

November 23, 2020

Aarti International Limited: Ratings downgraded to [ICRA]BBB+/ [ICRA]A2; outlook revised to Stable from Negative

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term fund-based cash credit	278.40	278.40	[ICRA]BBB+ (Stable); downgraded from [ICRA]A- (Negative); outlook revised to Stable from Negative
Long-term fund-based term loan	113.83	101.36	[ICRA]BBB+ (Stable); downgraded from [ICRA]A- (Negative); outlook revised to Stable from Negative
Long-term non-fund based Bank Guarantee	2.00	2.00	[ICRA]BBB+ (Stable); downgraded from [ICRA]A- (Negative); outlook revised to Stable from Negative
Long-term unallocated limits	6.24	18.71	[ICRA]BBB+ (Stable); downgraded from [ICRA]A- (Negative); outlook revised to Stable from Negative
Short-term non-fund based Letter of Credit	25.30	25.30	[ICRA]A2; downgraded from [ICRA]A2+
Long-term/Short-term Interchangeable	(278.40)	(278.40)	[[ICRA]BBB+ (Stable)/ [ICRA]A2; downgraded from [ICRA]A-(Negative)/ [ICRA]A2+; outlook revised to Stable from Negative
Total	425.77	425.77	

*Instrument details are provided in Annexure-1

Rationale

The rating action reflects moderation in Aarti International Limited's (AIL or the company) operational performance and financial risk profile in FY2020 as well as in the current fiscal year. Following demand-side pressures and ensuing shrinkage in contribution margins in FY2020, Covid-19 led operational disruptions and demand-side pressures have affected cotton spinners (spinning accounts for ~80% of AIL's revenues) during the current fiscal. Although the company has reported a sequential improvement in the capacity utilisation and recovery in sales in the recent months following an all-time low performance in Q1 FY2021, the sub-optimal performance has adversely affected the company's return as well as debt protection metrics (expected ROCE of less than 5%, interest cover of less than 2.0 times and DSCR of ~1.1-1.2 times in FY2021E). This is despite reduced annual debt repayment obligations for the company in FY2021 vis-à-vis last year. ICRA notes that AIL's debt levels remain high owing to debt-funded capacity additions undertaken in recent years as well as high working capital requirements of the business, leveraging AIL's capital structure. ICRA, however, derives comfort from a demonstrated track record of timely funding support from the promoter Group and healthy financial flexibility available to AIL as a part of the Ludhiana-based (Punjab) Aarti Group, which provides comfort in its liquidity position. Further, the ratings continue to draw strength from AIL's more than two decade-long track record in the spinning business, its large-scale operations with a single location spinning capacity of 1,75,000 spindles, a wide product portfolio of basic and value-added yarn and partial forward integration into knitting and fabric processing. This increases the value addition and diversification, while moderating the impact of cyclicity in the spinning industry.

The ratings are, however, constrained by the commoditised nature of the company's products, which coupled with the fragmented industry structure result in limited pricing power, keeping profitability under check. Further, the ratings factor in the high working capital intensity of AIL's operations due to the seasonal nature of cotton availability that

requires stocking during the harvest season, keeping the leverage high and profitability vulnerable to volatility in cotton prices. Moreover, as AIL continues to derive a large share of its revenues from exports (though the dependence upon exports has declined considerably in the past three years), the earnings remain dependent on its ability to effectively hedge its export receivables on a consistent basis, besides the demand trend in export markets.

The Stable outlook on the rating reflects ICRA's opinion that a recovery in demand from the downstream textile segments in H2 FY2021, would help the company reduce the impact on full year revenues and profitability, despite a challenging H1 FY2021. Coupled with lower repayment obligations for the year, this is expected to translate into adequate debt protections metrics for the company.

Key rating drivers and their description

Credit strengths

Large-scale spinning operations with established market position and sizeable presence in value-added products – AIL is a Ludhiana-based spinner with a single location capacity of 1.75 lakh spindles, which is large compared to an average capacity of ~28,000-30,000 spindles per unit in India. The large scale in yarn manufacturing augurs well for its cost structure in a commoditised market. The company manufactures pure cotton and blended spun yarn across a wide count range, with 30s and 32s counts accounting for a predominant portion of the production. In addition to the basic grey yarn, it also manufactures value-added yarn. The ability to manufacture a diversified product range across various counts and varieties not only improves its value addition, but also provides AIL with the flexibility to switch among its product offerings, depending upon the demand scenario. Further, its forward integration into knitting and fabric processing increases the value addition and diversification, while moderating the impact of cyclical in the spinning industry.

