



ICRA Rating Feature

Rating Methodology for Entities in the Textile Industry - Apparels

Overview

This rating methodology updates and supersedes ICRA's earlier methodology note on this subject, published in March 2018. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the Textile (Apparels) sector remains materially similar. This methodology document covers key rating considerations for the third-party apparel manufacturers as well as the branded apparel retailers (having own brands).

Industry Structure

Apparel Manufacturers: 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 based on design capabilities, offering of consistent quality products as per the delivery schedule and the 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, resulting in better cost structure and profitability. In addition, a 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.

Branded Apparel Retailers: The Indian branded apparel retail industry is intensely competitive, with the presence of several large domestic and international brands, as well as smaller, regional brands. Apparel retailers typically use a combination of sales channels for retailing their products, i.e. multi-brand outlets (MBOs¹) and exclusive brand outlets (EBOs²). While the MBO route provides greater and faster geographical reach with low fixed capital investments; the EBO route has greater scope 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 need to provide minimum guaranteed returns on investment to the franchisees, depending on the terms of the franchisee agreement.

Rating Methodology

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 the rating of apparel manufacturers and retailers. This methodology does not include an exhaustive treatment of all factors that are reflected in the ratings but enables the reader to understand the rating

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

considerations that are usually 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.

Industry risk analysis

- Demand cyclicality/ macroeconomic risks impacting consumer spending
- Access to fiscal incentives
- Competitive intensity

Business risk analysis

- Scale
- Diversification – customers/ sales channels, geographies, products/ segments and brands
- Customer profile
- Brand strength
- Arrangement with channel partners and inventory management

Financial risk analysis

- Profitability
- Working capital management
- Liquidity, cash flows and financial flexibility
- Leverage and debt coverage indicators
- Foreign currency risks
- Tenure mismatches, and risks relating to interest rates and refinancing
- Debt-servicing track record
- Accounting quality and Contingent liabilities/ Off balance sheet exposures

Management Quality and Corporate Governance

Other Considerations

- Level of integration
- Project risk
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Industry Risk Analysis

Demand cyclicality / macroeconomic risks impacting consumer spending

Performance of apparel entities is closely linked to macro-economic conditions, consumer confidence and spending patterns, particularly considering the discretionary nature of their products. Sales of apparel retailers, particularly, remain vulnerable to the consumers' changing tastes and preferences, and the competition from branded as well as unbranded segments.

Access to fiscal incentives

To support the capital investments in the sector, various fiscal incentives are available from the Central and state governments. Interest and capital subsidies (on term borrowings) reduce the overall cost of borrowings and improve the debt coverage ratios for players with the same levels of operating profitability and debt. 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. Thus, to improve the competitiveness of apparel exporters in international markets, cheaper working capital finance and fiscal incentives such as interest subvention may be facilitated/ provided by the Central/ State governments, which are factored in while assessing profitability.

Besides interest and capital subsidies, other major benefits include export incentives for apparel exporters in the form of duty drawback, rebate of state and central taxes and levies, etc. Besides supporting

profitability, these incentives support growth in sales by making domestic textile manufacturers competitive in the global market. This exposes the exporters' profitability to any adverse changes in the policies, and liquidity to delays in clearance of the dues.

Competitive intensity

As the apparel manufacturing and retailing sectors are fragmented and unorganized, the competitive intensity is high and the pricing ability is restricted to large retailers and strong apparel brands, besides niche boutique/ designer stores. While given the low cost of production and sufficient availability of raw material, a large chunk of domestic apparel requirement is met from domestic manufacturing, apparel imports have also grown at a significant pace in the recent years (at a compounded annual growth rate or CAGR of over 20% in the five-year period ended FY2019), from key apparel manufacturing nations such as China, Bangladesh, Spain, Sri Lanka and Vietnam. Also, retail sales of international brands that have entered the Indian market in recent years, have been growing at a strong pace, posing a stiff competition to the domestic brands.

Business Risk Analysis

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 are important considerations, among others. 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 could be 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 typically 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.

Diversification – customers/ sales channels, geographies, products/ segments and brands

Sales diversification can be measured in terms of:

- Customers/ sales channels
- Geographies; and
- Products/ segments
- Brands

Customers/ Sales channels

For apparel manufacturers: Unlike apparel retail entities, which by structure, enjoy greater customer diversification, apparel manufacturers typically tend to be dependent on a limited set of customers. Apparel manufacturers typically source their orders directly from customers or buying houses/aggregators. 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.

The 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 those sourced through buying houses where the discretion to give the purchase order lies with the buying house.

A diversified sales channel with dealers/ buying houses and/or a diversified customer base is a positive attribute. It protects the manufacturer 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.

For apparel retailers: Given the trade-off between the two sales channels, viz. the MBOs and the EBOs, 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.

Geographies

For apparel 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 regulations (such as increases in import duty imposed by the destination country or a duty-free access provided to a competing country) or a decline in demand in the importing country, or reductions/removals of export incentives for exports to a particular country.

