Ratings

May 28, 2015

Domestic demand and policy: Saviour of cotton yarn sector

Background

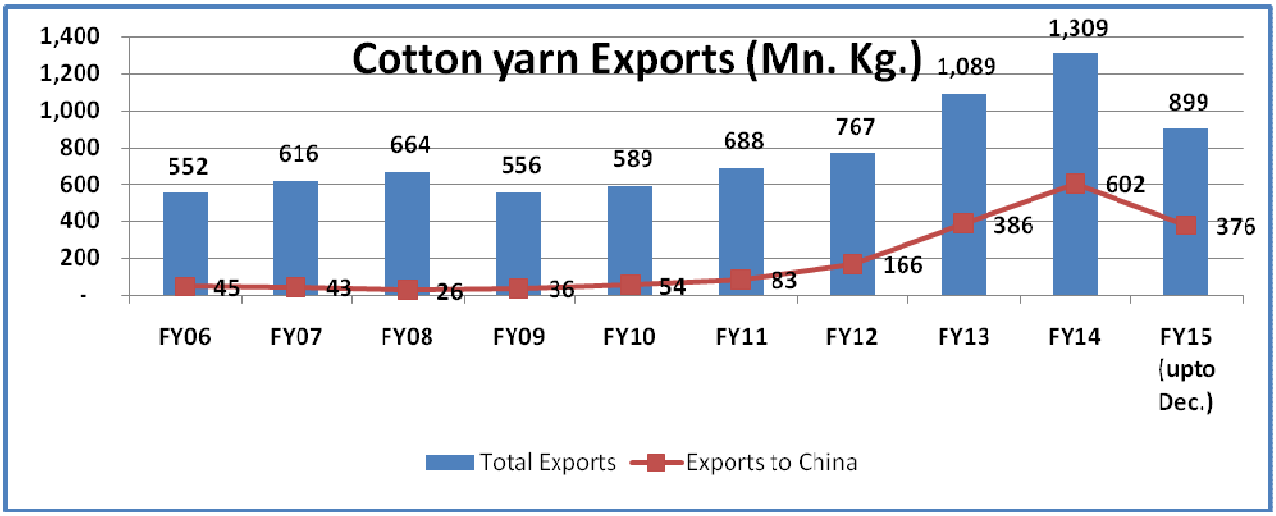
Indian spun yarn industry is the world's second-largest spinning industry, having an installed capacity of nearly 50 million spindles as on March 31, 2015, and currently producing over 6,600 million kg of spun yarn annually of which nearly 4,000 million kg is cotton yarn (approximately 61% of the total yarn production). Over the past 4 years ended FY15 (refers to the period April 1 to March 31), the Indian cotton yarn production has risen steadily except in the year FY12 (due to lower availability of raw cotton). The growth in production was largely due to improvement in capacity utilisation of the existing spinning units along with addition of new capacities aided by high growth in exports sales where the exports volumes have grown by 11%, 42% and 20% in FY12, FY13 and FY14, respectively. India exports around 30-35% of its total cotton yarn production. The growing export volumes of yarn and improving average sales realisation aided by rupee depreciation have led to improvement in credit profile of many domestic cotton spinning units in recent past. However, the industry dynamics changed in FY15 on the back of fall in export demand from China.

Change in Chinese Government Policy

During April 2014, the Chinese government ended its 3-year-long programme to stockpile raw cotton to support local growers and is instead, offering subsidies directly to the farmers. As a consequence of the Chinese government's policy to offload its reserve stock of cotton, the Chinese spinning mills have got access to cheaper cotton from the local market and the same has reduced their dependence on imports. As a result, the export of cotton and cotton yarn to China has taken a significant hit in FY15.