Track record of healthy operating performance, corroborated by high utilisation of spinning mill – Given its established market position in the industry with extensive relationships with clients and a value-added product profile, AIL's spinning unit's production levels have remained healthy, with more than 95% capacity utilisation in most years. In addition, AIL's capacity utilisation in the spinning division has been partially supported by increased captive consumption in the knitted fabrics division in the recent years. This is corroborated by a healthy capacity utilisation of ~100% in the company's spinning division in FY2020, despite a moderation from 106% in FY2019 owing to severe demand-side pressures in the market during the year. The capacity utilisation level moderated to ~76% in 5M FY2021. However, the same is exceptional, and the result of Covid-19 led demand and operational disruptions witnessed during Q1 FY2021. ICRA notes that the capacity utilisation of AIL's spinning division recovered in Q2 FY2021 from the all-time lows in Q1 FY2021, following an improvement in demand from the downstream segments.

Financial flexibility as part of Aarti Group – AIL is a part of the Ludhiana-based Aarti Group led by Mr. Shiva Prasad Mittal. The Group also has interests in the iron and steel sector through Aarti Steels Limited (ASL)¹ and in the warehouse consignment business through Salig Ram Shiv Parshad (SRSP). The Group has also established a charitable hospital (Deepak Memorial) in Ludhiana. Deepak Memorial is a multi-speciality hospital with round-the-clock medical emergency facilities. The Group also operates a cinema hall in Ludhiana. The promoters have been actively involved in operations of the steel and textile businesses for over two decades.

Credit challenges

Average financial risk profile – AIL's financial risk profile remains average, as characterised by volatile profit margins, modest return indicators, leveraged capital structure and modest debt protection metrics. The operating margin declined steeply to 6.5% in FY2020 from 13.0% in FY2019 because of pressure on the contribution margin of cotton yarn

¹ ICRA has [ICRA]A+(Stable)/[ICRA]A1 ratings outstanding for the bank lines of Aarti Steels Limited. For details, please refer to ICRA's website, www.icra.in.

amid a weak industry scenario. Coupled with moderation in revenues, this resulted in moderation in cash accruals and return indicators with a ROCE of 3.9% in FY2020 over 11.1% in FY2019. Further, given the fixed as well as working capital intensive nature of operations, AIL's financial leverage, similar to other domestic spinning companies, has remained high over the years. While the debt outstanding on its books had declined steadily for four consecutive years till FY2017, it increased again in FY2018 due to debt-funded capex concluded during the year. From FY2019 onwards, the quantum of debt outstanding has started to decline again and is expected to come down further with scheduled amortisation of term borrowings. Nevertheless, the capital structure has remained leveraged with a Total Outside Liabilities/ Tangible Net Worth of 1.3 times as on March 31, 2020, owing to high working capital requirements of the business. Leveraged capital structure together with subdued return metrics keep its debt coverage indicators modest, as reflected in an interest cover of 1.5 times and a DSCR of 1.0 time in FY2020. Nevertheless, AIL's cash accruals remained adequate to support its debt repayments. Besides, regular funding support from the promoters and reduction in annual debt repayment obligations from FY2021 onwards provide comfort on the company's debt servicing ability as well as liquidity position, despite performance pressures witnessed during the current fiscal year.

Susceptibility to volatility in cotton and cotton yarn prices, and currency movements – Similar to other entities in the spinning sector, AIL stocks cotton during the harvest season from October to March. This practice exposes it to the fluctuations in cotton and, hence, cotton yarn prices during the non-harvest period as the procurement cost for AIL becomes fixed. This results in a high dependence upon working capital borrowings and keeps the leverage high, particularly at the year-end. Further, as it derives about 25-30% of its revenues from exports, AIL's profitability remains dependent on its ability to effectively hedge its export receivables on a consistent basis and on the demand in export markets.

Commoditised nature of yarn, coupled with fragmented industry structure, keep profitability under check – The spinning and knitting industries are highly fragmented with a significant share of the unorganised segment. While AIL manufactures a wide variety of products encompassing yarns with varying levels of value addition and knitted fabrics, its product portfolio continues to be concentrated towards medium-count and low to medium value-added yarns and fabrics. As a result, it enjoys limited pricing power, which is likely to keep its profitability under check.

Liquidity position: Adequate

AIL's liquidity position remains **adequate**, corroborated by sufficient undrawn working capital limits (average undrawn fund-based limits stood at ~Rs. 44 crore in the six-month period ended August 2020, vis-à-vis drawing power available to the company). Despite the performance pressures in FY2020 as well as in the current financial year, AIL's liquidity position has been supported by reduction in the company's debt repayment burden from FY2021 onwards and need-based infusion of funds by the promoters. Although the company does not propose to repay the unsecured loans in the near term, any substantial cash outlays towards the repayments without a corresponding improvement in the cash flow generation capacity of the business vis-à-vis scheduled repayments and incremental requirements may impact its liquidity profile.

Rating sensitivities

Positive triggers – The ratings could be upgraded if the company reports a healthy improvement in its scale of operations, along with a sustained recovery in its profitability, which results in an improvement in its return and debt protection metrics. Further, efficient working capital management, which improves AIL's liquidity position and reduces its dependence upon promoters' support could be a positive rating trigger. Specific credit metrics would include DSCR of more than 1.8 times on a sustained basis.

