RATING METHODOLOGY - TEXTILES (SPINNING)

March 2022

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in February 2020. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the Textiles (Spinning) sector remains materially similar.

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Overview

Spinning is the process of manufacturing of yarn from fibre on spindles (ring frame spinning) or rotors (open end spinning) and involves twisting together of fibres to form long continuous length of interlocked fibres (yarn). The yarn can be made from cotton or from manmade fibres like polyester, viscose and acrylic. Manmade yarn can also be alternately manufactured through the extrusion process, and such yarn is called filament yarn. Due to abundant availability of cotton fibre and relatively higher indirect taxes on the manmade one which impact export competitiveness, the Indian spinning industry is largely skewed towards the cotton spinning and cotton yarn accounts for ~70% of the total spun yarn production in the country, while the balance is accounted by the blended (manmade and cotton blend) yarn, within which cotton/polyester and polyester viscose are the major contributors to the production. The yarn manufactured is woven/knitted into fabric, which is then processed/finished before being fabricated into apparels/home textiles etc.

India has the second largest spinning capacity in the world after China, with more than 50 million spindles, equivalent to ~20% of the global spun yarn capacity. Due to lack of competitiveness in the export market, manmade yarn produced in India is largely used for domestic requirements and consumption, whereas almost 25-30% of the cotton yarn is typically exported from the country. Further, with a sizeable proportion of cotton yarn exports concentrated on a few countries, including China and Bangladesh, demand-supply trends in these export markets are seen to have a material bearing on the performance of the domestic cotton spinning segment.

Overall, the Indian spinning industry is highly fragmented, with the largest player in the industry accounting for less than 3% of the overall installed capacity of the country. As per ICRA's estimates, installed capacities in the Indian spinning sector average at ~30,000 spindles per unit.

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 spinning entities. 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 considerations that are usually the most important.

Industry Risk Assessment

- Growth Prospects
- Cyclicality
- Competitive Intensity
- Regulatory/ Policy Risk

Business Risk Assessment

- Scale of operations
- Diversification – Products, customers/ sales channels and geographies
- Vintage of machinery
- Inventory risk

Financial Risk Assessment

- Profitability
- Working capital management
- Liquidity and cash flows
- Leverage and debt coverage indicators

Other Elements of Credit Risk Assessment

- Level of forward integration and fibre diversification
- Parentage/ Group Support
- Exposure to currency risks
- Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing
- Accounting Quality
- Financial flexibility
- Debt Servicing Track Record
- Contingent Liabilities and Off-Balance Sheet Exposures
- Event Risk
- Project Risk

Management Quality

Assessment of Environmental, Social and Governance (ESG) Risks

- Environmental (E) and Social (S) Risks
- Governance Risks

Industry Risk Assessment

Growth Prospects

Accounting for nearly 25-30% of the domestic cotton yarn production, exports play a crucial role in determining demand-supply situation for the segment, as domestic demand for cotton yarn remains fairly range bound. The growth for the cotton yarn segment is, thus, influenced by the demand trend in major export destinations like China and Bangladesh. Government incentives also have a bearing on price competitiveness of domestic spinners in the international markets. As an example, inclusion of all cotton yarn exports under Remission of Duties and Taxes on Exported Products (RoDTEP) scheme from January 2021 onwards (as notified in August 2021) has supported price competitiveness of domestic spinners in the international markets and is likely to support export demand for Indian cotton yarn.

Growth prospects for the manmade yarn in India are also favourable. Manmade fibre accounts for ~65% share in the world's fibre consumption. Increasing preference/usage for manmade fibre (MMF) apparels globally is reflected in a decline in the share of cotton apparels in total imports of the US from 58% in CY2011 to ~50% in CY2021. In contrast, cotton yarn accounts for nearly 70% of the total spun yarn production in India.

The MMF segment's growth in India in the past has been marred by the adverse indirect tax structure on the manmade fibres against cotton. Besides being taxable at higher rates, the MMF segment has an inverted duty structure which affects competitiveness of players in the segment. Hence the production of manmade yarn is restricted largely for the domestic requirements and consumption, whereas ~25-30% of the cotton yarn is exported from the country. To address this, the industry has been seeking correction of the inverted duty structure, to reduce the working capital blocked in taxes.

