October 09, 2019

Somany Ceramics Limited: Rating reaffirmed and placed under watch with developing implications

Summary of rated instruments

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Commercial Paper	150.00	150.00	[ICRA]A1+&; reaffirmed and placed under watch with developing implications
Total	**150.00**	**150.00**	

** Instrument details provided in Annexure-1*

Rationale

The rating action factors in the recent incident of default in payment by a stockbroker[1] and higher inter-corporate deposits (ICDs) to unrelated entities by Somany Ceramics Limited (SCL) that raises concerns on the investment policies adopted by the management, given the uncertainty on the credit quality of these exposures. SCL's advances to unrelated parties increased substantially to Rs. 59 crore[2] as on March 31, 2019, which coupled with the recent incident of default by the broker for Rs. 26 crore has resulted in moderation in liquidity position, although it remains adequate. Going forward, strengthening of investment policies of the company, and subsequent reduction in exposures towards unrelated entities would be a key monitorable.

Notwithstanding the concerns on investment policy, the rating continues to draw comfort from SCL's established position in the domestic tiles market with long track record of operations in the industry, its well-recognised brand, significant manufacturing presence and pan-India distribution reach. The company continues to be one of the largest players in the Indian tiles industry, with a sizeable scale of operations (revenues of Rs. 1,695 crore in FY2019) and a well-diversified customer base with presence across both retail and institutional segments. Moreover, the rating takes into account the comfortable financial profile of the company, with gearing of 0.48 times as on March 31, 2019 and Net debt/OPBITDA of 1.9 times in FY2019. Further, while the competitive intensity in the industry has remained high, the recent regulatory developments such as the ban by National Green Tribunal (NGT) on captive coal gasifier plants in the Morbi region along with stricter implementation of GST/E-way bill, are expected to expected to increase the compliance costs for unorganised players, which augurs well for demand prospects of organized players like SCL.

[1] On 6th September 2019, SCL had disclosed to the exchanges that a cheque of Rs. 26.2 crore issued in favor of SCL by Mentor Financial Services Pvt Ltd (Mentor), a stockbroker of the company, had bounced owing to insufficient funds. The company issued demand notices for repayment to Mentor. However, In view of continued default by Mentor, the company subsequently filed a criminal complaint

[2] Includes Rs. 9.1 crore advance to Mentor

At the same time, ICRA takes note of the intense competition in the tiles industry, marked by both large and organised players as well as numerous small-scale tile manufacturers. Intense competition in the backdrop of muted end-user demand, has limited SCL's ability to pass on the increase in input costs to customers, which is reflected in the decline in its average realisations and operating margins over the past two years. Further, decline in operating margin, along with provisioning of loss against the misappropriation of funds worth Rs. 15.9 crore by an employee, led to a decline in SCL's net margin in FY2019. Although the company has an insurance cover against the aforesaid fraud, such an incident raises concern on the efficacy of its internal control systems and underscores the need for strengthening the same.

Additionally, SCL's return metrics have been impacted by a decline in margins as well as inadequate asset utilisation. This is reflected by the decline in return on capital employed (ROCE) to 10.9% in FY2019 (14.2% in FY2018). Further, in order to increase sales amid heightened competition, the company provided higher credit period to its dealers in FY2018, which led to an increase in the working capital intensity of operations. Although the same improved in FY2019 on the back of the stricter credit control measures implemented by the company, the revenue growth during the fiscal was modest. Moreover, with decline in profits and cash accruals in FY2019, along with largely similar debt levels as on March 31, 2018, the debt coverage indicators somewhat moderated. In the near term, given the muted demand from the retail segment along with slower pace of construction activities in institutional segment, the company's revenue growth and return metrics are expected to remain subdued. Further, with the expected provisioning of loss against broker default, the cash accruals and debt coverage metrics are unlikely to witness any material improvement in the near term.

Key rating drivers and their description

Credit strengths

Established position in domestic tile market; well-recognized brand with pan-India presence in distribution and manufacturing - SCL is one of the leading players in the domestic tiles industry with four-decade-long track record of operations, well-recognized brand and pan-India distribution reach. The company has an established distribution network comprising around 10,000 touch points, including dealers, sub-dealers and franchisee-managed showrooms/display centres. With presence across multiple price points and products, significant distribution reach as well as brand recognition, the company has been able to maintain a healthy business position.

