June 26, 2020

Jeans Knit Private Limited: [ICRA]BBB+(Stable)/ [ICRA]A2 assigned

Summary of rating action

Instrument*	Current Rated Amount (Rs. crore)	Rating Action
Fund Based – Term Loan	129.57	[ICRA]BBB+(Stable); Assigned
Fund Based – Working Capital Facilities	70.00	[ICRA]A2; Assigned
Unallocated limits	25.43	[ICRA]A2; Assigned
Total	**225.00**	

**Instrument details are provided in Annexure-1*

Rationale

The assigned ratings derive strength from Jeans Knit Private Limited's (JKPL) favourable operational profile, supported by extensive experience of its promoter in the apparel exports industry, the company's established track record of operations and relationships with a reputed overseas clientele. This has facilitated regular repeat business from its key customers over the years. Although lower orders from one of the key customers, coupled with overall slowdown in demand, led to a decline in the company's revenues in FY2019 and FY2020, its profitability has been improving consistently with an estimated operating margin of ~15% in FY2020 (E) compared to 7.6% in FY2016, supported by cost rationalisation initiatives. The apparel export sector also benefits from favourable Government policies in the form of export incentives, which have also supported JKPL's profitability over the years. This, however, exposes the profitability to any adverse change in the export incentives structure or rate of export incentives. Despite healthy profitability, JKPL's return metrics remained modest due to sizeable capital investments made in the recent years, sub-optimal utilisation of the installed capacities as well as high working capital requirements of the business. Nevertheless, healthy accretion to reserves, over the years, resulted in the build-up of a strong net worth base leading to a comfortable capital structure (total debt/ tangible net worth of 0.3 times as on March 31, 2020 (E)), despite high debt levels to support the working capital requirements and capex outgo in the recent years. Further, the company's debt coverage metrics remain comfortable supported by healthy profit margins. ICRA expects JKPL's debt levels to reduce substantially in FY2021 with the scheduled repayments of term debt, lower working capital debt and proposed adjustment of supplier's finance against the resale of unused machinery.

The ratings are, however, constrained by the high client as well as geographical concentration risks, exposing the company to counterparty credit risk as well as the risk of adverse developments in a particular market/ region. Moreover, its high inventory holding, along with an elongated receivables cycle, results in high working capital intensity. High inventory holding also exposes the company to risk of volatility in the prices of raw material and finished goods, as there is a lag between order booking and deliveries. In addition, high dependence upon exports exposes its profitability to any adverse change in foreign currency exchange rates. The ratings are constrained by the intense competition in the industry, which limits the pricing flexibility of industry participants, including JKPL.

While assigning the ratings, ICRA notes the expected pressures on the company's operating performance and financial risk profile in the near term, owing to the Covid-19 pandemic-led demand-side pressures in the key markets as well as disruptions in operations following the lockdown. Widespread temporary store closures and potential slowdown in consumer discretionary spending across markets are expected to impact demand and hence could affect its revenue growth.

The Stable outlook on the long-term rating reflects ICRA's opinion that JKPL will continue to benefit from its vast track record of operations and established relationships with clients, despite the temporary demand-side pressures due to the Covid-19 pandemic. Notwithstanding the near-term pressures, ICRA expects the company's debt coverage metrics to remain comfortable, supported by healthy profitability.

Key rating drivers and their description

Credit strengths

Extensive experience of promoter in apparel exports industry – JKPL's promoter, Mr. Anupam Kothari, is a textile engineer and has an extensive experience spanning over three decades in the apparel manufacturing and exports industry.

Established relationships with leading international brands – JKPL, along with its 51.5%-owned subsidiary FFI Global S.R.L (referred to as the FFI Global Group or the Group, hereafter), derives almost its entire revenues from the export market. Over the years, it has fostered relationships with leading global apparel retailers, establishing a strong client base including G-Star, Netherlands and Adidas. The company's client base has been providing repeat business on a sustained basis, reflecting favourably on its track record and competitive positioning in the sector.

Healthy profit margins, comfortable capital structure and healthy debt protection metrics – There has been a decline in the company's revenues during the last two years (FY2019 and FY2020), due to multiple factors including a churn in the customer base, low orders from one of the key customers, and operational disruptions caused by the Covid-19 pandemic in the recent months. Nevertheless, its profitability has been improving consistently, as reflected in an operating margin of ~15% in FY2020 (E) vis-a-vis 7.6% in FY2016. This has been supported by consolidation of manufacturing facilities and cost rationalisation measures such as employee base optimisation and installation of less labour-intensive/advanced-technology machineries. Further, while JKPL's debt levels increased significantly in FY2018 with the conclusion of a debt-funded capex towards backward integration, its capital structure has remained strong owing to a consistent accretion to reserves and net worth since the commencement of operations. This is corroborated by a healthy gearing (Total Debt/ Tangible Net Worth) of 0.3 times as on March 31, 2020 (E). The company's healthy profit margins translate into adequate debt protection metrics, corroborated by an interest cover of 8.3 times for FY2020(E). Its capital structure and debt protection metrics are expected to improve further with a substantial decrease in total debt in FY2021, supported by the scheduled repayments of term debt, reduced working capital requirements and settlement of a sizeable supplier's credit facility (Rs. 22.30 crore, besides Rs. 55.7 crore outstanding as capital creditors) against return of an unused machinery. This coupled with the reduction in annual debt repayment obligations (Rs. 21.6 crore from FY2021 onwards vis-a-vis Rs. 38.0 crore in FY2020) is expected to help JKPL achieve an improvement in its DSCR vis-a-vis ~1.2 times in FY2020 (E).

