Indian Spinning Sector: Weakening Credit Outlook

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Industry going through a challenging phase amidst global economic slowdown

The performance of the Indian cotton yarn industry has been under tremendous pressure over the last two years owing to intense competition, significant debt-funded capacity build-up [supported by the Technology Upgradation Fund Scheme (TUFS)] and increasing costs. The credit profiles of spinning companies have become increasingly stressed over the last one year, following significant contraction of demand for textile products in the key markets of the United States (US) and Europe[1].

India's competitive advantages of raw material availability (being the second largest producer of raw cotton in the world, currently) and relatively low labour costs had, over the years, helped form a huge export base for cotton textiles (forming over 60 per cent[2] of total Indian textile exports). The ongoing economic recession in developed markets has had a severe impact on consumer spending, thereby resulting in significant rationalisation of inventories by many international retailers and consequent scale-down of new orders. This in turn has affected the direct and derived demand (yarn that is consumed in fabrics for manufacture of garments and home textiles meant for exports) for cotton yarn. ICRA expects domestic demand also to grow at a slower pace, as the overall economic slowdown restricts consumption expenditure.

All of these factors have resulted in substantial inventory build-up for the Indian spinning industry, thereby exerting pressure on liquidity. The industry has responded with significant production cuts. The sustained downturn in the industry is expected to have a severe impact on smaller players with high leverage on account of limited financial flexibility.

Increasing costs and limited pricing flexibility exert pressure on profitability

The profitability of a spinning unit is primarily driven by raw material costs (which account for around 55 per cent of operating income). The increase in cotton prices over the past one-and-a-half years has depressed the margins of spinners. While demand contraction has led to softening of international cotton prices since October 2008, domestic prices have increased on account of the recent hike in minimum support price for raw cotton (by 40 to 50 per cent for medium/ long staple varieties). The resultant gap between the international and domestic prices induced spinners to increase imports of raw cotton to some extent. Spinners are unable to pass on hike in input costs owing to the fragmented nature of the industry, characterised by excess capacities, and significantly lower demand. ICRA also notes that falling crude prices are expected to result in competitive polyester yarn prices, thus constraining further the pricing flexibility of cotton yarn producers.

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[1] The US and Europe together accounted for more than 55 per cent of Indian textile exports for the nine months ended December 2008 according to the Ministry of Textiles, Office of the Textile Commissioner.
[2] Source: Foreign Trade Statistics of India (Principal Commodities & Countries), DGCIS, Kolkata

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The benefits of the expected softening of domestic cotton prices (some correction evident in the last one month) in the near term are likely to be largely negated by sluggish demand conditions. Also, Indian players would continue to face pricing pressures on account of intense competition from other low-cost countries.

The credit profiles of yarn exporters have also been adversely affected by volatility in foreign exchange rates. Even as steep appreciation of the Indian Rupee against the US Dollar in 2007-08 dented operating margins, relative depreciation/ insignificant appreciation of other competing currencies affected the competitiveness of Indian exporters. The favourable exchange rates during the current financial year have failed to provide much benefit owing to significant hedging losses in addition to other factors already discussed. Going forward, the winding up of hedging contracts, juxtaposed with possible appreciation of the Chinese Yuan, may provide some relief to Indian exporters.

High working capital intensity strains liquidity

Spinning companies have been facing liquidity pressures due to stressed margins and high working capital requirements. Spinners need to carry significant cotton inventory in order to optimise procurement costs and operational efficiencies. Normally, spinners carry four to five months of inventory towards the end of the cotton procurement season, that is, October to March. The current market conditions, coupled with inventory build-up and stretching of receivables period due to tightening liquidity of customers, have resulted in substantial weakening of the credit profiles of cotton yarn producers.

Highly leveraged balance sheets coupled with low cash accruals deteriorate credit metrics

The spinning industry is highly capital-intensive. In anticipation of increased demand, the sector has undertaken large capacity additions post abolition of quotas, primarily driven by the interest subsidy under TUFS. (*Refer **Charts 1** and **2** below.*) While unfavourable market conditions have resulted in significant under-utilisation of capacities and inadequate absorption of fixed costs, the combination of declining accruals, high working capital requirements and substantial debt-funded capital expansion has led to highly leveraged financial profiles and weak debt coverage indicators. ICRA notes that some of the players with limited financial flexibility have been unable to service their debt obligations in a timely manner, and that a few players are currently negotiating debt restructuring packages.