In addition to correction of inverted duty structure with revision being proposed in GST rates on MMF products, launch of the Production-Linked Incentive (PLI) scheme aims to strengthen India's presence in MMF textiles. Higher investments in the sector led by PLI scheme, could spur growth in the MMF segment and help India gain a larger chunk of the global apparel market pie, as scale and automation become critical for global competitiveness, particularly in the mass-volume apparels (for instance MMF-based t-shirts).

Cyclicality

Spinning industry is cyclical in nature, given that its performance is linked to the level of volatility in commodity prices (oil or cotton). For entities in the cyclical industries, a shift in commodity price cycles can significantly impact their debt-servicing ability. Given the cyclical nature, spinning companies have lower tolerance for financial and operating leverage as adverse swings in revenues and profits heighten the probability of default.

While the main raw material for manufacturing cotton yarn is raw cotton, the key input for the manmade spun yarn includes manmade fibres such as polyester, viscose etc. Cotton as well as manmade fibres are abundantly available in the country. The prices of these fibres, however, tend to be volatile owing to changes in the global as well domestic demand supply scenario for cotton fibre, and crude oil intermediates prices for the manmade fibres. The risk of inventory loss, however, is higher for mills based on cotton vis-à-vis manmade fibres because of the higher stocking requirements/ tendency in the former (discussed in detail in the subsequent sections).

Competitive Intensity

The Indian spinning industry is highly fragmented. For instance, the largest player in the cotton spinning segment accounts for less than 3% of the total capacity. Moreover, given the commoditized nature of the product with limited product differentiation, the competitive intensity is high with minimal pricing power. However, companies manufacturing value-added yarn such as compact yarn, slub yarn, mélange yarn etc. can command premium pricing and differentiate the products to some extent.

As far as the export market is concerned, the share of manmade yarn in exports is much lower vis-a-vis cotton yarn due to the weak competitive positioning vis-a-vis international players (like those in China) which have significantly larger manufacturing capacities for manmade fibre and benefit from economies of scale.

Regulatory/ Policy Risk

The sector could be sensitive to major changes in Government policies such as minimum support prices (MSP) for raw cotton, restrictions on import of cotton fibre/ export of cotton yarn, and export incentives on cotton yarn. As cotton is the largest cost component in spinning, any significant increase in the MSP increases the domestic cotton prices, which could reduce the demand due to fibre substitution and export competitiveness of cotton yarn. In addition, any restrictions on import of cotton fibre or export of cotton yarn could increase challenges for the players, while reduction in export incentives can reduce the off-take and realizations for the Indian cotton spinners. However, sharp fluctuations in Government policies and severe impact of such changes on performance of domestic spinners has not been seen in the past, mitigating the risk to some extent.

Business Risk Assessment

Scale of operations

Larger scale in yarn manufacturing results in better cost structure. Thus, entities having smaller scale vis-à-vis the industry average may find it difficult to have a competitive cost structure in the commoditised yarn market.

Despite being a commoditised product, ICRA notes that capacity utilisation is not a material differentiating factor in the spinning industry, considering the ability of the entities to consistently operate at healthy levels of >85%. Nevertheless, the inability to consistently operate plants at healthy capacity utilisation is a negative attribute. This in turn could be a function of the various parameters like the company's product offerings and quality, machinery vintage and condition, power supply issues and labour-related issues.