Credit challenges

Pressure on revenues and profitability, amid tough operating environment – Being sensitive to consumer discretionary spending and supply-chain disruptions, the Indian apparel sector's performance is being adversely affected by the Covid-19 pandemic across the globe. In line with the broader industry trend and on account of loss of business during the lockdown period (starting March 25, 2020 and effective till May 03, 2020), JKPL's revenues and profit margins are expected to be adversely impacted in H1 FY2021. This follows a decline in the company's turnover for two consecutive years in FY2019 and FY2020, owing to a churn in customer base and low orders from one of the key customers.

Working capital-intensive nature of operations and sub-optimal capacity utilisation constrain return metrics – JKPL's operations are working capital-intensive in nature, as indicated by gross working capital cycle (debtors and inventory holding) of over 300 days in FY2020 (E). This can be primarily attributed to high inventory holding, besides elongated receivables cycle. The inventory levels remain high as raw material specifications are different for all the buyers and the company is required to import raw materials from the customers' approved international vendors, which involves a longer transit time. Further, the production cycle ranges between 25-30 days and the goods are shipped once the entire lot is manufactured, which also increases the inventory levels. High working capital intensity and sub-optimal capacity utilisation of the company's knitting capacities constrain its return metrics, as indicated by an average core return on capital employed (ROCE) of 2.4% during the past three years. JKPL had undertaken a sizeable debt-funded capital expenditure of Rs. 250 crore in FY2018 towards backward integration, involving installation of 800 knitting machines. However, the operations did not ramp up as envisaged because of lack of orders, which resulted in sub-optimal utilisation of capacities and weak return metrics. It is in the advanced stages of reselling a part of the unused machinery (~200 knitting machines). Besides reduction in corresponding long-term liabilities in the form of suppliers' credit, this is expected to help the company achieve an improvement in its return metrics.

High client concentration risk – The company derives almost its entire revenues from the export market, mainly driven by Netherlands (more than 50% of total sales), followed by the USA (~16% in FY2020). High reliance on exports with concentrated exposure to Netherlands and the USA exposes JKPL's revenue as well as profitability to slowdown in these markets. Besides, it has a concentrated client exposure, with top five clients accounting for ~81% of the total sales and the largest customer alone accounting for 57% of the total sales in FY2020. Besides exposing it to business risks on account of pressure on performance of these clients, high client concentration exposes the company to counterparty credit risk. This is more so considering that adding a new large customer is typically a time-consuming process, with significant compliance requirements.

Profitability exposed to change in rates of export incentives, slowdown in export markets, volatility in raw material prices and exchange fluctuations – Similar to other apparel exporters, high dependence on export incentives exposes the company's profitability to any adverse change in the export incentives structure. In the recent years, there have been several frequent revisions in the export incentive structure as well as rates, which results in lack of clarity while pricing the products. Given that the export incentives support competitiveness of the domestic apparel manufacturers in the intensely competitive global apparel markets, any changes in the structure or rates, particularly with retrospective effect, tends to affect the performance of the companies in the sector. Further, similar to other apparel exporters, the company's profitability is susceptible to adverse movement in raw material prices and foreign exchange rates, given its export-driven revenue profile. A significant appreciation of the Rupee vis-à-vis the Dollar can adversely impact its revenues and profitability as well as its competitiveness against other exporting countries. However, benefits of partial natural hedging, given the reliance on import of raw materials and use of foreign currency borrowings mitigate the risk to some extent.

Limited bargaining power due to significant competition in garment exports business – The garment export industry is highly fragmented and characterised by intense competition among exporters from India and other low-cost countries. The stiff competition keeps the pricing power in check, thereby limiting the profitability and the ability of industry participants to pass on the increase in input costs of yarn and fabric.

