

## Rating Methodology for Cotton Textile Manufacturing

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### Industry Overview

Cotton is one of the principal crops in India with the nation being one of the largest producers of cotton in the world along with China. The cotton textile industry value chain comprises cultivation, spinning, weaving/ knitting, processing, garmenting and distribution. India has an advantage in terms of availability of cotton and low labour cost. Players in the industry can be categorized as the companies having presence in only one segment and the companies having presence in multiple segments of the value chain. The entire cotton textile value chain is highly fragmented in nature having both small and large players operating, thereby making the industry highly competitive.

### Rating Methodology

CARE Ratings has a standard methodology for rating of the companies belonging to the manufacturing sector. As per this methodology, CARE's rating process begins with the evaluation of the economy/industry in which the company operates, followed by the assessment of the business-risk factors specific to the company. This is followed by an assessment of the financial and project-related risk factors as well as the quality of the management. This methodology is followed while analysing all the industries that come under the purview of the manufacturing sector. However, considering the size and diversity of the sector, CARE Ratings has developed methodologies specific to various industries within the sector. These methodologies attempt to point out factors, over and above those mentioned in the broad methodology, which will be assessed while carrying out rating exercises of companies belonging to the particular industry.

The following are such additional factors, along with their analytical implications, considered by CARE Ratings while arriving at the rating of players that operate in the cotton textile manufacturing industry.

### A. Business and Operational Risks

#### 1. Operational Efficiency

**Raw material cost** constitutes the largest portion of the total operational cost in the entire cotton textile value chain.

Prices of cotton fibre are highly volatile, making the profitability margins of the **cotton spinners** susceptible to adverse fluctuations in the fibre prices. Cotton, being an agricultural commodity, its availability and price are dependent on the vagaries of nature, international demand and supply, expectation of crop during the on-going season and also in the next season, Minimum

Support Price (MSP) fixed by the Government, time of procurement, prices of polyester fibre/ yarn and also by the distance of the cotton spinning unit from the major cotton fibre sourcing centre. Cotton spinning companies are analysed based on their cotton procurement strategies and the ability to manage the volatility. The companies which are capable of procuring large quantities of similar quality cotton fibre are looked at favourably as it enables them to maintain uniformity in the quality of yarn manufactured. Also, cotton spinners which are capable of producing multiple counts/ varieties of yarns using different varieties of cotton fibres are viewed favourably as it allows them to shift from one variety to the other in case of price fluctuations in one variety.

For companies engaged in **cotton fabric manufacturing**, the raw material procurement cost will depend on the factors governing the prices of cotton fibre coupled with demand and availability of yarn. However, for a fabric manufacturer, susceptibility of profitability margins to any adverse movement in the raw material (yarn) prices remains low, as majority of fabric manufacturers generally procure cotton yarn on need basis because of its ready availability throughout the year.

For a **cotton garment manufacturer**, raw material procurement cost will depend on the demand-supply scenario for fibre, yarn and fabric. Here also, the susceptibility to any adverse fluctuations in the raw material (fabric) cost remains low as most apparel manufacturers undertake manufacturing against confirmed orders, where prices are fixed as per the prevailing market prices of the fabric.

Fabric and garment manufacturers managing the volatility in raw material prices by accumulating need-based inventory are looked at favourably by CARE. Also, companies which have integrated nature of business (from yarn-to-fabric/ from fabric-to-garment/ or, from yarn-to-garment) are generally benefitted by the synergies associated with lower raw material procurement cost/lower logistics cost and are viewed positively.

**Power cost** forms the next major cost component for a company engaged in the cotton textile value chain (especially spinning). Depending on the state in which the unit is located and the source of power it uses, 'power cost per unit produced' can vary for different players. Different power tariffs and quality of supply in different states can put certain players at an advantageous position compared to their peers. Players using captive generation have an assured and uninterrupted supply of power. However, the same increases their capex requirement. The power cost incurred will also depend on the source of power (viz., coal, diesel, or renewable) being used in the captive power unit, which again can lead to difference in 'power cost per unit produced' for different mills. Managements' initiatives in reducing power cost are looked at favourably. Players using different sources of power enable them to shift to the cheaper option if and when available. Power cost will also be a function of level of modernisation of the plant,

as relatively less power cost will be associated with a more modernised plant and vice versa. The ability of a company to regularly replace obsolete machines with modern state-of-the-art machines helps it to reduce its power cost and is viewed favourably.

