

Softer cotton prices to save the day for spinners

January 2018

Margins hit a 20-quarter low in Q2, but lower cotton prices and demand restoration can ease pressure

The second quarter of fiscal 2018 was the least profitable in five years for spinners, or cotton yarn mills. Margins touched 10.3%, compared with a peak of 18.8% in the corresponding quarter of fiscal 2014.

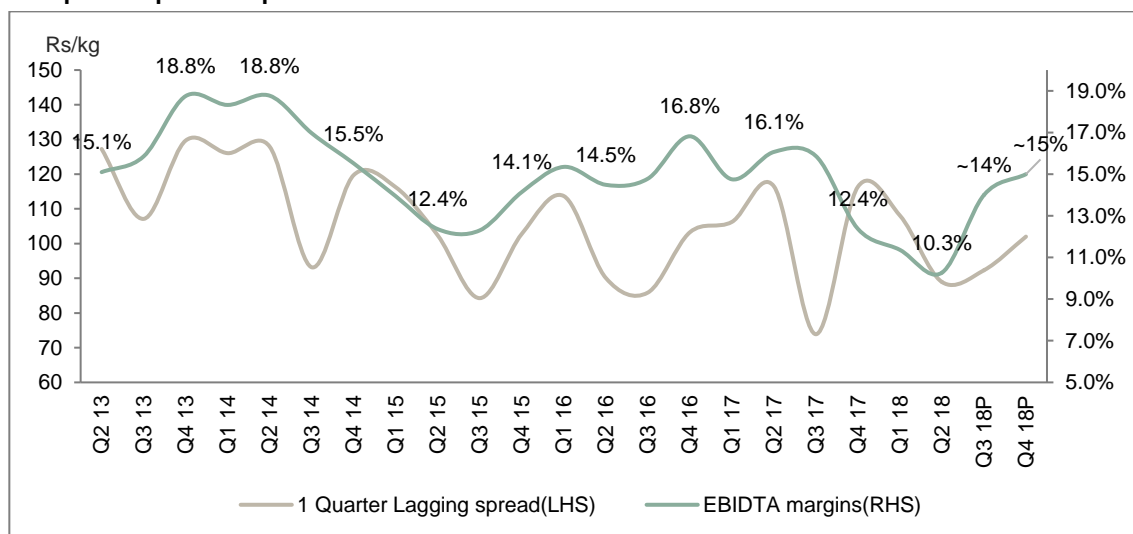
That's because the spread between prices of cotton (with a one-quarter lag) and cotton yarn was at a low of Rs 89/kg (compared with Rs 130/kg at peak in the fourth quarter of fiscal 2013). The spread is a good indicator of the profitability of mills, considering cotton accounts for over 65% of the total operating cost. A one-quarter lag in cotton prices is presumed as most spinners maintain an inventory of 60-90 days.

Among other issues, disruptions stemming from rollout of the Goods & Services Tax (GST) took a toll. As such, excess spinning capacity in the past two years (~2.5 million spindles added over fiscals 2016 and 2017) in anticipation of expiring textiles policies in Maharashtra and Gujarat had affected the pricing flexibility of mills. Further, a decline in yarn exports, induced by reduced sourcing from China (accounting for 36% of India's exports), also impacted the margins.

However, a sharp increase in cotton production (expected ~375 lakh bales) in cotton season (CS) 2017-18 will be a shot in the arm for spinners in the last two quarters of this fiscal, and thwart further drop in margins. Also, demand normalisation after demonetisation and GST-led disruptions would improve utilisation.

Falling cotton prices will also improve prospects for cotton yarn exporters in the second half of this fiscal. India is the largest producer of cotton, which improves competitive advantage of local mills for fibre procurement. Further, rising synthetic fibre prices amid inflationary pressure on crude oil will drive substitution demand towards cotton yarn manufacturers. Overall, we still expect ~200 bps fall in the margins for cotton spinners on year basis in fiscal 2018 inspite of the improvement expected in the second half.

