CARE Ratings
Professional Risk Opinion

Rating Methodology for Manmade Yarn Manufacturing Sector

[Issued in December 2019]

Industry Overview

Manmade fibres (MMF) can be broadly categorised under two heads- Synthetic and Cellulosic. Under the Synthetic fibre segment, there are three types of major fibres- Polyester Staple Fibre (PSF), Acrylic Staple Fibre (ASF) and Nylon Staple Fibre (NSF); whereas under Cellulosic, Viscose Staple Fibre (VSF) constitutes the major proportion. Unlike other MMFs, VSF is not synthetic and is made from wood pulp, a naturally occurring cellulose-based fibre. Out of these, the polyester segment accounts for more than 80% of the total MMF industry. MMF is primarily used to produce blended fabrics (blended with cotton or other MMFs) and 100% non-cotton fabrics, which are further used in the manufacturing of readymade garments, home textiles and other industrial textiles. The MMF capacity in India is highly organised with Reliance Industries, Indo Rama Synthetics, Bombay Dyeing, and Grasim holding nearly 95% of the total capacity. The manmade yarn industry, on the other hand, is relatively fragmented compared to the MMF industry, with both small and large spinners operating in the segment.

Rating Methodology

CARE Ratings has a standard methodology for rating of 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 Manmade yarn manufacturing industry.

A. Business and Operational Risks

1. Operational Efficiency

Raw material (fibre) cost constitutes the largest portion of the total operational cost in a man-made yarn spinning company. Polyester is the largest contributor to the entire man-made fibre/ yarn value chain and a direct substitute of cotton. Any price change in cotton fibre and its relative availability have a direct impact on the prices of PSF. The prices of PSF are also dependent on the prices of PTA (purified terephthalic acid) and MEG (mono ethylene glycol), the two petrochemical derivatives, costs of which are subject to volatility in the crude oil prices. For a company manufacturing PSF, primary raw material would be PTA and MEG, while for companies engaged in polyester yarn manufacturing, raw material can vary from PTA & MEG to Polyester Chips or Partially Oriented Yarn (POY) depending on the level of backward integration. Being derivatives of crude oil, PSF prices are inherently volatile in nature, making the margins of the spinners susceptible to adverse fluctuations in the fibre prices. The prices of ASF and NSF are also crude oil dependent, while the prices of VSF are dependent on the prices of wood pulp. Apart from the fluctuation in the prices of the feed-stocks, global supply-demand and exchange rate volatility also has an impact on the price of a particular MMF. Manmade yarn spinning companies are analysed based on their raw material procurement strategies and ability to manage the volatility. Spinning companies which are capable of producing multiple counts and blends of yarns using different varieties of fibres are viewed favourably by CARE. It allows them to shift from one variety to the other in case of price fluctuation in a particular category. Distance of the spinning mill from the raw material supplier is also an important factor. Mills located close to the raw material suppliers are at an advantageous position as it allows them to save on to their inward freight costs and are viewed positively. Further, companies which have integrated nature of business (from fibre-to-yarn or yarn-to-fabric) at a single location are viewed favourably as it leads to saving in packing and transportation cost.

Power cost forms the next major cost component for a company engaged in the Manmade yarn spinning segment. 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. Also, 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 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.

2. Inventory Management

Manmade yarn manufacturers do not face seasonality risk like their cotton counterparts. Inspite of that, inventory management plays a crucial role owing to the linkage of the raw material with crude oil prices, etc. Track record of the entity in terms of inventory stocking along with its prevailing inventory policy is looked at closely. CARE analyses the inventory carried by a company and compares it with the other peer group entities. Mills maintaining optimal raw material and finished goods inventory are generally insulated from the adverse movement in the raw material prices or demand slowdown, and are viewed favourably. Owing to the competitive nature of the industry leading to thin profitability margins, any adverse inventory fluctuation can have an impact on the overall financial risk profile of a company. Hence, inventory management plays a very important role as companies procuring optimum quantity of MMF and stocking the raw material can ensure availability of good quality raw material at a reasonable price. At the same time, because of the inherent volatility in the MMF prices, excess stocking can expose the companies to the risk of inventory loss. Companies using efficient inventory management policies are viewed positively by CARE.