Market diversification aside, ICRA also considers the geographic presence of the apparel entity's manufacturing facilities. A geographically diversified manufacturing base reduces an entity's exposure to risks emanating from adverse developments in any particular unit or region.

For apparel retailers: A national or a widespread geographical presence protects an apparel retailer against the decline in demand in a particular state/region because of unforeseen events such as changes in weather conditions, local economy slowdown, increase in competition because of entry of new players etc.

Products/ Segments

A wide product portfolio, which caters to demand across target markets, seasons and end-user categories is a credit positive for an apparel entity as it minimises the seasonality and volatility in sales. It reduces the vulnerability of sales and profitability for a third-party manufacturer as well as retailer to adverse demand scenario in a particular segment/ season, while providing flexibility to an entity to switch among product offerings, depending on the demand scenario, thereby mitigating the product obsolescence or inventory write-off risks to some extent. The ability of an apparel retail entity to alter its product mix by interpreting the market trends, plays an important role in determining its market positioning and helping it maintain its market share and customer loyalty, in an intensely competitive scenario.

Brands

ICRA analyses the brand diversification for apparel retailers in terms of the contribution of the largest brand(s) in the overall sales mix of the entity. A retailer with diversified brand offerings catering to different target markets on the lines of price points, customer segments, age groups etc. will be less prone to loss of business from a particular brand owing to factors such as reputational risk and customer perception issues, vis-à-vis a retailer with a concentrated portfolio. On the contrary, a large number of brands in an entity's portfolio, with no brand having a material scale, may reflect on an entity's weak market presence, exposing it to intense competitive pressures from the fragmented/ unbranded segment. ICRA considers a diversified

portfolio of brands, with at least a few brands having a good recall value and a reasonable scale, as a positive rating attribute.

Customer profile

For an apparel manufacturer, resilient business ties with fundamentally strong and renowned customers reflects favourably on the entity's operational strengths, including ability to consistently adhere to quality requirements and delivery schedules. Besides providing comfort on timeliness in receipt of payments, repeat business from large and reputed customers underpins the manufacturer's adherence to best practices for manufacturing. 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. Growth trends in these parameters are analysed along with a comparison of profitability levels vis-à-vis other industry players. Fluctuating sales with low profitability reflect 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 involved 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 involved 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.

In some cases under the SOR model, the sale is recognised when the entity transfers the inventory to the channel partner, and 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. In such cases, 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. However, as per the Indian Accounting Standard (IndAS) 18 on revenue recognition, if an entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. Accordingly, several companies have started reporting sales adjusted for probable returns post transition to IndAS, carrying returnable inventory in the channel on their own books. While suitable adjustments are made to analyse sales growth trend on a comparable basis, the IndAS accounting treatment provides a fairer view of an entity's inventory risks.

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 the MBOs/franchise managed the 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 analyses 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.

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.

Financial Risk Analysis

While ICRA believes that a strong business profile drives strong financial profile in the long-term, the 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. 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 an entity under various scenarios. This is done to assess the impact on profitability, cash flows and coverage metrics in the event of volatility in key variables such as volumes, growth rates, number of stores, product realisations and inventory levels. 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

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 analysed. In addition, for an apparel exporter, the share of the OPBDITA contributed by the Government incentives (such as export incentives) is also analysed as a high share of incentives indicates vulnerability of the OPBDITA and operating margin on the sustenance and level of the export incentives.

While analysing an entity's profitability, factors driving the revenue growth are 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. This has been witnessed in recent years wherein frequent revisions in the export incentive rates, partly to make the export incentive structure compliant with the World Trade Organisation (WTO) norms, have affected profitability of the Indian apparel exporters.

A detailed cost structure analysis is also done. 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 ~88-90% 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 the yarn prices and typically tends to vary as per the domestic as well as the international demand-supply scenario for the fibre and yarn. 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 rates is thus a positive factor. Manufacturing units located in the garmenting hubs of Delhi – the National Capital Region (NCR), Ludhiana (Punjab), Bangalore (Karnataka), Tirupur (Tamil Nadu) and Mumbai (Maharashtra) have been seen to have relatively better access to skilled labour compared to that in other locations. Further, several large companies have started setting up units in states such as Jharkhand, to benefit from favourable textile policies providing employment generation subsidy, which brings down the wage bills.

These apart, the profit margins of an entity are also seen in relation to the overall return on capital employed (ROCE³). While an 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. These can be a longer working capital cycle than the industry average, backward integration (requiring more capital) without

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

commensurate returns on such investment, or a lower fixed asset turnover. For instance, apparel retail 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 an entire in-house manufacturing, as the need for stocking raw materials/work-in progress gets eliminated. Similarly, apparels can be retailed either through MBOs or EBOs. In contrast to the owned-EBO distribution model, entities retailing through the 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. Accordingly, entities relying on the outsourcing model or the MBOs/ franchisee-managed EBOs could have relatively better or comparable ROCE vis-a-vis companies with more capital-intensive businesses, despite having lower operating margins.

