

Ratings criteria for the cotton textile Industry

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Executive summary

CRISIL evaluates financial, management, and business risk profiles as part of its rating of players in all industries. In its analysis of financial and management risks of cotton textile entities, CRISIL follows the standard rating criteria applied for all manufacturing companies. Under business risk profile, CRISIL factors in the market position and operating efficiency. The quality and count range of cotton, degree of diversification in product, customer and geographical profiles, and ability to capture new markets are evaluated under market position. While assessing operating efficiency, efficiency in raw material procurement and cost structure (mainly of labour and power), degree of modernization in manufacturing facilities, and benefits from economies of scale are considered.

Scope

While the broader criteria of manufacturing companies¹ apply to entities in the cotton textile sector as well, this article² details the industry-specific factors that impact the business risk profiles of cotton textile players—in particular, their market position and operating efficiency.

CRISIL's assessment of cotton textile players

India's cotton textile industry is critical to the nation's economy, given its contribution to industrial production, employment generation, and foreign exchange earnings. The dual advantages of raw material availability—India was the world's largest producer of cotton in fiscal 2017—and low labour costs strengthen the production base. India also benefits from its presence in the entire textile value chain—from cotton production to garment manufacturing. The cotton yarn spinning industry is highly capital intensive, faces acute cyclical nature, has extremely fragmented capacities, and is intensely competitive on account of the commoditised nature of the product. Garment manufacturing, on the other hand, is not as capital intensive as yarn spinning; however, capacities in this category are fragmented, resulting in lower economies of scale. The fabric weaving and knitting sector has both large integrated players, and small operators.

CRISIL has rated a number of companies across the textile value chain. CRISIL's experience shows that some players fare better than others at managing the inherently cyclical nature of the industry, and simultaneously, at adding value by diversifying the product range. For instance, the established, vertically integrated companies have modernised their manufacturing facilities, and have therefore, been able to enter new global markets.

¹ The detailed criteria is on the CRISIL website under the "Criteria and Methodology" section – Rating Criteria for Manufacturing and services sector companies and "CRISIL's approach to financial ratios"

² For accessing the previous published document on "Rating criteria for the cotton textile industry", kindly follow below mentioned link: https://www.crisil.com/content/dam/crisil/criteria_methodology/consumer-discretionary/archive/CRISIL-Ratings-criteria-cotton-textile-industry_2007.pdf

Business Risk

Market position

Product diversity and presence across the value chain

Companies that produce both cotton and blended yarn (blend of cotton and synthetic fibre) are better able to manage cyclicalities than pure cotton yarn units. A diversified product mix with textile variants in addition to yarn and forward integration reduces the impact of cotton price fluctuations on profitability, CRISIL takes a positive note of value addition in products, including twisted yarn, dyed yarn, gassed and mercerised yarn, and compact and melange yarn, as these fetch better realisations, and help to capture niche markets, thereby strengthening the market position. Likewise, a wider range of fabrics, colours, and designs helps forge strong relationships with garment exporters and international retailers, resulting in a preferred vendor status. In garmenting (the stitching of fabric into garments), the key strengths required are strong design capabilities and grasp of fashion trends and needs.

Quality and range

A key factor distinguishing players in the commodity yarn market is their count range. A tilt towards finer counts partly shields them from cotton price fluctuations; this is because yarn realisations in the finer counts are generally less elastic than cotton prices, and are substantially higher than those in coarser counts. Though the higher counts fetch better realisations, their demand is lower than that of the medium counts. CRISIL views positively a presence across a wide count range. The key factors distinguishing players in the commodity fabric segment are the texture and colour ranges. The fabric that needs least processing before it can be used in garmenting will have the least price elasticity. This is applicable for woven and knitted fabrics. Garmenting is the final stage of manufacturing in the textile industry. This segment is generally not commoditised, and adding variety to the product range catering to changing consumer preferences is key.

Geographical and customer profiles

CRISIL believes geographical diversification helps minimise risks associated with a particular market or geography; such risks include political unrest or economic slowdown in any particular region

CRISIL also assesses the ability to capture new markets during periods of downturn in existing markets. Geographical diversification, recognition by large garment and fabric houses, and a steady customer base are key factors for long-term success in exports. Companies that have economies of scale, modern plants, effective cost-control measures, and export thrust are better placed. In the fabric segment, manufacturers that offer services such as design development and weaving/knitting as per the requirements of garment exporters stand to benefit. CRISIL expects garment exports to drive overall textile export growth, and integrated players to benefit on account of consistent quality and adherence to time schedules.

CRISIL also views a diversified customer base positively in view of minimal counterparty risks. If, for instance, the bulk of revenue is derived from a particular customer and the latter delays payment due to financial difficulties, overall working capital requirement may be stretched. In addition to the quality of the customer base, the length of relationship with key customers is also considered.