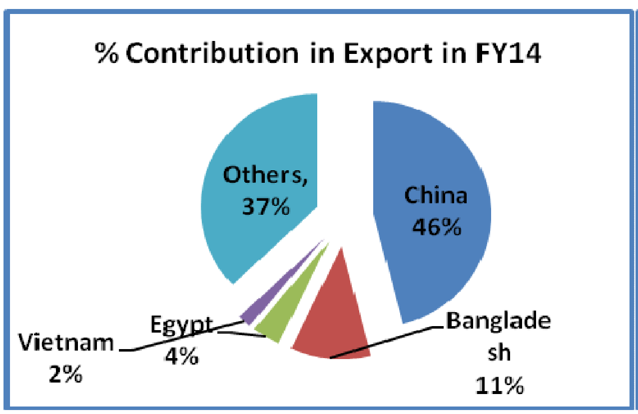
Fall in cotton yarn export to China

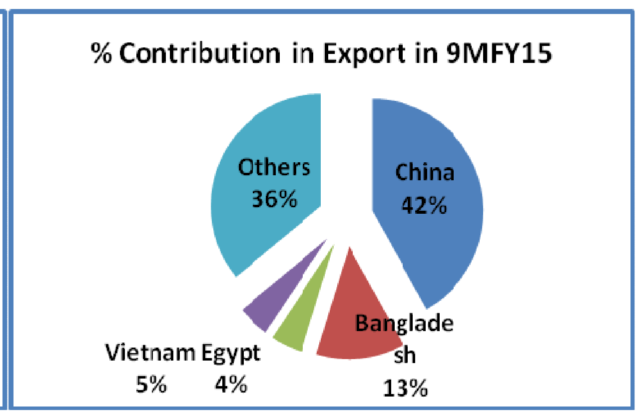
After witnessing a very high export growth rate in FY12 and FY13, the growth rate declined in FY14 and went to negative territory in 9MFY15. Over the past periods, the Indian cotton yarn exports were largely driven by growth in export to China and hence with decline in export to China, the overall growth in export has also declined.



Source: Centre for Monitoring Indian Economy (CMIE)

During 9MFY15, the export to China declined significantly by around 17% to 376 million kg. However, the decline in overall exports was restricted due to growth in export to other emerging countries like Bangladesh, Egypt and Vietnam which recorded export growth of 18%, 33% and 170%, respectively, over 9MFY14. Further, during 9MFY15, the share of these emerging countries has also increased in Indian cotton exports. As per the monthly export data, after witnessing sudden jump in export volumes in the month of November 2014 and December 2014, the export volume again declined in the month of January 2015 and February 2015. During FY15, the total cotton yarn export volumes is expected to decline by around 7% to 1,200 million kg as against 1,300 million kg in FY14. However, CARE expects demand of cotton yarn to recover going forward led by domestic consumption and growth in export to emerging countries.

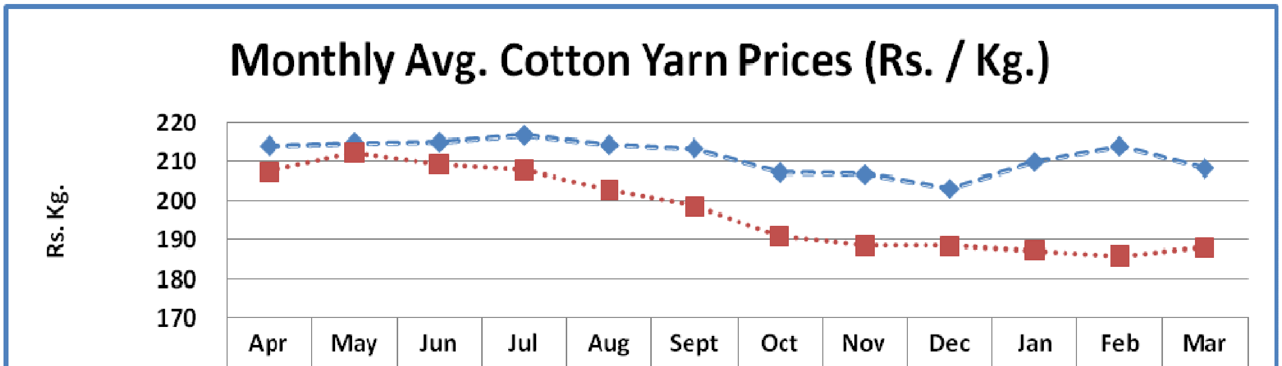




Source: CMIE

Low demand from China plunges cotton yarn prices southwards

After witnessing a significant decline in prices in H1FY15 (declined nearly 11% from its peak), the prices of cotton yarn have stabilised at around Rs.185-190/kg in H2FY15.



	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar
FY13-14	214	215	215	217	214	214	207	207	203	210	214	208
FY14-15	207	212	209	208	203	199	191	189	188	187	186	188

Source: Office of the Textile Commissioner, Ministry of Textile

Cotton spinning units are expected to report relatively subdued financial performance in FY15 compared to FY14

FY14 was an exceptionally good year for many cotton spinning units in India due to increasing export volumes and steady domestic consumption along with high average sales realisation. However, the decline in export demand mainly from China is likely to result in moderation in their performance during FY15. Further, cotton spinning units have suffered inventory losses in Q2FY15 and Q3FY15 on the back of decline in cotton and cotton yarn prices.

As per the working result published by the top 20 listed cotton spinning companies, in terms of sales value, have reported aggregate net sale of Rs.13,846 crore and PAT of Rs.317 crore in 9MFY15 as against Rs.13,953 crore and Rs.830 crore in 9MFY14, respectively, signifying muted growth coupled with fall in profitability.