Capital intensive nature of spinning operations

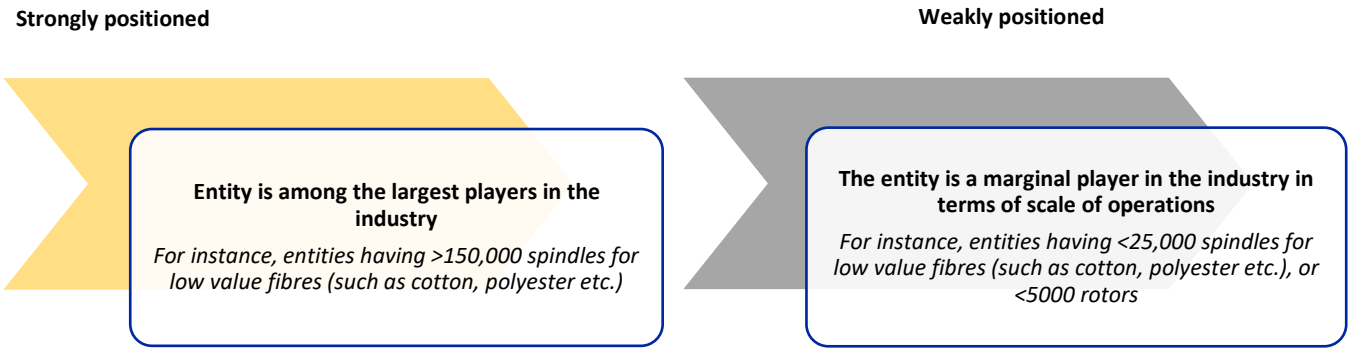
Spinning is a highly capital-intensive industry requiring significant investments in plant and machinery. A typical spinning plant with ~25,000 spindles involves a capital outlay of ~Rs. 90 to 100 crore - depending on land cost, degree of automation and nature of expansion, i.e. greenfield or brownfield. A spinning unit of this scale has the potential to generate revenues of ~Rs. 90 to 110 crore, depending on the fibre usage and yarn count being produced by the mill. With the continued availability of fiscal incentives, such as interest subsidy from some state governments, there is a high tendency of entities in the industry to operate at high leverage, resulting in interest and repayment burden. Given this, the ability to consistently operate at high capacity utilisation levels is of utmost importance to reduce the capital costs per unit of production.

It is pertinent to note that the production level of spinning units with similar spindleage capacity can vary significantly based on the yarn count. Thus, a spinning unit focusing on a higher count[1] range will have lower production per spindle, and vice-versa. Also, the mill producing yarn in the higher count range will have lower yield but will have higher realisation and profit margin. This apart, the production from the spindles is also a function of the fibre being used by the spinning unit. Use of manmade fibres, like acrylic, polyester, viscose etc. results in higher production per spindle as compared to cotton fibre, given the higher fibre strength which allows operating spindles at higher speeds, as well as longer and consistent fibre length, which results in a higher throughput. Accordingly, ICRA assesses the capacity derived at the average count range being produced by the entity and the type of fibre used as reference for calculating capacity utilisation levels.

[1] Defined as a numerical value indicating mass per unit length or length per unit mass of yarn

Assessment of Scale

[Relative assessment from the perspective of the industry]



Diversification – Products, customers/ sales channels and geographies

For a spinning mill, diversification can be achieved not only by way of fibre content, but also in terms of count range, varieties and colour range of the yarn manufactured. This apart, diversification can also be achieved in sales channels (dealers vs direct sales) and geographies (domestic vs exports, as well as degree of diversification in export markets).

Products: The ability to manufacture a diversified product range across various counts, varieties and colours (dyed vs grey yarn) are positive factors, as it improves the value addition and provides the flexibility to switch among product offerings and retain some pricing power, given the otherwise commoditised nature of yarn.

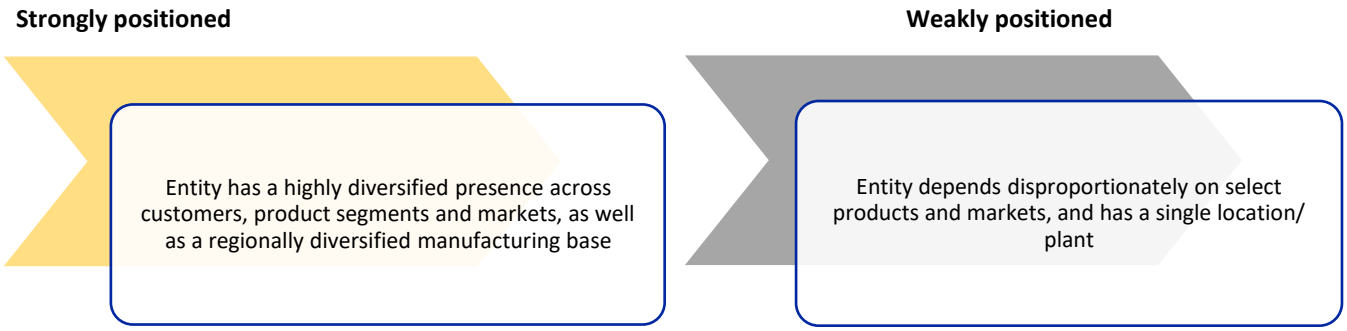
Customers and sales channels: A diversified and an established customer base which has a track record of providing repeat business protects an entity from the vagaries of adverse developments at any one large customer's end and enables the spinners to consistently operate at healthy capacity utilisation levels. 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. It is noted that entities with niche product offerings or consistency in quality and delivery are placed better to establish direct relationships or get nominated by large and established weavers or garment manufacturers[2].

