

October 12, 2020

## Somany Ceramics Limited: Rating downgraded to [ICRA]A1 from [ICRA]A1+; removed from rating watch with negative implications

### Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Commercial Paper	150.00	75.00	[ICRA]A1; downgraded from [ICRA]A1+; rating removed from watch with negative implications
<b>Total</b>	<b>150.00</b>	<b>75.00</b>	

\* Instrument details provided in Annexure-1

### Rationale

The rating action factors in the ICRA's expectations of weak demand prospects for the ceramic tile industry that would in turn result in relatively muted profitability and coverage indicators of Somany Ceramics Limited (SCL). ICRA notes that during FY2016–FY2020 the sales of SCL remained rangebound and operating profits declined despite sizeable capital expenditure (capex) incurred during this period, translating into deterioration in return indicators and credit metrics. The company's ROCE declined over the last three years following contraction in operating margin as well as decline in asset turnover. In addition, SCL's net profits have contracted over the past two fiscals due to provisioning of exceptional items (employee fraud in FY2019 and loss due to stockbroker<sup>1</sup> payment default). As the company was in expansion phase, its debt levels increased till FY2019. Even though there was some reduction in FY2020, it remained high and resulted in moderation of credit metrics such as TD/OPBIDTA and interest coverage ratio to 4.0x and 2.7x, respectively in the fiscal year. SCL's credit profile is expected to further moderate in FY2021, given the subdued demand prospect in the end-user real estate industry and lower absorption of fixed costs, further exacerbated by uncertainty regarding demand recovery amid Covid-19 pandemic. ICRA notes that the Covid-19 crisis has significantly impacted SCL's Q1 FY2021 performance as factories remained shut, resulting in 57% YoY decline in sales and the consequent weakening of operating margin to -6.9% in Q1 FY2021 from 7.7% in Q1 FY2020 on account of negative operating leverage. Although the management has indicated a recovery in sales in Q2 FY2021, ICRA believes that muted demand prospects in the current fiscal could result in contraction of sales, operating profits and cash accruals, notwithstanding the various cost-control measures undertaken. Despite the recovery of Intercompany deposits (ICDs) from unrelated parties, there could be a delay in the recovery of the balance outstanding ICDs amidst the pandemic.

The rating continues to be constrained by intense competition, especially from the unorganised sector that remains formidable despite 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) that resulted in higher compliance costs.

<sup>1</sup> On September 6, 2019, SCL disclosed to the exchanges that a cheque of Rs. 26.2 crore issued in favour 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.

Moreover, the labour unavailability and liquidity challenges faced by many small players have resulted in consolidation and augur well for the market position of organised players over long term.

Nonetheless, the rating continues to draw comfort from SCL's established position in the domestic tiles market with a long track record of operations in the industry, its well-recognised brand, significant manufacturing presence and pan-India distribution reach as well as favourable long-term demand prospects in the ceramic tiles industry. The company continues to be one of the largest players in the Indian tiles industry, with a sizeable scale of operations and a well-diversified customer base with presence across both retail and institutional segments (with the retail segment constituting 70–80% of its sales). With presence across multiple products, significant distribution reach as well as brand recognition, the company has been able to maintain a healthy business position.

In the current fiscal, SCL has implemented cost-reduction measures in light of the decline in sales volumes, including reduction in employee costs, selling and advertising expenses, overheads as well as lower interest expense pursuant to prepayment of higher interest-bearing loans (earlier availed moratorium on debt servicing on this loan under the RBI forbearance scheme). In addition, SCL's operating performance is further likely to benefit from the reduction in crude oil prices resulting in lower power and fuel costs, which is a major cost component. Nevertheless, operating profits and cash accruals may contract in FY2021 and may recover meaningfully only in FY2022 with recovery in demand prospects. ICRA also notes that SCL's receivables cycle has reduced considerably over the last two years to 63 days in FY2020 from 104 days in FY2018 and improved further as the company introduced channel financing for its trade partners and improved its collection cycle, supporting SCL's liquidity to an extent.

## Key rating drivers and their description

### Credit strengths

**Established position in domestic tile market; well-recognised 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-recognised 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. In terms of revenue breakup, North India is the biggest market for the company, accounting for 43% of its revenues in FY2020, followed by the South (27%), the East (17%) and the West (8%).

**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 (ranging between around Rs. 1,600 crore and Rs. 1700 crore over the last three years on a consolidated basis). The company has a moderately diversified customer base with established presence across both retail and institutional segments, with retail constituting around 70–80% of the revenues. As indicated by management, there has been an increase in order inflows from tier II and tier III cities, where the impact of Covid-19 was short-lived and construction activity picked up, while localised lockdowns continued in metro cities. Higher demand from tier II and III cities has helped increase proportion of sales in retail segment to 80–90%.

**Favourable long-term demand prospects for organised tile manufacturers amid stricter regulatory requirements; labour availability issues and liquidity constraints faced by unorganised players support organised players' market position in near term** - The tiles industry is characterised by the significant presence of the unorganised sector, resulting in intense competition. The intense competition, especially from the unorganised sector that remains formidable, notwithstanding the regulatory developments such as the ban by NGT on captive coal gasifier plants in the Morbi region

along with stricter implementation of GST/e-way bill) that resulted in higher compliance costs. Moreover, the labour unavailability and liquidity challenges faced by many small players has also resulted in consolidation and augurs well for market position of organised players.