3. Scale and Flexibility

In the fragmented manmade yarn industry, which is characterised by low profitability margins, size and capacity utilisation level of the plant plays an important role in the financial performance of a company. Large scale leads to higher bargaining power for a company and enables it to access different markets.

Large capacities producing same variety of products lead to optimal utilisation of the mills and offer the benefits of economies of scale, leading to better profitability margins. However, the level of production for two similar capacity units will depend on the specification of products being manufactured. At the same time, companies having flexibility to manufacture diverse varieties of yarns (multiple count/denier, blended or different varieties of value added yarns) 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 cyclicality in demand. Furthermore, players having 'finer count' yarn in their product mix, cater to the elite market segment where demand is relatively price inelastic and margins are high.

4. Level of Integration

Manmade yarn spinning mills having forward or backward integration are looked at favourably by CARE. Yarn manufacturers can either have backward integration into fibre manufacturing or forward integration into fabric manufacturing or into certain value addition jobs (yarn dyeing, etc.). By having multiple processes of the manufacturing value chain, in-house, the value addition at various stages leads to cost savings and eventually better profitability margins for such companies. Further, a company having upstream capacities commensurate to the downstream capacities ensure the benefits of manufacturing process integration are completely obtained by that company. Such companies are hence viewed positively by CARE.

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:** CARE analysis the revenue contribution of top-10 customers to whom the company supplies to. Diversified customer base helps mitigate the risk of business getting affected in case financial health of the counterparty deteriorates. This holds increased importance due to the cyclical nature of the textile industry. Apart from that, CARE also looks at the channel wise break-up of sales derived from top-10 customers. Direct

sales to end customers can lead to better profitability margins for the yarn manufacturers vis-à-vis sales made through the dealer network or through buying houses. However, the same can lead to elongated payment terms. Sales through the dealer network, on the other hand, can result in bulk procuement from the mills and timely payment realisation.

6. **Fiscal Incentives and Regulatory Risks**

The Government of India provides various fiscal incentives [Scheme for Integrated Textile Parks (SITP), duty drawbacks, etc.] to companies operating in the manmade yarn manufacturing. 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 spinning units or undertaking modernisation at their existing units. These incentives constitute a major portion of the profitability margins of the companies and are looked at closely. Reckoning high capital cost involved in the sector, such financial incentives improve the profitability, capital structure and debt coverage indicators for the eligible companies. Such companies are viewed positively, in relation to companies not eligible for such incentives. Furthermore, the industry is governed by various central government regulations including GST rates, duties imposed on the import of various Manmade fibres/ yarns, etc. Fragmented and competitive nature of the industry and competition with the cotton yarn segment limits the ability of manmade spinning companies to completely pass on any major increase in the prices of MMF to their customers and can hence affect their profitability margins. Companies also face the risk of removal or lowering of various incentives given by the State and Central Governments. Hence, CARE closely monitors the key policy decisions taken by both the Central Government and the State Governments.

B. Financial Risk

Liquidity requirements

Owing to the volatile nature of raw material prices, cyclicality inherent in the manmade yarn industry and fixed nature of expenses, the companies engaged in manmade yarn manufacturing need to have sufficient liquidity cushion at any point in time to meet both- their operational expenses and debt obligations. Companies having sufficient liquidity to counter the cyclicality and volatility in the raw material prices are viewed positively by CARE. CARE assesses the cushion available in the working capital limits along with the management intent to maintain liquidity at any given point in time. CARE also closely looks at the current and the quick ratios along with the receivable position (apart from the inventory position; as discussed above) of the companies engaged in the manmade yarn manufacturing to analyse the liquidity profile.

The receivable position of a company 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) 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*.

Forex exchange risk analysis

Many companies in the manmade yarn industry are exposed to foreign exchange risk due to export of yarn and/or import of fibre. 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. An impact analysis of change in foreign exchange rates (for the un-hedged part) is conducted to check the impact of adverse fluctuations in foreign exchange rates on profitability of an entity.

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.

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