Geographies: Apart from geographic diversification through exports, ICRA also considers a spinning mill's concentration towards a particular export market. Export sales to a diverse set of countries can protect against adverse outcomes, including trade restrictions (such as imposition of import duty) or decline in demand in the destination country. A diversified marketing network imparts flexibility to the mill to sell its production in different markets and maintain stability in sales and profitability.

Market diversification aside, ICRA also considers geographic presence of the spinners' manufacturing facilities. Being located in a region close to the raw material sources and/ or the target market helps a company to save on transportation costs, besides ensuring its access to uninterrupted supply of raw materials and/or orders, thereby supporting profitability. Further, a geographically diversified manufacturing base reduces an entity's exposure to risks emanating from adverse developments in any particular unit or region.

[2] ICRA notes that dealers are important intermediaries for spinning mills for the purpose of order aggregation, customer service and sometimes also financing by making faster payments to mills vis-a-vis payment realisations from end customers. Dealers also share the spinning entities' credit risk exposure to end customers, who may not be known to the mills. As a result, sometimes, even the direct sales are routed by the mills through dealers for client servicing.

Assessment of Diversification



Vintage of Machinery

The degree of modernisation of a manufacturing unit is seen to be a key driver of production yields, as a modernised facility typically results in lower wastages. Also, in contrast to an old unit, which may suffer from higher breakdowns, lower yield and higher manpower and maintenance costs, a modernised/ automated unit would have the advantage of lower downtime and higher throughput, along with lower manpower costs. Hence the vintage of the manufacturing facilities (average age of spindles) can influence the cost structure and the overall profitability of a spinning unit. Modernised machinery also improves the ability to produce consistent quality products, thereby improving the entities' ability to derive better sales realisations on the overall production.

Inventory Risk

The key raw material for the spinning industry is fibre, which can be either natural, such as cotton, wool or silk, or manmade, such as polyester, viscose or acrylic.

A mill should have adequate fibre stock to execute the orders in hand to hedge against the increase in raw material prices. While manmade fibres are available throughout the year and can accordingly be stocked based on the millers' order book position, the seasonality of cotton (as fresh crop is available from October till March and getting quality cotton could be a challenge in the non-harvest season[3]) 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 manmade fibre.

This apart, given that the prices of fibres can be volatile, excess stocking (in relation to the orders in hand) can expose the mills to the risk of inventory loss. The volatility in cotton fibre prices after the harvest season can be driven by the estimates of crop production in the next season, whereas manmade fibres, being crude oil derivatives, witness volatility on account of crude oil prices. The volatility in fibre prices, apart from the above factors, can also be driven by the domestic/ international demand-supply situation in the particular fibre or because of the exchange rate volatility (affecting landed costs in the domestic market), given that fibre is an internationally traded commodity. The risk of inventory loss, however, is higher for mills based on cotton vis-à-vis manmade fibres because of the higher stocking requirements/ tendency in the former.