## Credit challenges

**Scale of operations remained rangebound over last four years despite sizeable capex** - SCL's sales remained rangebound between FY2016 and FY2020, notwithstanding the sizeable capex incurred by the company during this period. In FY2020, the company witnessed a de-growth in operating income of 6%, mainly led by decline in volumes on account of Covid-19 crisis in March 2020. Moreover, decline in domestic demand of ceramic tiles and intense competition has resulted in moderation in average realisations and also contributed to the decline in revenues. The pandemic is expected to further exacerbate the weakness in demand in its end-consumer industry hence, domestic sales are likely to be severely impacted in FY2021.

**Deterioration in return metrics in past three years led by decline in operating profit margin and moderation in asset turnover** - SCL's ROCE declined in the last three years to 4.6% in FY2020 from 23.8% in FY2017 following a decrease in the operating margins to 8.2% in FY2020 from 13.6% in FY2017 (on account of higher power and fuel costs in FY2019 and on account of lower volumes sales in FY2020) even as the company invested in capacity creation besides extending significant advances to unrelated entities. SCL's operating profitability and return metrics likely to be negatively impacted in FY2021 due to lower absorption of fixed costs amid weak demand prospects for the real estate industry, exacerbated by uncertainty regarding pace of recovery.

**Moderation in credit metrics in FY2020; expected to continue in FY2021** - The decline in sales volumes, de-growth in realisations and lower absorption of fixed costs led to a decline in operating profits and cash accruals. This coupled with the increase in total debt resulted in moderation of SCL's credit metrics—total debt/OPBDITA increased to 4.03 times as on March 31, 2020 from 2.13 times as on March 31, 2017 and interest coverage indicator declined to 2.7x in FY2020 from 6.0x in FY2017. The credit metrics are expected to moderate further in the near term on account of expectation of subdued operating profits and cash accruals. However, SCL's gearing remained comfortable at 0.76 times as on March 31, 2020 (marginally lower than 0.82 times as on March 31, 2019).

**Recovery of ICDs delayed on account of Covid-19** - The quantum of ICDs given to unrelated entities by SCL declined to Rs. 12 crore as on September 30, 2020 from Rs. 30 crore as on March 31, 2020. However, there could be a delay in the recovery of the outstanding amount amid the Covid-19 pandemic.

**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 and FY2020. Furthermore, SCL has arranged for channel financing for its dealer network to improve liquidity in supply chain and maintain its working capital cycle.

## Liquidity position: Adequate

SCL's liquidity is **adequate**, supported by the cash flow from operations and unutilised limits against drawing power (Rs 75.7 crore as on August 31, 2020). Notwithstanding the expected contraction in fund flow from operations in FY2021 owing to a decline in operating profits, the cash generation from operations are likely to be supported by working capital management. The long-term debt repayments are of around Rs. 60 crore and capex of around Rs. 50 crore (at consolidated level) in FY2021. At the standalone level, SCL has limited debt repayments of around Rs. 6.2 crore in H2

FY2021 and has prepaid loan of Rs. 21.8 crore in August 2020) and Rs. 18.9 crore in FY2022 when cash generation is expected to improve with recovery in end-user demand.

## Rating sensitivities

**Positive triggers** – Significant and sustained growth in revenues, profitability, coverage indicators and liquidity could trigger for a rating upgrade.

**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 or if there is any stretch in its receivables cycle leading to an increase in working capital needs and reduction in liquidity buffer. Moreover, any sizeable investments in the future to unrelated entities could lead to a rating downgrade.

## Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	<a href="#">Corporate Credit Rating Methodology</a>
Parent/Group Support	Not applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the consolidated financials of SCL. SCL has 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 the UK as a widely held company. Since then it has extended production capacities as well as the product range. SCL manufactures, outsources and trades in 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 its JVs and subsidiaries, the company has access to an aggregate capacity of 54 msm. Further, the company has outsourced capacity of 9 msm. It markets its tiles under the established brand names like Somany, Durastone, Duragress, VC Shield, Somany Express, etc. SCL has also entered into sanitaryware and bath fittings segment through JVs and outsourcing.

## Key financial indicators - Consolidated (Audited)

Rs. Crore	FY2019	FY2020
Operating Income (Rs. crore)	1,715.1	1,610.1
PAT (Rs. crore)	53.3	19.5
OPBDIT/OI (%)	9.6%	8.2%
RoCE (%)	9.2%	4.6%
TOL/TNW	1.37	1.22
Total Debt/OPBDIT (times)	3.76	4.03
Interest Coverage (times)	3.60	2.66
DSCR	1.28	0.99

**Status of non-cooperation with previous CRA: Not applicable**

**Any other information: None**

**Rating history for last three years**

Instrument	Rating (FY2021)				Rating History for the Past 3 Years				
	Type	Amount Rated	Amount Outstanding	Current Rating	Earlier Rating	FY2020	FY2019	FY2018	
				12 Oct 2020	13 Apr 2020	9-Oct-2019	30-Nov-2018	13-Oct-2017	17-Jul-2017
Commercial Paper	Short Term	75.0	-	[ICRA]A1	[ICRA]A1+@	[ICRA]A1+&	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

*\* as on March 31, 2020*

**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](http://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	75.00	[ICRA]A1

Source: SCL; @- under watch with negative implications

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

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

Source: SCL

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