June 03, 2019

Zodiac Clothing Company Limited: Rating revised to [ICRA]A2 from [ICRA]A2+

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action[1]
Short-term fund-based facilities	70.0	70.0	[ICRA]A2+ revised to [ICRA]A2
Short-term non fund-based facilities	10.0	10.0	[ICRA]A2+ revised to [ICRA]A2
Total	**80.0**	**80.0**	

** Instrument details are provided in Annexure-1*

Rationale

The rating revision factors in the continued weak business and financial performance of Zodiac Clothing Company Limited (ZCCL), as reflected in the YoY decline in revenues and operating loss during 9M FY2019 and higher working capital intensity leading to pressure on debt protection metrics. The export business remained under pressure because of subdued consumer off-take in the key markets of the US, the UK and the Middle East, and competition from other low-cost countries, which was exacerbated after reduction in export incentives, post the introduction of the Goods and Services Tax (GST). The top line of the domestic business has remained under pressure post closure of 20 non-performing stores during FY2017 and a further seven stores each during FY2018 and 9M FY2019. Additionally, consumer sentiments were weak and competitive intensity remained high. Though there has been improvement in gross margins with increased focus on value-added products in the domestic business, the YoY decline in revenues has led to under-absorption of fixed costs, and hence the operating loss.

The rating nevertheless favourably factors in equity infusion by the promoters'—Rs. 30 crore through a preferential share allotment and Rs. 15 crore towards warrants—during FY2019 which has helped the company fund its losses, working capital requirements and capital commitments in the short-term. Though the equity infusion and the company turning EBITDA profitable during Q3 FY2019 are positives in the near-term, sustained improvement in business performance across markets would be crucial to support the company's profitability and overall credit risk profile. The rating continues to favourably factor in the extensive experience of the promoters of ZCCL in the readymade garments business; its professional management team, low gearing and adequate market value of its strategic investments.

ICRA continues to draw comfort from its holding of listed liquid investments (Rs. 25 crore as on May 27, 2019), which can be used to fund its business. Further, collection of its Rs. 18.5-crore receivables (as on March 31, 2019) from the sale of its second level subsidiary holding properties in the UK during FY2017 would help support the company to fund any expansion in the overseas business. ICRA continues to acknowledge the company's established brands in the premium men's wear category and their niche positioning in the branded garments industry. In the exports market, the business is supported by its in-house design capabilities and the long-term relationships that ZCCL enjoys with its customers.

Going forward, ICRA would continue to monitor the company's quarterly performance. Continued pressure on profitability and an adverse liquidity position would be key rating triggers.

[1] *For complete rating scale and definitions, please refer to ICRA's website www.icra.in or other ICRA Rating Publications*

Key rating drivers

Credit strengths

Promoters have vast experience in the business, supported by a sound management team - The promoters have more than 40 years' experience in the readymade garment business and are backed by an able management team.

Established brand name with focus on the premium segment of domestic market through branded business - The company has strong domestic brands in the premium category, represented by Zodiac, ZOD! and Z3 with their niche positioning in the formal wear, club wear and casual wear categories, respectively. The domestic business, which has been undergoing a challenging phase in the past three years because of macro-economic factors and intense competition, reported some recovery in Q3 FY2019. Furthermore, increase in export incentives announced by the Government in March 2019 is expected to support the exports business and make it more competitive vis-à-vis other countries. The exports business was challenged after reduction in export incentives post implementation of GST. Reversal in the revenue trajectory and scaling up of the same would be critical to achieve the scale benefits necessary in the business.

Strong design focus in exports business and established overseas customer base - The company has an established track record and healthy relationships in the exports business backed by its in-house designing capabilities. Its design focus has enabled it to register higher than the domestic industry's export price realisation and helped it compete in the domestic market.

Track record of low gearing, equity infusion and value of listed strategic investment provides comfort in the short-term - The company has a track record of maintaining a conservative capital structure (0.23 time as on March 31, 2018) and limiting its external borrowings. Equity infusion by promoters—Rs. 30 crore through a preferential share allotment and Rs. 15 crore towards warrants—has aided the company's capital structure and liquidity position. ICRA also derives comfort from the value of the company's listed investment (around Rs. 25 crore at present) which it has liquidated in the past to contain its borrowings and fund its losses.

Credit challenges

Loss continues in 9M FY2019; sustained improvement in business performance across markets crucial - The company reported a standalone PAT loss of Rs. 10.2 crore (before comprehensive income) during 9M FY2019 as it reported a decline in volumes for both its domestic and export markets, leading to under-absorption of overhead costs. Though the company reported a positive EBITDA during Q3 FY2019, sustained improvement in performance across markets would be critical to support its growth and improve its adverse margin trajectory during the subsequent quarters.

Highly competitive nature of the readymade garments business - The domestic branded apparel business remains highly competitive with several domestic and international brands competing for the consumer's wallet share. ZCCL has a policy of non-discounting, holding only a single annual sale, unlike many other fashion brands. This has put a strain on the company's growth since it results in lower footfalls for its own stores. However, its innovations and focus on introducing high value-added collections, whose share has increased in FY2019, have helped it attract footfalls and partly offset the volume decline.

Vulnerable to inherent industry risk of accurately predicting fashion trends and change in consumer tastes - Though the company's exports business is order backed, its domestic business faces the inherent risk of accurately predicting fashion trends and changes in consumer tastes, which could make the inventory vulnerable to markdowns and lead to higher working capital intensity.