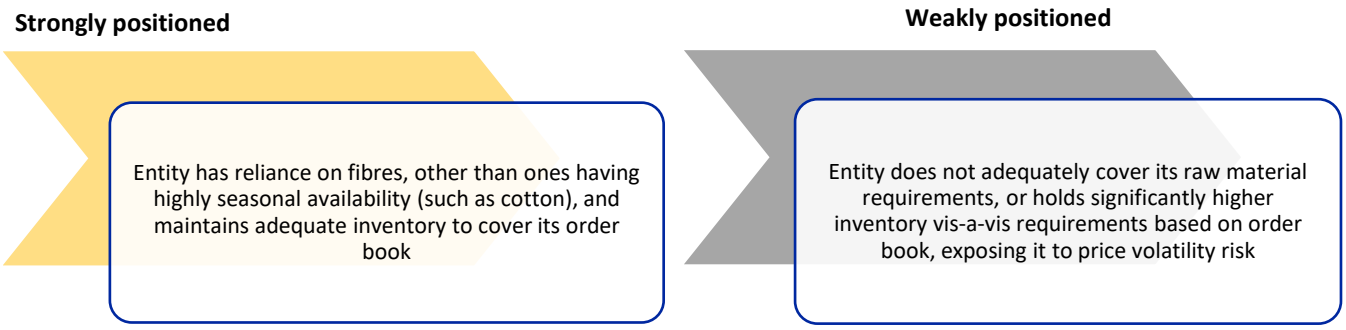
ICRA notes that the approach and stance of an entity's management plays an important role in inventory stocking levels. The track record of the management in terms of prudent inventory stocking (as measured by the stock levels maintained in relation to the order book) remains a key input to determine the risk appetite of the management.

For spinning companies, it has been observed that the fiscal year-end inventory levels average close to ~three months for cotton-based spinners and typically stand at ~1 month (at year-ends) for mills based on manmade fibre. Apart from the overall

[3] Besides availability of quality cotton, shortage in supply during non-harvest season tends to result in an increase in prices in some instances. To mitigate raw material availability and price volatility risk, companies tend to stock cotton fibre during the harvest season to cover part exposure. Extent of stocking varies across companies depending on factors such as liquidity available, management expectations of prices etc.

inventory, the inventory mix in terms of raw material, finished goods and work-in process are also benchmarked in relation to the industry average, whereby the finished goods for the spinning mills (cotton-based as well as manmade fibre based) vary from ~2-3 weeks depending on market conditions, whereas the work-in process typically stands at ~5 days, depending on the level of integration and product range.

Assessment of Inventory Risk



Apart from inventory holding in the issuers' own books, management discussions are held to understand their off-balance sheet inventory exposure (such as advances extended by the company to its suppliers for future purchases at pre-decided rates). This apart, discussions are also held with the management and auditors to understand arrangements with any related/ unrelated entities, wherein the latter maintains inventories on behalf of the issuer, with a commitment from the issuer to offtake stocks at pre-determined rates.

Financial Risk Assessment

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 the risk appetite and growth plans of the management. ICRA analyses the long period past financial performance trends and estimates future financial performance to assess the financial risk exposure of an entity. The financial metrics provide a useful reference not only to evaluate the performance trends of an entity over a given time horizon, but also enable a comparison with its peers. 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 contribution margins/ profitability, cash flows and coverage metrics in the event of volatility in key variables such as sale volumes, raw material prices as well as product realisations. Thus, the financial risk assessment is not done in isolation but in conjunction with the business and the industry risks that the entity is exposed to. An entity with low exposure to business and industry risks would generally have stable cash flows and thus would have a higher tolerance to operate with a relatively modest financial risk profile. In contrast, entities that are exposed to high business and industry risks need to maintain a stronger financial risk profile to have adequate cushion to manage cash flow volatility. The various financial metrices assessed by ICRA could be divided into five categories viz., Profitability, Working Capital Management, Leverage, Coverage, Liquidity and Cash Flows. This document provides a summary of these ratios. For a more detailed description, readers may refer to the document titled, 'Financial Ratio Analysis' published on ICRA's website. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis to assess the impact of the key variables on the various financial metrics.

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 seen in relation to the 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. Thus, in line with the approach followed typically for profitability assessment of entities manufacturing commoditised products, ICRA assesses the gross and net contribution level per kg of yarn sales for spinning entities as well. The analysis facilitates assessment of the key cost and realisation drivers and the movement in these factors.