As such, under utilisation of capacities due to lower export volume and inventory losses are expected to keep the profits for cotton spinning units under check in FY15.

Outlook

Increasing garment export likely to benefit the domestic spinning sector

India is also amongst the largest exporter of garments in the world and with rise in export of garments, the consumption of fabric and yarn is also expected to increase. The export of readymade garment witnessed a healthy double digit growth of around 13% during April 2014-February 2015 which was primarily attributed to healthy demand from the United States (US) and the European Union (EU) which accounts for bulk of the apparel exports from the country. Economic activities in the US and the EU have witnessed sign of improvement and as a result, CARE expects growth in demand for apparels from both the regions to continue.

In the domestic market too, factors such as urbanisation, expected rise in per capita income, favourable demographics and a shift in preference for branded products would continue to boost the demand for apparels and fabrics. Besides, a decline in cotton yarn prices is likely to improve its competitiveness vis-à-vis synthetic yarn.

Continued thrust from Central and various States Governments through favourable policies

The continuation of Technology Upgradation Fund Scheme (TUFS) until the end of the 12th Five Year Plan is likely to sustain fresh investment in the textile sector. The 12th Five Year Plan envisages investments worth US $28 billion in the textile sector on the back of policy initiatives. Furthermore, Government of India, in union budget 2015-16, has also allocated a sum of Rs.1,520 crore towards the TUFS incentive. Furthermore, to encourage the export of value-added products, Government of India provides higher interest rate subsidy under TUFS to weaving and garmenting units as compared with the subsidy to spinning units.

Recently, in April 2015, Government of India unveiled the new Foreign Trade Policy (FTP) 2015. Under the FTP, the Government has introduced a new scheme for merchandise exports, i.e., Merchandise Exports from India Scheme (MEIS). This scheme will provide various benefits for exports of specific products under the readymade garments category to specific markets. This is likely to aid the growth in apparel exports in the coming years.

With Government's continued thrust on export of value-added products like garments, home furnishing, etc, domestic consumption of yarn is expected to increase. This would also in line with government's vision to maximise the employment generation and value creation within the country under 'MAKE IN INDIA' campaign.

Over and above Central Government assistance, certain State Governments such as Gujarat, Rajasthan, Maharashtra, Madhya Pradesh and Karnataka are also offering various benefits which include capital subsidy, interest rate subsidy, concession in power tariff, concessional state sales tax / value-added tax on inputs, etc. However, the rates and nature of incentives differs from state to state as enumerated in the table below.

Incentives / State	Gujarat	Maharashtra	Rajasthan	Madhya Pradesh	Karnataka
Capital Subsidy	No	Yes	No	No	Yes
Interest rate Subsidy	Yes	Yes	Yes	Yes	Yes
Concessional Power Tariff	Yes	No	No	No	Yes
Sales Tax / VAT Concession	Yes	No	Yes	Yes	Yes

Due to favourable government policies along with steady demand for cotton yarn, CARE expects capacity addition of nearly 3-4 million spindles over next 3 years till March 2018e, which is approximately 6-8% of the existing capacities. Among all the states, Gujarat is witnessing highest capacity addition in the sector due to its locational advantage in terms of easy access to raw material being the largest cotton growing state with access to stable power supply and port infrastructure which are the prerequisites for the sector.

Expected rise in demand from China in the medium to long run

On a long-term basis, as the Chinese stock of low cost raw cotton exhausts, the demand from China for cotton yarn is again expected to rise. Further, continuously increasing cost of production like labour and power cost in China would also aid the export volumes to China. Furthermore, China is the largest exporter of readymade garment in the world and they are cutting down some of the low value added processes like conversion of yarn from cotton which in turn also results in high demand of cotton yarn from China.

Conclusion

Going forward, CARE expects the recovery in demand for cotton yarn to be driven by steady growth in domestic consumption along with export growth from China. Apart from this, Bangladesh and Vietnam continue to augment their yarn purchases from India to service their growing apparel export industry. The continued government thrust on the sector would also facilitate the growth in the domestic market.

Further, lower cotton prices is expected to benefit the cotton spinning mills albeit the improvement in profitability margin would be restricted as they need to pass on the benefit of lower cotton prices to their customers. Furthermore, with the lower cotton prices, mills' working capital requirement is expected to decline which will result in saving in interest cost. However, in the medium term, Chinese demand and volatile foreign currency may play a crucial role and it would remain a key monitorable.

CARE also envisages that the cotton spinning units that have moderate to low leverage and sound management of working capital and foreign exchange would be better placed in credit metrics given the volatile and cyclical nature of the sector.

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