**Labour relation and labour cost** play a significant role in efficient running of a cotton textile mill. Companies having cordial labour relations are better placed in terms of labour productivity and smooth operations. Hence, adequacy of quality labour at competitive cost in the near vicinity of a textile mill is viewed positively. Also, mills having higher level of modernisation, have lesser reliance on labour and are viewed favourably.

## 2. Inventory Management

Companies engaged in **cotton yarn spinning** are exposed to higher inventory risk compared to their manmade counterparts. This is on account of the seasonal nature of cotton. Procurement of cotton by spinning mills start from October every year (with the start of cotton harvesting) and continues till February - March. Mills have to make sure that they have sufficient raw material inventory during the non-harvesting period so that their operations are not affected. Spinning mills usually procure cotton fibre stock during the harvesting season to ensure optimisation of operations during the non-harvesting season. Quantum of the same is decided taking into account the expected order flow and anticipated price and availability of the fibre in the domestic as-well-as the international markets. This, however, exposes the players to adverse fluctuations in the raw material prices. Any significant decline in the prices of the fibre, especially for the entities having excess inventory on their books, can lead to inventory losses. Therefore, the track record of the entity in terms of inventory stocking along with its prevailing inventory policy is looked at closely. Inventory management thus plays an important role as companies procuring optimum quantity of crop and stocking the raw material can ensure availability of good quality raw material at a reasonable price. At the same time, owing to the inherent volatility in the cotton prices, excess stocking can expose the companies to the risk of inventory loss. The companies using efficient inventory management policies are viewed positively by CARE Ratings.

For **fabric and garment manufacturers**, the susceptibility of margins to fluctuations in the raw material prices remains low as the manufacturing is generally order backed where prices are fixed as per the prevailing market price of the raw material. Companies manufacturing against confirmed orders, fixing the prices taking into account the prevailing raw material prices, and maintaining raw material inventory position commensurate to their order book positions, are insulated from the fluctuations in raw material prices. Such companies are viewed favourably by CARE. On the other hand, players maintaining raw material inventory position higher or lower in proportion to their order book position bear the brunt in case of adverse fluctuations in the raw material prices. Higher stocking of raw material compared to the order book position can affect

the margins in case of downward movement in the raw material prices. At the same time, lower stocking can have an impact on the profitability margins if there is any upward movement in the raw material prices.

### **3. Scale and Flexibility**

As the industry is characterized by intense competition, profitability will depend on the volume of sales and the product profile. Large capacities producing same variety of products lead to optimal utilisation of the mills and offer the benefits of economies of scale. However, the level of production for two similar capacity units will depend on the specification of products being manufactured. A spinning unit manufacturing ‘finer count’ of yarn or a fabric unit manufacturing ‘higher thread count’ fabric will have relatively lower production levels. For the garment manufacturers, apart from cost advantage, large capacities allow the mills to deal directly with the large domestic or international end-customers rather than selling the products through dealers/ distributors.

At the same time, companies having flexibility to manufacture diverse varieties of yarns (multiple count or different varieties of value-added yarns) or fabrics (gram per square metre range, thread count range, etc.) are looked at favourably as it allows the mills to account for lower/higher demand in one particular variety and hence provides stability to the revenue stream. CARE views companies having the flexibility to offer multiple product categories to be better equipped to withstand cyclical demand. Furthermore, players having ‘finer count’ yarn or ‘higher thread count’ fabric in their product mix, cater to the elite market segment where demand is relatively price inelastic and margins are high.

### **4. Level of Integration**

Spinning mills having their own ginning facilities or engaged in contract farming of cotton get the advantage of uniformity in raw material quality. Such companies ensure regular supply of quality cotton. Fabric manufacturers having backward integration with spinning units save on their freight expenses, selling cost and packaging expenses apart from having better control on the quality.

A garment manufacturing unit can also have backward integration with a fabric or a yarn manufacturing unit (though restricted to large players only because of the capital intensive nature). The same generally leads to relatively higher profitability margins owing to the presence of more number of value-added jobs in-house. For a garmenting unit, backward integration with a fabric manufacturing unit also allows it to have better control on the quality at the weaving and processing stages.

In an integrated unit, cost saving will also be a function of the level of modernisation at the mill as a more modernised plant will have better profitability margins owing to better efficiency.

### 5. Geographical and Customer Diversification

CARE closely looks at the concentration of sales towards any particular end-customer or a dealer or a particular geography while evaluating the companies.