Liquidity position: Adequate

JKPL's liquidity profile is **adequate**. Proposed settlement of a supplier credit (availed for capex in the past) and scheduled repayment obligations on the company's long-term borrowings are estimated to entail an outflow of ~Rs. 35 crore in FY2021. ICRA expects JKPL's cash flow from operations to remain adequate against the said obligations. In addition, the company's liquidity profile is supported by no major capex plans, free cash and bank balances of Rs. 6.6 crore as on March 31, 2020 and average cushion of ~Rs. 10-15 crore in its fund-based working capital facilities in YTD FY2021, despite disruptions faced in operations and cash flows in the recent months owing to the Covid-19 pandemic. ICRA expects the company to maintain a comfortable cushion in its working capital facilities. In this context, availability of a significantly higher drawing power (averaging at around Rs. 160 crore in the past three months), vis-a-vis the currently sanctioned fund-based working capital facilities (Rs. 60 crore), provides comfort.

Rating sensitivities

Positive triggers – The ratings could be upgraded if there is a healthy improvement in the company's scale of operations and profits, along with an improvement in its return metrics. Further, JKPL's ability to diversify its presence across clients and geographies, together with efficient working capital management, would be positive rating triggers.

Negative triggers – The ratings could be downgraded if there is a sustained pressure on the company's sales growth and profitability, which results in a deterioration in its return and debt coverage metrics. Additionally, JKPL's rating would be prone to a downgrade if a stretch in working capital cycle, delay in conclusion of machinery resale deal or crystallisation of contingent liabilities affects its capitalisation and coverage metrics and weakens its liquidity position. Specifically, its inability to improve DSCR to more than 1.5 times and Total Debt/ OPBIDTA to less than 3.0 times on a sustained basis, could be negative triggers for the ratings.

Further, the company also faces prepayment risk given the possibility of debt acceleration upon the breach of covenants, including rating-linked covenants. Upon a failure to meet the covenants, if JKPL is not able to get waivers from the lenders or the lenders do not provide adequate time to the company to arrange for alternative funding to pay-off the accelerated loans, the ratings would face a downward pressure.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Entities in the Textiles Industry - Apparels Rating Methodology for Entities in the Textiles Industry – Fabric Making
Parent/Group Support	Not applicable
Consolidation/Standalone	While ICRA has reviewed the standalone as well as the consolidated financials of the company, the ratings are primarily based on the standalone business and financial risk analysis, as it is the principal driver for the Group's credit risk.

About the company

Incorporated in 2004, JKPL is a part of FFI Global Group, Bengaluru (Karnataka). The company manufactures and exports denim garments, along with sportswear and winterwear. It operates out of its manufacturing facilities located in Bengaluru (Karnataka) and Chennai (Tamil Nadu). Besides garment manufacturing, the company has in-house knitting capacities, to manufacture knit fabric panels required for captive consumption.

JKPL caters to the premium denim segment across all the customer segments (men, women and kids) and exports its products to renowned brands in Europe and the USA, such as G-Star and Adidas. While the company also markets garments under its own brand, Free Soul, the proportion of these sales remains low.

JKPL's Italy-based subsidiary company, FFI Global S.R.L, in which it owns a 51.5% stake, is a marketing arm of the company. Most of JKPL's sales (~70-75%) to end customers such as G-Star are routed through FFI Global.

In FY2019, the company reported a net profit of Rs. 28.9 crore on an operating income (OI) of Rs. 435.1 crore compared to a net profit of Rs. 12.8 crore on an OI of Rs. 442.4 crore in the previous year.

Key financial indicators (audited)

	FY2018	FY2019
Operating Income (OI) (Rs. crore)	442.4	435.1
Profit after tax (Rs. crore)	12.8	28.9
OPBDIT/OI (%)	12.8%	15.0%
Return on capital employed (RoCE) (%)	4.2%	2.5%
Total Outside Liabilities/Tangible Net Worth (times)	1.1	0.8
Total Debt/OPBDIT (times)	4.5	3.3
Interest Coverage (times)	8.9	6.2
Debt service coverage ratio (DSCR)	5.2	5.5

Source: JKPL's Annual reports, ICRA research

Note: OPBDIT: Operating profit before depreciation, interest and taxes

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2021)				Rating History for the Past 3 Years		
		Type	Amount Rated	Amount Outstanding	Rating 26-Jun-20	FY2020 -	FY2019 -	FY2018 -
1	Term Loans	Long Term	129.57	68.8	[ICRA]BBB+ (Stable)	-	-	-
2	Working Capital Limits	Short Term	70.00	NA	[ICRA]A2	-	-	-
3	Unallocated Limits	Short Term	25.43	NA	[ICRA]A2	-	-	-

Amount in Rs. crore

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Term Loans	FY2018-FY2019	NA	FY2023-FY2024	129.57	[ICRA]BBB+ (Stable)
NA	Working Capital Limits	NA	NA	NA	70.00	[ICRA]A2
NA	Unallocated Limits	NA	NA	NA	25.43	[ICRA]A2

Source: Jeans Knit Private Limited

Annexure-2: List of entities considered for consolidated analysis: Not applicable

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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.

For more information, visit www.icra.in

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