The spinning industry is raw-material intensive with the fibre cost accounting for roughly two-thirds of the total revenues, followed by power and fuel (P&F) cost, accounting for ~8-10% and manpower cost accounting for ~5% of the revenues. Other manufacturing expenses (like repairs, stores and consumables etc), selling expenses (packing costs, outward freight, discounts etc.) and general and administrative expenses further form ~8-10% of the total revenues.

Raw Material Costs: Besides variations in market prices of fibre, on account of domestic as well as the international demand-supply scenario, raw material costs for spinning entities also vary, depending on the distance of a mill from the centres of raw material production.

Production Yields: The production yield in terms of final yarn production is a reflection of a spinning mill's operating efficiency. Though yarn production and waste generation are also a function of the type of yarn manufactured (combed/carded yarn) and the type of fibre (cotton/man-made fibre), the minimisation of fibre loss supports revenues and profitability. A modernised facility typically results in lower wastages and downtime, and may require lower manpower and maintenance costs, compared to an old unit. Hence the vintage of the manufacturing facilities (average age of spindles) can influence the cost structure and the overall profitability.

Power Costs: The cost of grid power can vary from state to state. Further, captive power costs can vary depending upon its source, viz., coal, liquid fuel, solar or wind. Hence, the overall power costs for mills can vary significantly, depending on the location of the mills and the source of power. Certain mills with the flexibility to source power through open access can benefit in a scenario of lower prices in merchant power markets.

An entity's ability to pass on the increases in key costs is assessed by its demonstrated track record of retaining/improving gross/net contribution levels. Sale realisations are also compared with the 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. Notwithstanding the commoditised nature of the product (yarn), focus on higher value-add products such as slub yarns, mélange yarns, dyed yarns etc. enables the entities to fetch higher realisations. Thus, besides the cost structure, the product profile in terms of ability to offer value-add/ differentiated products also enables the entities to improve their contribution margins.

These apart, the profit margins are also seen in relation to the product profile as well as the degree of backward or forward integration (which requires more capital) and hence in relation to the overall return on capital employed (RoCE[4]). 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 longer working capital cycle than the industry average. Similarly, profitability of companies manufacturing different qualities of yarn may not be comparable because of the difference in realisations and yields, though their ROCE may be comparable.

Although the RoCE is seen to be typically low in spinning segment, the same compares favourably with the average cost of capital, given that some of the domestic spinning mills tend to enjoy interest subsidy benefits from the state governments under their respective textile policies[5].

Working Capital Management

Apart from inventory, which has been discussed earlier, the level of working capital is also driven by the receivable position. The overall receivable position is analysed for its ageing (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, the credit risk mitigants such as export credit risk insurance cover or Letter of Credit (LC)-backed receivables are taken as comfort factors.

Liquidity and Cash Flows

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.

Given the working capital-intensive nature of operations and seasonality in working capital requirements, the peak working capital requirements are typically higher for cotton-based spinning mills than their average working capital requirements. Accordingly, the sanction of sufficient working capital limits to fund the peak-level working capital requirements provides comfort. 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. The drawing power can be a function of the inventory valuation and hence it is seen in relation to the realisable value, especially in a declining price scenario.

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 working capital and planned capital expenditure. If the projected levels of cash accruals (after repayments) are lower than the equity funding requirement for capital expenditure and

[4] RoCE is defined as profit before interest and taxes / average capital employed for the year
[5] Spinners used to be eligible for interest subsidies under the Technology Upgradation Fund Scheme (TUFS) of the Government of India earlier, which was discontinued for new loans for spinning entities with effect from January 2016 onwards.

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.

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 leverage in their business.

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

Some of the key indicators considered by ICRA include –

- Leverage indicators: Total Outside Liabilities/Tangible Net Worth (TOL/ TNW), Total Debt/OPBDITA

Assessment of Leverage
[Indicative Metrics[6]]

	Strongest		Weakest
Indebtedness Ratio	<=0.9x	→	>3.0x
Debt to Profit Ratio	<=0.5x		>5.0x

- Debt coverage ratios: Interest Coverage, Debt Service Coverage Ratio (DSCR)

Assessment of Coverage
[Indicative Metrics]

	Strongest		Weakest
Interest Coverage	>=18.0x	→	<2.0x
DSCR	>=4.0x		<1.1x

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 the debt coverage as entities with longer tenure debt and similar levels of leverage will be more comfortably placed as compared to entities with shorter tenure debt. Even earlier, when entities used to avail of loans under the TUFS where interest subsidy used to be available for seven years from the date of sanction of the loan, there were entities that availed of a longer tenure loan to spread out the debt repayment liability over a longer duration.