- **Geographical diversification:** Players catering to both domestic as-well-as export markets can diversify the risk of sluggishness in a particular market. Export-oriented companies catering to different countries have lower country-specific risk.
- **Customer diversification:** Direct sales to the end customers can lead to better profitability margins for the textile companies vis-à-vis sales made through the dealer network or through buying houses. However, the same can lead to elongated payment terms and exposes the companies to credit risk of the end customers, especially if major sales are being derived from a particular set of customers. Sales through the dealer network, on the other hand, can result in bulk production for the mills and timely payment realisation.

### 6. Fiscal Incentives and Regulatory Risks

The Government of India provides various fiscal incentives [Amended Technology Upgradation Fund Scheme (TUFFS), Scheme for Integrated Textile Parks (SITP), Rebate of State and Central Taxes and Levies (RoSCTL), etc.] to companies operating in the textile value chain. These incentives constitute a major portion of the profitability margins of the companies and are looked at closely. In addition to that, in order to promote investment, certain State governments also provide fiscal incentives in the form of capital or interest subsidy to players setting up new textile units or undertaking modernisation at their existing units. CARE analyses various incentives available to a company and the impact of the same on the profitability, capital structure and debt coverage indicators.

Furthermore, the industry is governed by various central and state government regulations. The Government of India decides the MSP of cotton every year. Fragmented and competitive nature of the industry and competition with the manmade yarn fibre/ yarn (where prices are governed by crude oil prices) limits the ability of cotton spinning companies to completely pass on any major increase in the prices of raw cotton to their customers and can hence affect their profitability margins.

Textile companies also face the risk of removal or lowering of various incentives given by the state and central governments.

At the same time, policies/ regulations of the destination countries in the export market are also looked at closely. Imposition of trade restrictions or more favourable policies towards the competitors can affect business of the companies engaged in exports.

CARE closely monitors the key policy decisions taken by both the central government (including budget allocation under various subheads) and the state governments and those taken by the major destination countries.

## **B. Financial Risk**

### **Liquidity management**

Companies engaged in cotton yarn spinning have large working capital requirements during the peak season (during inventory procurement for the non- harvesting period), compared to their average requirements. Furthermore, the apparel manufacturers generally have seasonality in their operations with major sales happening during the winter season (festive season in India and abroad). However, owing to fixed nature of expenses, the companies need to have sufficient liquidity cushion at any point in time to meet both- their operational expenses and debt obligations. CARE assesses the cushion available in the sanctioned working capital limits of the companies to analyse the liquidity position. High repayment obligations especially at the time when companies are holding excess inventory can be a cause of concern.

CARE takes cognisance of the top clients of the entity for their overall credit quality. Business relation with strong counter-parties ensures timely payments. Debtor ageing profile along with concentration of debtors is closely looked at. The receivable position may vary depending on the geographies catered to, with entities deriving significant income from exports generally having elongated average collection period. Entities taking Letter of Credits (LCs) from their clients and having cover from Export Credit Guarantee Corporation (ECGC) are viewed positively.

### **Capital structure and debt coverage indicators**

Owing to the capital intensive nature of business, companies having operations in the industry typically have high reliance on external debt to fund their fixed capital expenditure and working capital requirements. Fiscal benefits provided by various governments [Technology Upgradation Fund Scheme (TUFS) and benefits provided by the central government to the spinning players in the past or fiscal incentives provided by various state governments] have also encouraged various entities to aggressively increase their installed capacities or set-up new capacities. Hence, the leverage ratios and coverage indicators of the companies in this industry are closely looked at in conjunction with their overall liquidity profile. Analysis of these ratios also holds importance due to the cyclical nature of the industry as comfortable capital structure and debt coverage indicators will make the company less vulnerable to cyclical downturns.

Some of the ratios analysed by CARE include: *long-term debt/ tangible networth; total-debt/ tangible networth; total debt/ PBILDT; total outside liabilities/ tangible networth; PBILDT/ Interest cost; Debt Service Coverage Ratio.*

### Foreign exchange risk analysis

Many companies in the industry are exposed to foreign exchange fluctuation risk due to export of the products manufactured and/or import of raw material. Though a company might be naturally hedged to an extent, policies of the company to mitigate the risk by availing of working capital borrowings in foreign currency, entering into derivative contracts, etc., are closely looked at.

### Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality, by taking into account the industry's cyclicality.

While the methodology encompasses comprehensive financial, commercial, economic and management analysis, credit rating is an overall assessment of all aspects of the issuer.

[For previous version please refer "Rating Methodology for Cotton Textile Manufacturing" issued in [October 2019](#)]

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