Healthy scale of operations with well-diversified customer base - SCL is among the largest players in the Indian tile industry, with a sizeable scale of operations (revenues of around Rs. 1,695 crore in FY2019). The company has a well-diversified customer base with established presence across both retail and institutional segments, with retail constituting around 70% of the revenues. Within the institutional segment, the company aims to further increase its presence across corporate and Government segments to diversify its revenue profile further.

Favourable demand prospects for organised tile manufacturers amid stricter regulatory requirements - The tiles industry is characterised by significant presence of the unorganised sector, resulting in intense competition. However, the recent regulatory developments, including the ban on captive coal gasifier plants in the Morbi region by NGT in March 2019 and stricter implementation of GST/e-way bill, are expected to increase the compliance costs for unorganised players and augur well for demand prospects of organised players like SCL.

Comfortable gearing level despite moderation in coverage indicators - SCL's gearing remained comfortable at 0.48 times as on March 31, 2019 (0.52 times as on March 31, 2018), while the coverage indicators deteriorated to some extent in FY2019 on account of a decline in operating profitability as well as cash accruals along with steady debt levels.

SCL's total debt/OPBITDA increased to 2.46 times as of March 31, 2019 (2.19 times as of March 31, 2018), while interest coverage declined to 4.41 times (7.48 times in FY2018). The coverage indicators are not expected to materially improve in the near term, on account of expectation of subdued profits and cash accruals.

Credit challenges

Scale of operations remains rangebound; modest revenue growth in FY2019 after decline in FY2018 - SCL's revenues declined 8% YoY in FY2018, impacted by implementation of internal enterprise resource planning solution in April 2017 as well as implementation of GST in July 2017. In order to recoup sales volumes, SCL relaxed credit terms in H2 FY2018 that resulted in an increase in receivable days to 104 days as on March 31, 2018. However, as the management targeted to control the credit period offered, the sales growth remained modest at 2% in FY2019, as the consumer demand remained weak.

Deterioration in return metrics in past two years led by decline in operating profit margin and moderation in asset turnover - SCL's ROCE declined over the last two years following a decrease in OPM (on account of higher power and fuel costs) even as the company invested in capacity creation as well as enrichment of product mix through the JV route, besides significant advances to unrelated entities. Going forward as well, SCL's operating profitability and return metrics remain vulnerable to increase in input costs and weak demand prospects for the real estate industry.

Highly competitive business with presence of large-sized organised players and several unorganised players – The presence of large organised players and numerous small-sized players along with the high pace of capacity additions in the recent past resulted in intense competition in the industry. This is reflected in the consistent decline in SCL's margins as well as increased collection period in FY2018. However, with stricter credit control measures implemented by the company, the collection period improved in FY2019.

Need for strengthening internal systems and processes to timely identify any operational lapses - The company reported extraordinary loss of Rs. 15.9 crore in FY2019 on account of misappropriation of funds by an employee. Although SCL has an insurance cover against the aforesaid employee fraud, such an incident raises concern on the efficacy of its internal control systems and underscores the need for strengthening the same.

Significant ICDs to unrelated parties along with broker default leads to moderation in liquidity and concerns on investment policies - The quantum of ICDs given to unrelated entities by SCL increased significantly to Rs. 59 crore as on March 31, 2019 from Rs. 9 crore as on March 31, 2018. A significant increase in ICDs to unrelated parties as well select other non-current investments coupled with the recent incident of default by broker resulted in moderation in SCL's liquidity (even though it remains adequate) and raised concerns on its investment policies.

Liquidity position: Adequate

SCL's liquidity position remains **Adequate** with cash balances and liquid investments to the tune of Rs. 68 crore as on March 31, 2019. Additionally, the company has maintained average cushion of Rs. 70 crore w.r.t its drawing power in the 12 months ended August 2019, which supports the liquidity position. Further, SCL has outstanding long-term debt of Rs. 127.5 crore on its books as on March 31, 2019, which is to be repaid by FY2024 in relatively spread out annual repayments. Therefore, it will not result in increased repayment burden in any particular year.