Operating efficiency

Cotton procurement

Most profitable textile companies are distinguished by their efficient cotton procurement strategies. Raw cotton, the primary input for spinning units, is the single largest cost component, and has a significant impact on operational performance. As cotton is an agricultural commodity, it is exposed to factors such as crop area, monsoons, and pest control. All other conversion costs and realisations remaining constant, fluctuations in cotton prices will result in a corresponding swing in operating profits.

CRISIL also looks closely at factors such as the expertise of the cotton unit in cotton crop estimation, proximity to procurement areas, modes of purchase (whether in bulk with an assured uniform quality or staggered throughout the season), and stocking and price positions adopted. While cotton arrivals are spread over a six-month period from October to March, quality cotton is usually available in the first few months. After the inventory losses incurred in fiscal 2012, cotton spinners are cautious on stocking cotton for long periods. Thus, most have shifted to a leaner inventory cycle of 2-3 months in fiscal 2017, as against the earlier norm of 6 months. CRISIL assesses the inventory policy and also the ability to withstand the impact of sharp movements in cotton prices.

CRISIL's experience shows that companies with strong financial positions and liquidity are able to source bulk quantities of quality cotton at the beginning of the season—a key factor that results in economies of scale.

Cost structure

Power and labour form the second largest chunk of cost elements. The cotton spinning industry is more power intensive than the other parts of the value chain such as weaving, processing, and garmenting, which are more labour intensive.

Labour: Unlike in developed countries, India's textile industry is only partly mechanised and continues to employ a large workforce. Given the labour-intensive nature of the industry, an optimal workforce and cordial labour relationships help ensure uninterrupted operations and controlled labour costs. Companies with frequent labour problems have poor labour efficiency, and therefore, low profitability.

However, due to the faster rise in costs and higher government incentives for modernisation through the Technology Upgradation Fund Scheme, the labour intensity has gradually declined. This has had only a minimal impact on operating margins, as several parts of the process chain, such as inter-process material transfer and packaging, remain labour intensive.

Power: For spinning mills, power costs typically account for 8-10% of the operating income; an uninterrupted supply of power is critical for consistent yarn quality. Power is a critical factor even for fabric manufacturers. Some large manufacturers also set up captive power plants, including windmills, to reduce power costs. CRISIL considers factors such as efficiency in power consumption, captive generation facilities, power cost-reduction measures, and the resulting impact on overall operations. Apart from captive generation, companies have also begun to explore other avenues to reduce power costs. Some CRISIL-rated textile units also enjoy concessional power from the state governments, which help them manage increases in per unit costs.

Modernisation

Modernising a textile unit is fairly capital intensive, and in general, the industry has lagged behind other cotton exporting nations in this respect; only a few financially strong companies resort to continuous modernisation. The spinning sector is more modernised than the weaving sector—capacity additions in the spinning sector were higher

due to availability of higher subsidy in spinning, through technology upgradation fund. Also many states have provided attractive incentives to promote modernization of plants and encourage setting up new capacities by offering various capital subsidy schemes.

However, the Indian spinning sector compares poorly with that of China and Southeast Asian countries, thus constraining global competitiveness. CRISIL favourably evaluates companies in the spinning sector that have constantly focused on modernisation as a strategy to retain global competitiveness. CRISIL positively views investments that provide value addition or reduce dependence on labour

Economies of scale

While scale of operations is a key factor in any industry, it assumes criticality in commodity industries such as cotton textiles, where profitability is dependent more on volumes than margins. Companies with higher capacities are likely to derive benefits of economies of scale. Large capacities also make future value additions economically viable. Furthermore, higher capacities in a single or near-by location can save costs. Hence, CRISIL assesses the capacities of textile units, and their ability to speedily shore up capacities in order to cash in on potential upswings in the market. Large-scale operations are also beneficial in fabric making and garmenting as they help in costing and in gaining competitive advantage. Quicker turnaround is a key differentiator for facilities with large capacities.

Financial Risk

CRISIL follows the standard criteria used in analysing the financial risk profiles of all manufacturing companies. These criteria are detailed in the CRISIL publications, 'Rating Criteria for Manufacturing and Services Sector Companies' and 'CRISIL's Approach to Financial Ratios'.

Management Risk

The management risk is evaluated using CRISIL's standard criteria for all manufacturing companies. The detailed criteria are presented in the document, 'Rating Criteria for Manufacturing and Services Sector Companies', on the CRISIL website, under the section, 'Criteria and Methodology'.

Conclusion

Thus, in CRISIL's opinion, the key factors impacting the business risk profiles of cotton textile units include:

- Presence across the value chain
- Revenue diversity in terms of product mix, customer, and geography
- Quality and count range of cotton yarn
- Cotton procurement efficiencies
- Effective mechanisms to control labour and power costs
- Modernisation in manufacturing facilities
- Economies of scale

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