

January 24, 2020

Aarti International Limited: Ratings reaffirmed; Outlook revised to Negative

Summary of rating action

Instrument*	Previous Rated Amount(Rs. crore)	Current Rated Amount(Rs. crore)	Rating Action
Long-term fund-based cash credit	233.40	278.40	[ICRA]A-(Negative); reaffirmed with revision in outlook from Stable
Long-term fund-based term loan	165.07	113.83	[ICRA]A-(Negative); reaffirmed with revision in outlook from Stable
Long-term non-fund based Bank Guarantee	2.00	2.00	[ICRA]A-(Negative); reaffirmed with revision in outlook from Stable
Long-term unallocated limits	0.00	6.24	[ICRA]A-(Negative); reaffirmed with revision in outlook from Stable
Short-term non-fund based Letter of Credit	25.30	25.30	[ICRA]2+; reaffirmed
Long-term/Short-term Interchangeable	(233.40)	(278.40)	[ICRA]A-(Negative)/ A2+; reaffirmed with revision in outlook on long-term rating from Stable
Total	425.77	425.77	

*Instrument details are provided in Annexure-1

Rationale

The ratings continue to draw strength from Aarti International Limited's (AIL or the company) more than two decade-long track record in the spinning business and the financial flexibility available to AIL as a part of the Ludhiana-based (Punjab) Aarti Group. Further, the ratings derive comfort from the company's large-scale operations with a single-location spinning capacity of 1,75,000 spindles, a wide product portfolio of basic and value-added yarns and partial forward integration into knitting and fabric processing. This increases the value addition and diversification, while moderating the impact of cyclicalities in the spinning industry.

The ratings are, however, constrained by the significant increase in AIL's debt levels during the last two years from a multi-year low in FY2017, owing to debt-funded capacity addition as well as higher working capital requirements following the increase in top line. This impacted the company's capitalisation and coverage metrics. Although, its overall performance improved in FY2019 following the industry trends, the performance has been affected in the current fiscal because of demand-side pressures in the domestic as well as international markets, which affected AIL's contribution margins. Pressures in the spinning segment's performance, which accounted for nearly 88% of AIL's revenues in FY2019, are expected to keep the company's return indicators (estimated return on capital employed (ROCE) of less than 10% for FY2020) and debt coverage metrics (estimated DSCR of 1.2 times in FY2020) moderate, warranting a revision in outlook to Negative. However, the fund flow from operations in FY2020 are likely to be adequate to support its debt repayments as well as margin funding requirements for capital expenditure and working capital. Further, ICRA derives comfort from a decline in the company's scheduled debt repayment obligations from FY2021 onwards, besides a demonstrated track record of timely funding support from the promoter Group and healthy financial flexibility at the Group level.

The ratings are also 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 ALL continues to derive a large share of its revenues from exports (though the dependence upon exports has declined considerably in 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 Negative outlook on the rating reflects a near-term pressure on ALL's credit profile, given the deterioration in profit margins and return indicators and the downward revision in the estimated cash profits in FY2020 amid an adverse industry scenario.

Key rating drivers and their description

Credit strengths

Large-scale spinning operations with established market position and sizeable presence in value-added products – ALL is a Ludhiana-based spinner having 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 yarns. The ability to manufacture a diversified product range across various counts and varieties not only improves the value addition but provides some flexibility to switch among product offerings, depending upon the demand scenario. Further, the forward integration into knitting and fabric processing increases the value addition and diversification, while moderating the impact of cyclicalities in the spinning industry

Healthy operational performance, corroborated by consistently high utilisation of spinning mill – Given the established market position in the industry with extensive relationships with clients and value-added product profile, ALL's spinning unit's production levels have remained healthy, with >95% capacity utilisation in most years. This apart, ALL'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 ~97% in the company's spinning division in H1 FY2020, despite severe demand-side pressures in the market.

Financial flexibility by virtue of being part of Aarti Group – ALL is a part of the Ludhiana-based Aarti Group that is led by Mr. Shiva Prasad Mittal. The Aarti Group also has interests in iron and steel business through Aarti Steels Limited¹ (ASL), and in 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 24X7 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

Leveraged capital structure and moderate debt coverage metrics – Given the fixed as well as working capital-intensive nature of operations, ALL's financial leverage, similar to other domestic spinning companies, has remained high over the years. While the debt outstanding in its books had declined steadily for four consecutive years till FY2017, it increased again in FY2018 due to debt-funded capex concluded in FY2018. 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 is expected to remain leveraged with an estimated Total Outside

¹ICRA 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

Liabilities/ TNW of over 1.3 times as on March 31, 2020(E), owing to high working capital requirements of the business. Leveraged capital structure together with subdued return metrics keep its debt coverage indicators moderate, as reflected in an interest cover of 2-3 times and a DSCR of 1.2-1.5 times over the past five years. Although its debt coverage metrics improved in FY2019, supported by a recovery in profitability, these are likely to moderate again in the current financial year (estimated interest cover of 2.7-2.8 times, Total Debt/ OPBDITA of 4.7-4.8 times and DSCR of ~1.2 times in FY2020E vis-a-vis 3.05 times, 3.7 times and 1.54 times, respectively, in FY2019), amid severe demand-side pressures and resultant decline in profitability. Nevertheless, ICRA believes that AIL's fund flow from operations will remain adequate to support its debt repayments as well as margin funding requirements for capital expenditure and working capital. Further, the reduction in annual repayments obligations from FY2021 onwards also provides comfort.