Rating sensitivities

Positive triggers – Not applicable.

Negative triggers – Negative pressures on SCL's rating could arise if there is a significant decline in the company's profitability and cash accruals, which results in deterioration of coverage indicators (total debt/OPBITDA exceeding 2.6x on sustained basis) or if there is any stretch in its receivables cycle leading to an increase in working capital needs and reduction in liquidity buffer (liquidity buffer including unavailed drawing power and cash and liquid investments falling below Rs. 125 crore on a sustained basis). Moreover, any sizeable investments in unrelated entities in the future and/or delay in recovery of earlier advanced loans to unrelated entities remains a key rating sensitivity.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology
Parent/Group Support	Not applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the standalone financials of SCL; Also, ICRA has considered the ongoing and expected future funding support that SCL may provide to its subsidiaries and associates in the ordinary course of business; as on March 31, 2019, SCL had 12 subsidiaries and associates that are enlisted in Annexure-2

About the company

SCL was incorporated in 1969 as a manufacturer of ceramic tiles, by Mr. H L Somany in collaboration with Pilkington's of U.K as a widely held company. Since then it has extended production capacities as well as the product range. SCL is engaged in manufacturing, outsourcing and trading of ceramic and vitrified tiles. The two manufacturing facilities are located at Kassar in Haryana (near Delhi) and Kadi in Gujarat (near Ahmedabad) and have an aggregate capacity of 26.28 msm. In addition, through JVs and subsidiaries, the company has access to aggregate capacity of 54 msm. Further, the company has outsourced capacity of 9 msm. The company markets its tiles under the established brand names like Somany, Du-rastone, Duragress, VC Shield, Somany Express, etc. SCL has also entered into sanitaryware and bath fittings segment through JVs and outsourcing.

For FY2019, the company reported profit after tax (PAT) of Rs. 46.3 crore on an operating income (OI) of Rs. 1,695.5 crore against PAT of Rs. 65.1 crore on an OI of Rs. 1,665.3 crore in FY2018.

Key financial indicators (Audited)

	FY2018	FY2019
Operating Income (Rs. crore)	1,665.3	1,695.5
PAT (Rs. crore)	65.1	46.3
OPBDIT/OI (%)	7.9%	6.8%
RoCE (%)	14.2%	10.9%
Total Debt/TNW (times)	0.52	0.48
Total Debt/OPBDITA (times)	2.19	2.46
Interest Coverage (times)	7.48	4.41

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

		Current Rating (FY2020)				Date & Rating in FY2019	Date & Rating in FY2018		Date & Rating in FY2017
	Instrument	Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)*	Date & Rating 9-Oct-2019	30-Nov-2018	13-Oct-2017	17-Jul-2017	27-Oct-2016
1	Commercial Paper	Short Term	150.00	86.00	[ICRA]A1+&	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

&- under watch with developing implications, * as on August 31, 2019

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)	Current Rating and Outlook
NA	Commercial Paper	-	-	7-365 days	150.00	[ICRA]A1+&

Source: SCL; &- under watch with developing implications

Annexure-2: List of entities considered for possible funding support from SCL

Company Name	Ownership	Consolidation Approach
SR Continental Limited	100%	Limited Consolidation
Somany Bathware Limited	100%	Limited Consolidation
Amora Tiles Pvt Ltd	51%	Limited Consolidation
Somany Excel Vitrified Pvt Ltd	100%	Limited Consolidation
Somany Fine Vitrified Tiles Pvt Ltd	51%	Limited Consolidation
Vintage Tiles Pvt Ltd	50%	Limited Consolidation
Acer Granito Pvt Ltd	26%	Limited Consolidation
Vicon Ceramic Pvt Ltd	26%	Limited Consolidation
Somany Sanitary-ware Pvt Ltd	51%	Limited Consolidation
Sudha Somany Ceramics Pvt Ltd	60%	Limited Consolidation
Amora Ceramics Pvt Ltd	51%	Limited Consolidation
Somany Bath Fittings Pvt Ltd	51%	Limited Consolidation

Source: SCL

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About ICRA Limited:

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For more information, visit www.icra.in

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