

# Rating criteria for the paper industry

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## Executive Summary

The paper industry can broadly be divided into four product groups: writing and printing paper (WPP), industrial paper, specialty paper, and newsprint (NP). The demand for paper products has grown significantly in India in recent times, and is linked to the overall growth in the gross domestic product (GDP). Given the low level of per capita consumption of paper products in India as compared with the global average, the rate of growth in domestic demand is expected to be higher than the global growth rate.

The paper industry is capital-intensive and fragmented, and has an uneconomic scale of operations. These constraints hamper the global competitiveness of the Indian paper industry; consequently, India's exports, which are primarily to neighboring countries such as Bangladesh and Sri Lanka, have traditionally been marginal. The industry is also highly cyclical, mainly on account of the bunching up of capacity additions, resulting in temporary demand-supply imbalances, rather than fluctuations in absolute demand, as is the case with developed economies.

## Scope

CRISIL assesses the business position in a comprehensive manner by analyzing the market position and operating efficiency. Though the broader criteria of manufacturing companies<sup>1</sup> applies to entities in the sector, this article<sup>2</sup> gives a brief insight into industry-specific risk factors, which impact the operations and financial flexibility of the players.

## Business Risk

### Market position

#### Product segments

The presence of players in the commodity and specialty grades of the market will determine their extent of vulnerability to cyclicalities. In the commodity grade segment, the ability to sell a diverse product range and cater to a wide cross section of the market will moderate the effects of cyclicalities. However, in the NP and niche segments such as coated or specialty paper, where the market size is limited and the number of players small, factors such as international price movements and level of import duty dictate the fortunes of domestic players. Hence, it is essential for them to have a competitive cost structure.

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<sup>1</sup> 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"

<sup>2</sup> For accessing previous published document on "Rating Criteria for the Paper Industry", kindly follow below mentioned link:

[https://www.crisil.com/content/dam/crisil/criteria\\_methodology/materials/archive/CRISIL-Ratings-criteria-paper-industry\\_2007.pdf](https://www.crisil.com/content/dam/crisil/criteria_methodology/materials/archive/CRISIL-Ratings-criteria-paper-industry_2007.pdf)

## **Flexible manufacturing facilities**

The ability to alter the product mix (to shift between NP and WPP, for instance, or within the various commodity grades in WPP) according to market trends will be a crucial factor, especially in a highly-cyclical industry.

## **Distribution strengths**

A large and geographically spread distribution network provides significant marketing strength and reduces off-take per dealer. A loyal and dedicated indentor/dealer network will enable the player to withstand market downtrends more effectively. Such loyalty is normally built up by selling/distribution policies such as unbiased allocation of volumes across distribution channels during market uptrends, ability to extend credit in periods of distress, and to supply a wide range of products. The customer profile in direct supplies and retail also has a bearing on the business risk profile.

## **Capital expenditure to maintain market share**

Developing economies usually experience high growth in demand; manufacturers therefore need to constantly add capacities to retain market share. In addition, the commoditised nature of the business requires regular modernisation of production facilities in order to remain competitive. With business being highly capital-intensive, the incremental funding requirement for capacity augmentation and modernisation tend to be enormous. The long gestation periods involved in expansion projects also require considerable project implementation skills and financial strength.

## **Operating efficiency**

### **Extent of integration**

This determines the fixed-cost intensity of the business. Units that are fully integrated, from pulping to conversion, will be more fixed-cost intensive, resulting in higher break-even volumes. During downturns in the industry, when pulp prices tend to be lower, integrated manufacturers are unable to take advantage of this. In contrast, manufacturers with a lesser degree of integration are better positioned to withstand downturns owing to their lower fixed-cost intensity, although this also means that their profitability tends to be average even during industry uptrends.

### **Fibre sourcing**

The linkages created to ensure a steady and adequate supply of raw materials are critical. The flexibility to use non-forest-based sources such as bagasse and waste paper as raw material is also important. That's because of the limited forest cover and increasing environmental awareness. However, a high usage of non-forest-based fibre resources limits production capabilities to the lower end commodity grades of paper. Therefore, it is crucial to strike an appropriate balance based on market requirement.

The extent of dependence on imported raw materials such as waste paper and intermediates like pulp is also very important. As the volume of exports tends to be negligible, a high level of imports results in an unhedged position that exposes the company to significant foreign exchange risks. A high level of imports also requires substantial liquidity to maintain adequate inventory; that's because imports are normally in quantities that are substantially higher than the daily production requirement.

## Cost structure

In a highly cyclical business such as paper, it is crucial for players to maintain a low-cost manufacturer status so as to remain competitive. CRISIL compares the cost structures with those of the peer group, the landed costs of imports, and past trends.

CRISIL also assesses the following factors to determine performance efficiency:

- Plant utilisation levels
- Power availability, tariff levels, extent of back-up, and facility for cogeneration of power
- Power and chemical consumption factors
- Pollution-control measures

## Financial Risk

CRISIL follows the standard criteria used for all manufacturing companies. This is articulated in detail in the CRISIL publications 'Rating Criteria for Manufacturing and Services Sector Companies' and 'CRISIL's Approach to Financial Ratios'.

## Management Risk

CRISIL follows the standard criteria used for all manufacturing companies. This is presented in detail in the CRISIL publication, 'Rating Criteria for Manufacturing and Services Sector Companies'.

## Conclusion

The key success factors for the paper sector include:

- Flexibility in product mix
- Distribution strengths
- A competitive cost structure
- Efficient fibre sourcing capabilities

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