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, which is from October to March. This stocking of cotton exposes the company to the fluctuations in cotton and hence cotton yarn prices during the non-harvest period as the procurement cost for AIL gets fixed. This results in a high dependence upon working capital borrowings and hence 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 profile remains **adequate**, with comfortable fund flow from operations vis-a-vis margin requirements for capex and working capital as well as repayment obligations. Although AIL's liquidity position has moderated during the last two fiscals (average utilisation of fund-based limits of 74% and 83% in FY2019 and 9M FY2020, compared to 62% in FY2018 and 49% in FY2017), due to outgo towards capacity expansion and higher cotton stocking, ICRA expects its liquidity position to remain comfortable. The liquidity position has also been supported by the timely funds infusion by the promoters (unsecured loans of Rs. 36.5 crore as on March 31, 2019 compared to Rs. 7.7 crore as on March 31, 2016).

Rating sensitivities

Positive triggers – Given the Negative outlook on the long-term rating, a rating upgrade in the near term looks unlikely. The rating could be upgraded if the company reports a healthy improvement in its scale of operations, while diversifying its presence across product segments, along with a sustainable 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, together with a material improvement in debt coverage metrics could be a positive rating trigger.

Negative triggers – The ratings could be downgraded if there is 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 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 yarns and knitted fabrics. The company has a large single-location spinning capacity of 1.75 lakh spindles, whereby it manufactures cotton and blended spun-yarns, with a focus on medium counts. To achieve partial forward integration, AIL forayed into fabric knitting with commissioning of 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 the fabric knitting capacity to 74 knitting machines.

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

In FY2019, the company reported a net profit of Rs. 28.9 crore on an operating income (OI) of Rs. 881.9 crore, compared to a net profit of Rs. 9.2 crore on an OI of Rs. 752.0 crore in the previous year.

Key financial indicators (audited)

	FY2018	FY2019	H1 FY2020 [^]
Operating Income (OI) (Rs. crore)	752.0	881.9	430.4
PAT (Rs. crore)	9.2	28.9	1.8
OPBDIT/OI (%)	8.3%	13.0%	8.7%
RoCE (%)	5.9%	11.1%	5.8%
Total Outside Liabilities/Tangible Net Worth (times)	1.5	1.5	1.1
Total Debt/OPBDIT (times)	6.9	3.7	4.4
Interest Coverage (times)	2.7	3.1	2.0
DSCR	1.2	1.5	1.3

Source: AIL, ICRA research; [^]provisional numbers

PAT: Profit after tax, OPBDIT: Operating profit before depreciation interest and tax, ROCE: Return on capital employed; DSCR: Debt service coverage ratio

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2020)				Rating History for the Past 3 Years			
		Type	Amount Rated	Amount Outstanding	Rating	FY2019	FY2018	FY2017	
					24-Jan-2020	31-Jan-19	22-Feb-18	6-Dec-2016	
1	Cash Credit	LT	278.40	NA	[ICRA]A-(Negative)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	
2	Term Loan	LT	113.83	113.83	[ICRA]A-(Negative)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	
3	Bank Guarantee	LT	2.00	NA	[ICRA]A-(Negative)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	
4	Unallocated Limits	LT	6.24	NA	[ICRA]A-(Negative)	-	-	[ICRA]A-(Stable)	
5	Letter of Credit	ST	25.30	NA	[ICRA]A2+	[ICRA]A-(Stable)	[ICRA]A-(Stable)	[ICRA]A-(Stable)	
6	Long-term/ Short-term interchangeable	LT/ST	(278.40)	NA	[ICRA]A-(Negative)/A2+	[ICRA]A-(Stable)/ A2+	[ICRA]A-(Stable)/ 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 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	Cash Credit	NA	NA	NA	278.40	[ICRA]A- (Negative)
NA	Term Loan	FY2010-FY2019	NA	FY2024-FY2027	113.83	[ICRA]A- (Negative)
NA	Bank Guarantee	NA	NA	NA	2.00	[ICRA]A- (Negative)
NA	Unallocated Limits	NA	NA	NA	6.24	[ICRA]A- (Negative)
NA	Letter of Credit	NA	NA	NA	25.30	[ICRA]A2+
NA	Long-term/ Short-term interchangeable	NA	NA	NA	(278.40)	[ICRA]A- (Negative)/ A2+

Source: Aarti International Limited

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

Analyst Contacts

Jayanta Roy

+91 33 7150 1100
jayanta@icraindia.com

Nidhi Marwaha

+91 124 4545 337
nidhim@icraindia.com

Pratika Bhandari

+91 124 4545 321
pratika.bhandari@icraindia.com

Relationship Contact

Jayanta Chatterjee

+91 80 4332 6401
jayantac@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani

Tel: +91 124 4545 860
communications@icraindia.com

Helpline for business queries:

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

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For more information, visit www.icra.in

ICRA Limited

Corporate Office

Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002

Tel: +91 124 4545300

Email: info@icraindia.com

Website: www.icra.in

Registered Office

1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001

Tel: +91 11 23357940-50

Branches

Mumbai + (91 22) 24331046/53/62/74/86/87

Chennai + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294,

Kolkata + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008,

Bangalore + (91 80) 2559 7401/4049

Ahmedabad+ (91 79) 2658 4924/5049/2008

Hyderabad + (91 40) 2373 5061/7251

Pune + (91 20) 2556 0194/ 6606 9999

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