[6] *The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrices on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrices on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it.*

Other Elements of Credit Risk Assessment

Level of forward integration and fibre diversification

The spinning mills can forward integrate into fabric manufacturing (including grey fabrics or finished products such as towels, home textiles, denim etc), apart from adding value in terms of yarn processing like yarn dyeing etc. While the prices of fabrics also tend to fluctuate in relation to the yarn prices, the profit margins in fabric-making are steadier vis-a-vis yarn manufacturing, considering higher raw material holding requirements as well as greater exposure to volatility in prices of raw materials (cotton/ polyester) in the yarn business. Besides diversification benefits, captive yarn availability for in-house consumption results in savings in transportation, packing and selling costs. Hence forward-integrated mills with sizeable in-house yarn consumption tend to witness lower volatility in margins than a standalone spinning mill. This is a positive rating attribute. Further, presence in more than one fibre segment (viz. cotton/ manmade) reduces vulnerability of mills' profitability to segment-specific risks and is thus considered a positive rating attribute.

Parentage/ Group Support

While the credit rating of an entity is a function of its standalone credit profile, in certain cases, the entity's credit quality can also be driven by the relationship with its parent or the promoter group (henceforth referred to as the parent).

All debt ratings necessarily incorporate an assessment of the quality of the entity's promoters as well as the strengths/weaknesses arising from the entity's being a part of a "group". Also of importance are the entity's likely cash outflows arising from the possible need to support other group entities, in case the entity is among the stronger entities within the group. 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

If the parent's credit profile is relatively stronger than the rated entity, ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here refers to financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period and advances in times of credit or liquidity stress on the entity. Support here does not mean operational support in the form of new business opportunities, technology sharing, distribution network sharing and so on, as these aspects are factored in the standalone credit profile assessment. If the parent's credit profile is relatively weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited, given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile[7].

Exposure to Currency Risks

Foreign exchange risk for spinning entities arises by virtue of foreign currency receivables from export orders. With most of the cost being rupee-denominated, the scope of a natural hedge remains limited for the entities. To hedge these risks, an entity may choose to avail of a working capital facility in foreign currency, like packing credit in foreign currency/bill discounting in foreign currency, which should be equivalent to the export order value or forex receivable position. Alternatively, an entity may also fund its current assets by rupee working capital borrowings and take a forward position equivalent to a 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 forex receivables position to check the overall unhedged exposure.

[7] *For more details on this, readers may refer to the document titled, "Impact of Parent or Group Support on an entity's Credit rating", available on ICRA's website*

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.

Accounting Quality

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.

Financial Flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access capital or money markets at 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, unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group.

In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital raising ability.

Debt Servicing Track Record

The debt servicing track record of the company forms an important rating consideration. Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company's future debt servicing capability and willingness. Nevertheless, the reason behind past defaults are also analysed, which could also be due to adverse demand situations in the underlying industry. The company's ability to honour its debt obligations during the period of cyclical stress is also factored in.

Contingent Liabilities and Off-balance Sheet Exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures as disclosed by the entity in its Annual Report and evaluates the likelihood of their devolvement and the financial implications of the same.

Event Risk

ICRA recognises the possibility of events, such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin offs, capital restructuring; and litigations, which could have a material impact on the credit profile of a company. Incorporating the impact of such discrete events in the credit rating, from the beginning, is often difficult. Depending on whether and when such events occur, the rating opinion could be substantially different. To take rating decisions in such cases, ICRA applies its analytical judgment based on the rated entity's track record, the credibility of the management and the

experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

Project Risk

Being highly capital intensive and due to the availability of various fiscal incentives for capital investments, capacity expansion has been a regular feature for the industry participants. An entity undertaking a large-sized project capital expenditure (capex) is exposed to several risks, including cost and time overruns.

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.