Negative triggers – The ratings could be downgraded in case of a sustained pressure on the company's sales growth and profitability. Additionally, AIL's rating would be prone to a downgrade if a stretch in working capital cycle, substantial withdrawal of funds by promoters or a sizeable capex weakens its liquidity position, taking the average utilisation to more than 85% of drawing power available on a sustained basis and/or results in an increase in the leverage and

deterioration in its debt protection metrics. Specifically, DSCR (excluding repayment of promoter debt) of less than 1.4 times, on a sustained basis, could result in a rating downgrade.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Entities in the Textiles Industry - Spinning Rating Methodology for Entities in the Textiles Industry – Fabric Making
Parent/Group Support	Ratings factor in the financial flexibility from being a part of the established Ludhiana-based Aarti Group
Consolidation/Standalone	The ratings are based on the standalone financial profile of the company

About the company

AIL, incorporated in 1994, is a Ludhiana-based manufacturer of ring-spun yarn and knitted fabric. The company has a large, single location spinning capacity of 1.75 lakh spindles, whereby it manufactures cotton and blended spun yarn, with a focus on medium counts. To achieve partial forward integration, AIL forayed into fabric knitting by commissioning 15 knitting machines in FY2017. The company has thereafter installed a fabric processing capacity of about 5.8 million kg per annum and has enhanced its fabric knitting capacity to 74 knitting machines.

AIL is part of the Ludhiana-based Aarti Group that has interests in the iron and steel sector through ASL, which manufactures sponge iron, steel billets/ingots, rounds and bars, steel wires and ferro alloys, and also has a captive power-generation capacity.

In FY2020, the company reported a net loss of Rs. 16.8 crore on an operating income (OI) of Rs. 823.8 crore, compared to a net profit of Rs. 28.9 crore on an OI of Rs. 881.8 crore in the previous year.

Key financial indicators (audited)

	FY2019	FY2020
Operating Income (OI) (Rs. crore)	881.8	823.8
PAT (Rs. crore)	28.9	-16.8
OPBDIT/OI (%)	13.0%	6.5%
PAT/OI (%)	3.3%	-2.0%
Total Outside Liabilities/Tangible Net Worth (times)	1.5	1.4
Total Debt/OPBDIT (times)	3.7	7.0
Interest Coverage (times)	3.1	1.5

Source: Company's Annual Reports, ICRA research; PAT: Profit after tax; OPBDIT: Operating profit before depreciation, interest and tax

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 23-Nov-20	FY2020 24-Jan-2020	FY2019 31-Jan-19	FY2018 22-Feb-18	
1 Cash Credit	LT	278.40	NA	[ICRA]BBB+ (Stable)	[ICRA]A- (Negative)	[ICRA]A- (Stable)	[ICRA]A- (Stable)	
2 Term Loan	LT	101.36	101.36	[ICRA]BBB+ (Stable)	[ICRA]A- (Negative)	[ICRA]A- (Stable)	[ICRA]A- (Stable)	
3 Bank Guarantee	LT	2.00	NA	[ICRA]BBB+ (Stable)	[ICRA]A- (Negative)	[ICRA]A- (Stable)	[ICRA]A- (Stable)	
4 Unallocated Limits	LT	18.71	NA	[ICRA]BBB+ (Stable)	[ICRA]A- (Negative)	-	-	
5 Letter of Credit	ST	25.30	NA	[ICRA]A2	[ICRA]A2+	[ICRA]A- (Stable)	[ICRA]A- (Stable)	
6 Long-term/ Short-term interchangeable	LT/ST	(278.40)	NA	[ICRA]BBB+ (Stable)/ [ICRA]A2	[ICRA]A- (Negative)/ [ICRA]A2+	[ICRA]A- (Stable)/ [ICRA]A2+	[ICRA]A- (Stable)/ [ICRA]A2+	

Amount in Rs. crore;

*LT: Long-term; ST: Short-term

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 [click here](#)

Annexure-1: Instrument details

ISI	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Cash Credit	NA	NA	NA	278.40	[ICRA]BBB+ (Stable)
NA	Term Loan	FY2010-FY2020	NA	FY2021- FY2027	101.36	[ICRA]BBB+ (Stable)
NA	Bank Guarantee	NA	NA	NA	2.00	[ICRA]BBB+ (Stable)
NA	Unallocated Limits	NA	NA	NA	18.71	[ICRA]BBB+ (Stable)
NA	Letter of Credit	NA	NA	NA	25.30	[ICRA]A2
NA	Long-term/ Short-term interchangeable	NA	NA	NA	(278.40)	[ICRA]BBB+ (Stable)/ [ICRA]A2

Source: Aarti International Limited

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

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