superior profitability are able to do so through internally generated resources with low dependence on external financing. Moreover, such entities are able to generate sufficient surplus for not only meeting debt servicing obligations but also to reward equity investors. This in turn improves their ability to attract fresh capital for future business requirements. Moreover, entities with higher profitability have better resilience to economic downturns and are more likely to generate adequate internal resources for re-investment and debt servicing. The profitability margins in terms of ratios like OPBDITA/OI (operating profits before depreciation, interest and amortisation/operating income) and PAT/OI (profit after tax/OI) are analysed. The operating profitability range depends on the product brand value, level of backward integration, product mix, Government incentives, sales channels, etc. Also, ICRA evaluates the stability in operating margins over a period of time, as it measures the entity's ability to withstand competitive pressure apart from event-specific risks. ICRA also measures the return on capital employed (RoCE) as diversified and mature entities exhibit relatively healthy and stable levels of return.

The footwear manufacturing industry is raw material and labour intensive with direct cost accounting for ~70-80% of the total revenue. Given the cost-intensive nature of the industry, the ability to control the costs at all levels becomes critical for the overall profitability margins of the entity.

The prices of major raw materials like leather, rubber and plastic polymers tend to vary as per the domestic as well as international demand-supply scenario. While the susceptibility to the fluctuation in raw material prices is generally low for footwear exporters as the manufacturing is undertaken against confirmed orders with product pricing taking into account the prevailing prices of raw materials. However, it is to some extent also dependent on the stocking policy of the manufacturer. Stocking/booking of raw materials to fully cover the confirmed export orders protects the profit margins of manufacturers in case of any adverse movement in prices. Conversely, excess stocking in relation to the order book position results in exposure to any downward movement in raw material prices. For branded footwear players, the ability to pass on the increase in prices depends on the strength of the brand.

Capitalisation and coverage indicators

In order to grow, the Indian footwear sector would require investments in plant and machinery, expanding retail presence and setting up new manufacturing facilities over the years. Overall, the capital requirement for an entity can vary depending on fixed and working capital intensity. Entities that pursue an aggressive financial policy, including heavy reliance on debt financing, are likely to be more vulnerable to slowdown than entities that employ a lesser degree of financial leverage in their business.

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 debt coverage as entities with longer tenure debt and similar levels of leverage will be more comfortably placed than entities with shorter tenure debt. Such flexibility is reflected in an entity's total debt/EBITDA and free cash flows/debt ratios. A low leverage ratio indicates adequate cushion in terms of raising funds, primarily from external sources (debt borrowings), for meeting funding requirements and is a credit positive.

Apart from the capital structure, ICRA pays attention to coverage indicators including interest coverage, debt service coverage, operating profit and net cash accruals relative to total debt, while evaluating the financial health of a footwear manufacturer. ICRA is particularly concerned with an entity's capability to honour its contractual obligations under stress conditions. The more robust an entity's performance is likely to be under stress scenarios, the better it is from a credit evaluation perspective.

Working capital intensity of operations

The footwear sector remains working capital intensive due to substantial requirements of raw material as well as finished goods inventory[1]. Further, the investment in receivables is considerable in case of footwear exporters while it is moderate for domestic footwear companies, due to higher business-to-business sales in exports. Within the players focussed on domestic market, the ones having good brand recall and/or extensive retail network have relatively lower receivables days due to substantial leverage arising out of strong customer pull or shorter cash conversion cycle. Further, the ones which focus on outsourcing of production will have lower inventory requirements and commensurately lower working capital intensity of operations. The working capital requirements of Indian footwear companies have been largely funded through short-term working capital borrowings from banks. For export companies, banks provide pre-shipment credit in the form of packing credit limits and post-shipment credit in the form of bill discounting limits.

Tenure mismatches, liquidity and financial flexibility

The footwear industry remains highly dependent on the banking system to meet its funding requirements, with limited access to capital markets except for a few large corporate entities. Any dependence on short-term borrowings to meet increasing investment in infrastructure exposes footwear companies to funding mismatches and refinancing risks, especially during periods of tight liquidity. The ratings factor in the existence of adequate buffers of liquid assets and bank lines to meet any short-term obligations and the extent to which the issuer could be impacted by interest rate movements on borrowed funds. ICRA assesses the management's approach and track record of maintaining sufficient liquidity and flexibility to access longer tenure funding to absorb any reasonable stress on cash flows. Financial flexibility and the existence of adequate buffers of liquid assets/bank lines to meet short-term obligations are viewed positively. Liquidity ratios measure the buffer, which an entity has in the form of cash or cash equivalents with respect to its obligations that can be utilised in case of any temporary cash flow mismatch. The entity's liquidity and financial flexibility is assessed by its unutilised bank/credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries, strategic importance of the entity to the Group to which it belongs, along with the financial strength of Group entities.

Foreign currency-related risks

Foreign currency risks for footwear industry emanate largely by virtue of export orders and the corresponding foreign currency receivables or due to import of raw material and corresponding foreign currency payables. While assessing the exposure of an issuer to foreign currency risks, ICRA focusses on the impact of adverse movement in foreign exchange rates on the cost structures, profits and net cash outflows, besides evaluating the hedging mechanisms in place.

Accounting quality

ICRA reviews the accounting policies, notes to accounts, and auditor's comments. Any deviation from the generally accepted accounting practices is noted and the entity's financial statements are adjusted to reflect the impact of such deviations.

[1] Finished good inventory is mainly required to be maintained by the business-to-consumer companies

Contingent liabilities/off-balance sheet exposures

ICRA evaluates the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and assesses the financial implications of the same on the rated entity.

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 after conducting a detailed evaluation of the issuer's business and financial risks, its competitive strengths, its 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 footwear manufacturing/branded footwear players involves an assessment of the business strength and weakness as reflected by their scale of operations, operating efficiencies, diversifications in terms of product, geography and customer profile, level of integration and brand strength. ICRA's financial risk analysis for footwear companies focusses on, among other things, the trend in revenues and profitability, the extent of leverage, ability to service debts, and financial flexibility. Lastly, ICRA appropriately factors in various company-specific qualitative aspects based on discussions with management, including the business strategy, growth plans as well as risk appetite, which may have an impact on the issuer's future performance.

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