Management Quality

In addition to the business and financial risk analysis, all debt ratings incorporate an assessment of the quality of the entity's management and its financial policies. An experienced management is considered a positive factor.

In addition, the likely cash flow impact on the rated entity, from the possible need to support other group entities are of importance, in case the rated entity is among the stronger entities within the group. Usually, a detailed discussion is held with the management of the rated entity to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the rated entity's industry.

Some of the points assessed are:

- Experience of the promoter/ management in the industry
- Commitment of the promoter/ management to the concerned line of business
- Risk appetite of the promoter/ management and risk mitigation plans
- The rated entity's plans regarding new projects, acquisitions, and investment in non-core business segments
- The rated entity's policies on leveraging, interest risk and currency risks

Periodic interactions with the management also help to estimate the possibility of the management's tendency to deviate from its core philosophy in times of stress.

Assessment of Environmental, Social and Governance (ESG) Risks

The assessment of ESG risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the environmental and social (E&S) risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the governance risks are largely entity driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally pull down the ratings, but generally the ratings are not pushed up even when the ESG context is favourable.

Environmental (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction.

While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly, if not precisely. Further, it is not always feasible to fully or precisely disaggregate the sub - components of E&S risks in credit analysis since these considerations often tend to overlap. That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differs widely across sectors and entities. In some cases, while the E&S risks could be material but their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future and, hence, these considerations do not necessarily weigh on the rating today — with the expectation that when these risks manifest in the distant future, the rated entity by then would possibly adapt itself by realigning its business model. While evaluating E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile.

Environmental considerations

Spinning companies using natural fibres are exposed to agro-climatic risks given that the quality, prices and supply of the natural raw material (such as cotton, wool, silk etc.), depends on various factors such as weather conditions/ temperatures, rainfall patterns, crop infestation etc. Further, MMF spinners use synthetic materials made from petrochemicals/ crude oil derivatives which are not readily biodegradable, and have long-term environmental pollution implications. Availability issues and/or shift in preference towards more environmental-friendly alternatives could result in demand-related concerns for MMF spinners. Resultantly, they are exposed to tightening environmental regulations in regard to breach of the waste and pollution norms which can lead to an increase in operating costs and new equipment/ capacity installment costs.

Social considerations:

The social risk for the sector emanates from high labour involvement, despite increasing mechanization. The sector is exposed to labour-relation risks and risks of protests/social issues with local communities, which might impact expansion/modernisation plans. Entities are also exposed to risks of disruptions due to inability to properly manage the human capital in terms of their safety and overall well-being.

Governance Risks

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the board of directors and the management. The constitution of an entity's board and the board of directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, its level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related-party transactions and instances of supporting group entities at the expense of debt holders are assessed.

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 an 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 the spinning entities involves an assessment of the business strength and weaknesses as reflected by their scale of operations, operating efficiencies owing to their presence in a highly commoditised product segment and diversifications in terms of the product profile. The operational strengths are typically reflected in 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 the ability to fund these at lower cost. These apart, given the risks arising from raw material price volatility as well as demand trends in key export markets, prudent inventory management also drives the credit risk profile.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating for a cotton spinning company

		Strong			Comfortable			Adequate			Moderate			Weak		
Industry Risk	Industry Position															
Business Risk	Scale (Installed capacity)															
	Customer profile and diversity															
	Product diversity and presence in value-added product segments															
	Vintage of machinery															
	Capacity utilisation															
	Inventory risk															
	Geographic Diversification - Markets															
	Geographic Diversification – Manufacturing presence															
Financial Risk	Leverage															
	Coverage															
		Enhance					**Support/ Neutral**					**Hinder**				
	Diversification															
Do these factors enhance or hinder the credit profile?	Refinancing Dependence, Liquidity and Financial Flexibility															
	Currency Risk															
	Financial Policy															
	Management, Governance and Reporting															
		Very High				**High**				**Moderate**				**Low**		
Parent Support	Likelihood of Parent Support															
	Rating of Parent	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category	
	Final Rating	**AAA**	**AA+**	**AA**	**AA-**	**A+**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**	**BB+**	**BB**	**BB-**	**B/ C category**	

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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