Although apparel manufacturing entities may have moderate RoCE (low to mid-teens), it needs to be viewed in conjunction with such entities' access to interest subsidies under Government policies. While interest subsidies under the Technology Upgradation Fund Scheme (TUFS) of the Government of India were available on the bank debt availed for setting up of the manufacturing unit till December 2015 only, some states continue to offer such subsidies (interest as well as capital subsidies) under their respective textile policies bringing down the average cost of borrowing for apparel manufacturers. Further, 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) under TUFS, vis-à-vis 10% under the earlier scheme.

Working capital management

In addition to inventory-holding requirements, the level of working capital for an apparel entity is also driven by the receivables position. Apart from the overall receivables 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 the Letter of Credit (LC) or the export credit risk insurance are also taken as comfort factors.

Liquidity, cash flows and financial flexibility

The apparel sales are seasonal with most of the sales in the second half of the year during festival season in both the domestic and export markets, and the sale of higher value winter wear apparels. This apart, pace of clearance of the Government dues (such as input credit refunds, export incentives, subsidies etc.) also determine an entity's cash flow position. While the working capital requirements vary during the year due to the aforementioned factors, 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.

Liquidity is the measure of an entity's ability to meet its short-term cash obligations from various internal or external resources. Internal resources include fund flow from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or equity capital. Short-term obligations include committed as well as contingent claims on an entity's cash, including the debt-servicing obligations, working capital requirements, capital expenditure and other investment outlays, dividend and share buyback-related outflows, besides the sudden demand arising from crystallisation of discrete events such as litigation penalty. The higher the cushion between available resources (especially internal resources) and obligations, the better the liquidity profile of an entity.

Also, for liquidity assessment, 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 available in working capital limits. 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.

As the apparel manufacturing/ retailing industry is working capital intensive, the working capital requirements increase with the revenue growth. While an entity may have a DSCR >1 over the projected period, ICRA also assesses sufficiency of balance cash accruals (after meeting scheduled repayment) to

fund the equity margin required for planned capital expenditure as well as for incremental working capital requirements. 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 satisfactory 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 factor.

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access the capital or the money markets at a short notice, attract diverse and marquee investors and enjoy the confidence of banks, financial institutions and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones in quick time, whenever required. Financial flexibility could emanate from factors such as an entity's large scale of operations with strong financials, large unencumbered cash flows (such as rental income, annuity payments in road projects), unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group.

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 downturns than entities that have a lesser degree of financial leverage⁴ 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, the Central (under TUFS) and the 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.

Some of the key indicators observed by ICRA include –

- Leverage Indicators
Total Outside Liabilities/Tangible Net Worth (TOL/TNW) and Total Debt/OPBDITA
- Debt Coverage Ratios
Interest Coverage and Debt Service Coverage Ratio (DSCR)

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.

Foreign currency risks

Foreign currency risks for the apparel industry arise out 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 receivables 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.

⁴ For entities where Ind AS 116 is not applicable, ICRA makes suitable adjustments to the reported debt numbers to account for the future lease rental payments

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.

Debt-servicing track record

Any history of past 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.

Accounting quality and contingent liabilities/off balance sheet exposures

ICRA relies on a company's audited financial statements to analyse its financial performance during the rating process. It interacts with the Statutory Auditors as well as studies the Auditors' Report and other Notes to Accounts disclosed by a company in its Annual Report. Some of the key factors looked at include — auditor qualifications with respect to internal control systems, debt servicing and asset liability mismatch. 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. The likelihood of devolvement of contingent liabilities/off - balance sheet exposures and the financial implications of the same are also evaluated

Management Quality and Corporate Governance

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):

- Experience of the promoter and management in the line of business concerned
- Commitment of the promoter to the business concerned
- Risk appetite of the promoter/ management and risk mitigation plans
- Entity's policies on leveraging, 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

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.

ICRA observes that backward integration for apparel entities 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.

While integration is a positive, it poses challenges as well, such as reduction in operational flexibility in responding to market conditions and heightened business risks, which could result from unrelated diversification in a segment in which the promoters and management do not have relevant experience and track record. The risk to profitability is particularly higher in case of backward integration into cotton yarn spinning. While a balanced level of backward integration, which matches the requirement for apparel manufacturing, is considered positive, an integration which heightens the operational and financial risks for an entity, is a negative rating attribute.

Project risk

To ascertain project risks, ICRA endeavours to understand the entity's rationale for undertaking new investments. The risk profile could be different, depending on whether the new project is a case of related diversification or an unrelated diversification. The risk is heightened if the expansion is in a new/unrelated segment wherein promoters/ management do not have a demonstrated track record or experience. Some of the other factors that are assessed include: (i) track record of the management in project implementation; (ii) experience and quality of the project implementation team; (iii) extent to which the capital cost is competitive; (iv) financing arrangements in place; (v) demand outlook; (vi) competitive environment; and (vii) marketing arrangement and plans. The impact of the project risk on the rating is influenced by the scale of projects being undertaken or planned to be undertaken in relation to the size of assets and cash flows of the entity's existing operations.

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:

- 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, 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 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, in addition to their level of integration and 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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