Competition from other low-cost countries and exchange risk for its significant export sales - ZCCL's exports to its key geographies, Europe, North America and the Gulf Co-operation Council (GCC) region faces stiff competition from other low-cost countries such as Bangladesh, Vietnam, Cambodia, Morocco and other African countries, which enjoy duty advantages and labour arbitrage compared to India. Change in the export incentive structure also impacts the competitiveness of Indian exporters. The increase in export incentives during March 2019 is, thus, expected to support the profitability of readymade garment exporters.

Timely measures to support liquidity critical - Though the company has adequate liquidity buffer in the near-term post equity infusion during FY2019 along with an adequate market value of its listed investments, it could require further capital to fund losses, if any, to meet its growth commitments and service its debt obligations. Timely infusion of funds through various measures will be critical.

Liquidity position

The company's liquidity at a standalone level was supported by equity infusion by the promoters' (Rs. 30 crore through a preferential share allotment and Rs. 15 crore towards warrants) during FY2019. Due to the equity infusion, the average working capital utilisation as a percentage of drawing power has remained at around 75% for the 12 months leading up to January 2019. As on March 31, 2019, at a standalone level, the company had cash and equivalents of Rs. 15.4 crore and investment in listed shares at around Rs. 25 crore, leading to adequate liquidity for the short-term. Furthermore, at a consolidated level, the company had Rs. 18.5 crore receivable as on March 31, 2019, from the sale of its UK subsidiary. Recovery of receivables is expected to support the liquidity and capital position of the company's overseas business. Though the equity infusion during FY2019 is a positive in the near-term, sustained improvement in performance across markets would be critical to support the company's liquidity position.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Indian Textiles Industry - Apparels
Parent/Group Support	Not applicable
Consolidation/Standalone	The analysis is based on the consolidated financials of ZCCL with its subsidiary, Zodiac Clothing Co. S.A. (Switzerland), its step-down subsidiary, Zodiac Clothing Co. (UAE) LLC and Zodiac Clothing Company Inc. (till June 15, 2017).

About the company

Promoted by Mr. M.Y. Noorani, the House of Zodiac commenced operations as a partnership firm in 1954 for manufacturing neckties for men. Zodiac Clothing Company Limited (ZCCL) was incorporated in 1984 and came out with an initial public offer in 1994. It started exporting readymade garments, mainly men's neckties and shirts, in the 1960s. Most of its current exports are made to Europe and North America. ZCCL entered the branded shirt business in India in the late '70s, when it positioned itself in the premium men's wear segment. Currently, ZCCL is present in men's formal wear through its flagship brand, "Zodiac", in party/club wear through its sub-brand, "ZOD!", and in relaxed casual wear through its sub-brand, "Z3", launched in 2008. All these three brands are under a perpetual licensing arrangement from its group company, Metropolitan Trading Company (MTC), a partnership firm that is 100% owned by the promoters. MTC charges a royalty of 1% over the annual turnover from ZCCL. In the exports segment where it focuses on design-driven value addition, it is present mainly in the men's casual wear and semi-formal wear categories. The readymade garments export business accounts for almost 49% of its turnover (FY2018), while the domestic branded business contributes the rest.

The branded business is mainly routed through three retail channels—exclusive brand outlets (EBOs) also referred to as own retail by ZCCL, multi-brand outlets (MBOs) and large format stores (LFS) of organised retailers. The company supplies to over 700-800 MBOs spread across Tier I and II cities in the country. Its 120 EBOs (as on March 31, 2019) are mainly concentrated in Tier I cities, with the rest being spread across Tier II and III cities and towns. ZCCL's manufacturing facilities are in Karnataka and Gujarat in India.

Key financial indicators (audited, consolidated)

	FY2017	FY2018
Operating Income (Rs. crore)	279.9	237.7
PAT (Rs. crore)	-4.4	-23.5
OPBDIT/ OI (%)	-3.1%	-9.2%
RoCE (%)	0.2%	-6.1%
Total Debt/ TNW (times)	0.2	0.2
Total Debt/ OPBDIT (times)	-6.8	-3.0
Interest Coverage (times)	-1.8	-4.8

OI: Operating Income; PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation; ROCE: PBIT/Avg (Total Debt + Tangible Net Worth (TNW) + Deferred Tax Liability - Capital Work in Progress)

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

	Instrument	Current Rating (FY2020) Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating June 2019	Chronology of Rating History for the past 3 years: Date & Rating in FY2019 April 2018	Date & Rating in FY2018 -	Date & Rating in FY2017 March 2017
1	Fund based facilities	Short Term	70.0	-	Revised from [ICRA]A2+ to [ICRA]A2	Revised from [ICRA]A1 to [ICRA]A2+	-	[ICRA]A1
2	Non-fund based facilities	Short Term	10.0	-	Revised from [ICRA]A2+ to [ICRA]A2	Revised from [ICRA]A1 to [ICRA]A2+	-	[ICRA]A1
3	Commercial Paper	Short Term	-	-	-	Revised from [ICRA]A1 to [ICRA]A2+ and withdrawn	-	[ICRA]A1

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 No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Proposed Rating and Outlook
NA	Short-term fund-based limits	-	NA	NA	70.00	[ICRA]A2
NA	Short-term non-fund-based limits	-	NA	NA	10.00	[ICRA]A2

Source: Zodiac Clothing Company Limited

Annexure-2: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
Zodiac Clothing Co. S.A. (Switzerland)	100%	Full consolidation
Zodiac Clothing Co. (UAE) LLC	100%	Full consolidation
*Zodiac Clothing Company Inc.	100%	Full consolidation

**Till June 15, 2017*

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About ICRA Limited:

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