Chart 1: Total disbursements under TUFS

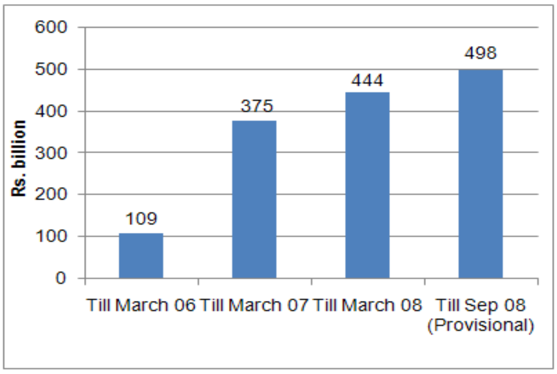
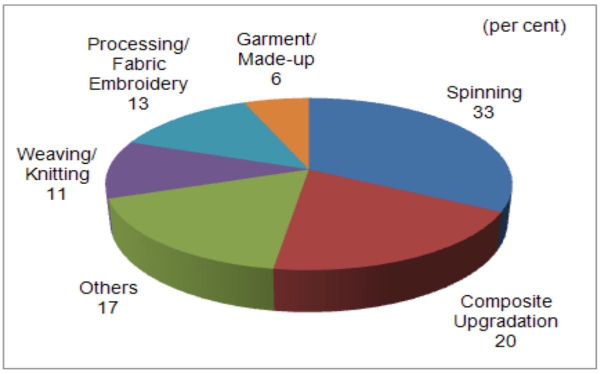


Chart 2: Composition of disbursements under TUFS (up to September 2008)



Source: Ministry of Textiles, Office of the Textile Commissioner

TUFS was introduced by the Government in April 1999 with an objective to enable textile companies to modernise and expand their units at low cost by providing interest subsidy of 5 per cent. The scheme was extended up to the Eleventh Plan in the Union Budget 2007-08. The spinning sector has been the largest beneficiary of the TUFS, utilising around 33 per cent (Rs. 163 billion) of the total amount disbursed under the scheme up to September 30, 2008. Consequently, the spinning sector grew without requisite investments in the downstream industries. Although the interest rate subsidy for spinning companies has been reduced to 4 per cent in 2007 to correct the skew in the investments towards this sector, it is likely to take some time before supply is at par with demand in light of the current market conditions.

Outlook remains strained over the medium term; marginal relief expected from stimulus packages

The revival of the spinning industry in the short-to-medium term will depend largely on demand recovery in international markets as well as improvement in macro-economic indicators for the domestic market. To provide relief to the industry, the Government introduced stimulus packages in December 2008 and January 2009, wherein it allocated Rs. 14 billion towards clearance of the backlog of disbursements due under TUFS. The Government has also reinstated an interest subvention of 2 per cent on export credit subject to minimum interest rate of 7 per cent (an earlier interest subvention of 4 per cent was withdrawn in October 2008), which has been extended up to September 30, 2009 in the Interim Budget announced in February 2009. Further, the Government has provided some relief in the value cap of duty drawback rates for certain categories of cotton yarn and has extended the DEPB Scheme[3] up to December 31, 2009. However, ICRA believes that these measures could only marginally alleviate the strain on short-term liquidity for the industry, given the challenging demand environment.

ICRA has rated a number of companies in the spinning sector and is closely monitoring the impact of the aforementioned trends on its ratings. In ICRA's view, entities with stronger capital structure, cotton procurement efficiencies, diversified product mix and geography, balanced presence across count ranges and favourable economies of scale are better positioned to tide over the current down cycle. ICRA also considers the foreign exchange derivatives exposure and foreign exchange risk hedging mechanism adopted by various entities in the sector.

ICRA notes that companies that produce cotton as well as blended yarn (blend of cotton and synthetic fibre) and that have greater focus on value-added products (like dyed yarn, gassed and mercerised yarn, and melange yarn) are better able to manage market volatility. ICRA also recognises that players with optimal installed capacity, modernised manufacturing facilities and favourable position on the quality spectrum, enjoy relatively better competitiveness.

[3] *The Duty Entitlement Passbook (DEPB) Scheme enables post-export replenishment/ remission of duty on inputs used in the export product.*

Annexure

Median Key Financial Indicators for ICRA-rated Sample of 14 Spinning Companies

	2005-06	2006-07	2007-08
Operating Income (Rs million)	590.6	805.4	877.8
OPBDITA/OI (%)	18.9%	17.9%	13.5%
PAT/OI (%)	5.9%	4.2%	2.2%
RoCE = PBIT/Average (TD + TNW + DTL – CWIP) (%)	10.3%	10.5%	6.4%
Gearing = TD/TNW (Times)	2.1	2.6	2.9
Total Outside Liabilities/ TNW (Times)	2.9	3.3	3.7
OPBDITA/ Interest & Finance Charges (Times)	3.7	3.6	2.3
Net Cash Accruals/Total Debt (%)	12%	10%	6%
Working Capital Intensity = NWC/OI (%)	43%	40%	45%
Retained Cash Flows/Total Debt (Times)	0.04	0.07	(0.01)

OPBDITA: Operating Profit before Depreciation, Interest, Tax and Amortisation; OI: Operating Income; PAT: Profit after Tax; RoCE: Return on Capital Employed; PBIT: Profit before Interest and Tax; TD: Total Debt; TNW: Tangible Net Worth; DTL: Deferred Tax Liability; CWIP: Capital Work-in-Progress; NWC: Net Working Capital; Retained Cash Flows: Cash Flows before Capital Expenditure and Debt Repayments

Source: Annual Reports of Companies and ICRA Estimates

While revenue growth has moderated in 2007-08 on account of appreciation of the Indian Rupee against major currencies, declining margins and deteriorating capital structure have resulted in weak debt servicing indicators over the last two years.

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