The profit spin for spinners



Note: 15 listed companies considered account for ~60% of organised spinning market and ~20% of overall industry

Source: CRISIL Research

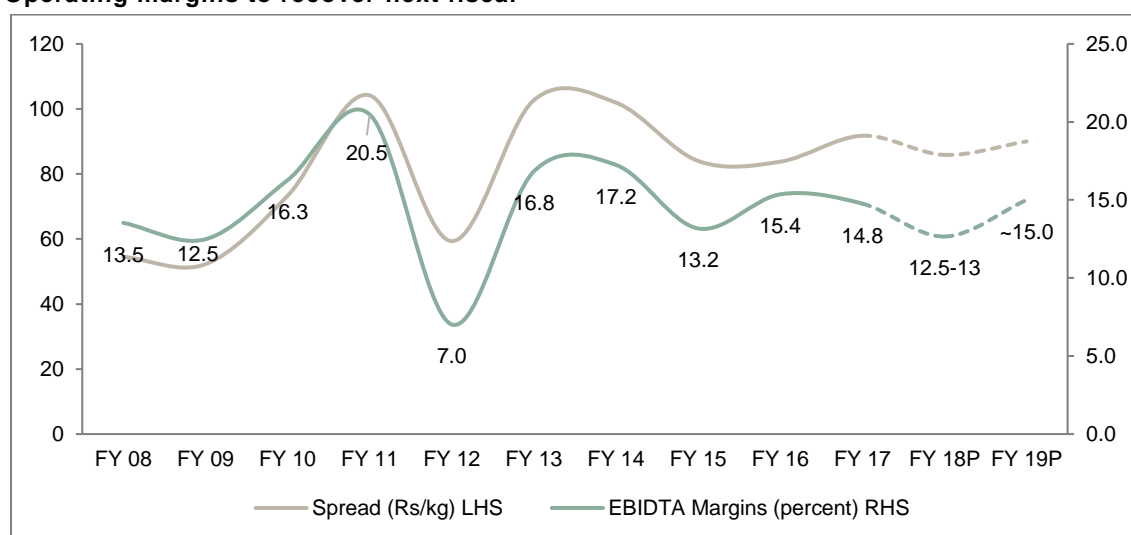
Nearly 70% of the cotton produced in CS 2017-18 would be used in the next financial year by spinners, giving us confidence that raw material cost would remain low in fiscal 2019. This, coupled with stabilising cotton yarn prices

amid better demand both in the domestic and export markets, and higher crude oil prices on average compared with the past fiscal, will widen the differential between cotton yarn and cotton and support EBITDA margin improvement.

While domestic demand will be supported by a consumption recovery for the Indian economy, a better economic outlook for most of our textile trade partners and restoration of export incentives, though lower than the pre-GST period, would also support higher growth and firm up yarn prices next fiscal.

Besides, supply coming on-stream will be slower in fiscal 2019, which will aid the operating margins of spinners due to higher pricing flexibility. The strong capacity additions over the past 2-3 years, though, will restrict the margins from breaching the levels attained in fiscal 2016.

Operating margins to recover next fiscal



P: Projected

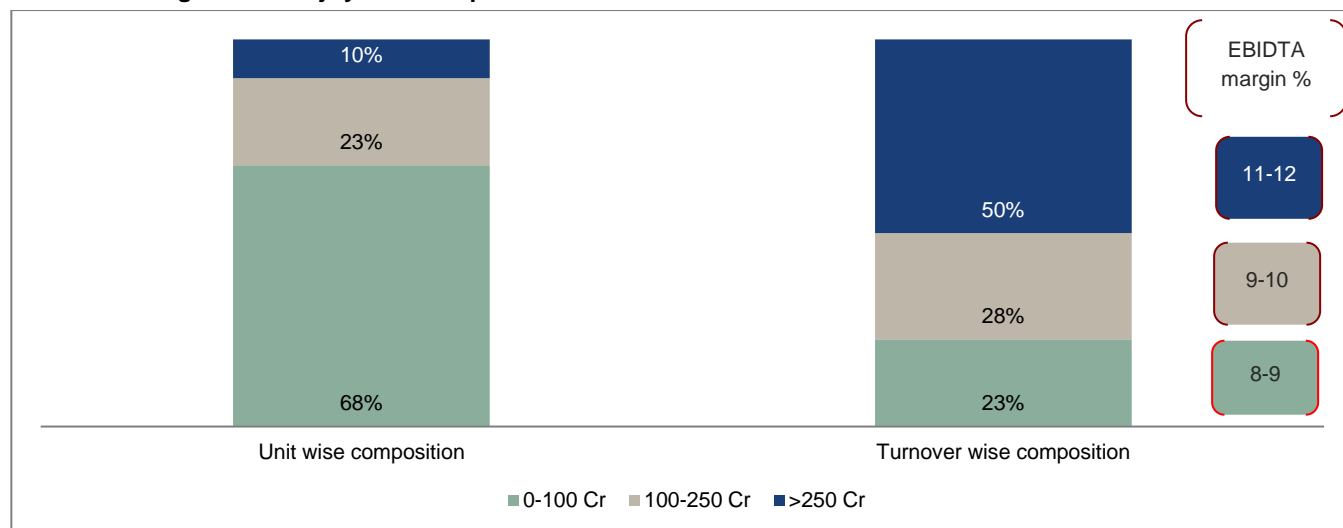
Notes:

- 1) Spread is calculated using average calendar year price for cotton (S-6 price) and average financial year prices for 40's count carded yarn
- 2) 15 listed companies EBITDA margins considered which account for ~60% of organised spinning market and ~20% of overall industry

Source: Cotton Association of India, Industry, CRISIL Research

The EBITDA margin profile is very different for large organised players due to efficient procurement practices as well as benefits accruing from economies of scale. Large units generally enjoy ~300 bps higher margins compared with smaller counterparts.

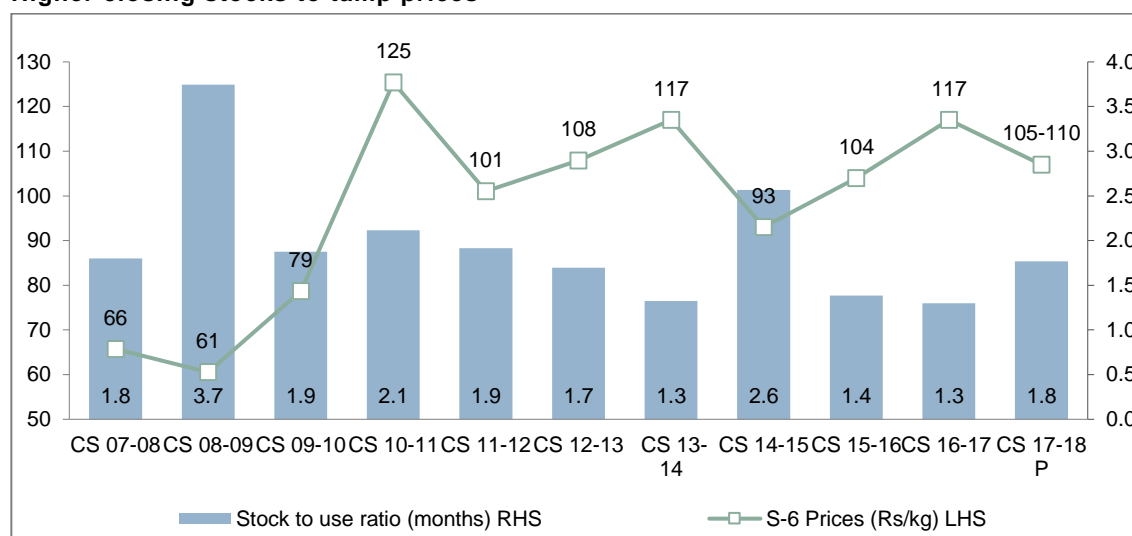
A tenth of large units enjoy half the pie



Note : Based on a sample of 270 CRISIL rated entities which account for 20 percent of the industry

Source: CRISIL Ratings, CRISIL Research

Higher closing stocks to tamp prices



Note :The years represent the domestic CS (October-September); ~70% of cotton from CS 2017-18 will be used in fiscal 2019

Source: CRISIL Research

CRISIL Research expects domestic cotton prices to decline to Rs 105-110 per kg in CS 2017-18, from ~Rs 117 per kg in CS 2016-17, due to ~11% increase expected in cotton production (~375 lakh bales). Acreage has risen as farmers have switched back to cotton following the price surge witnessed in CS 2016-17.

According to estimates, the planted area under cotton has increased 19% to 123 lakh hectares compared with 103 lakh hectares in CS 2016-17. It is also 7% higher than the 5-year average of 115 lakh hectares. However, overall yield is expected to fall ~7% to 520 kg/hectare due to erratic monsoon rains and anticipated pest-related losses.

Andhra Pradesh and Telangana to lead in cotton production growth in CS 2017-18

State	Sown area (in '000 hectare)	Yield (kg/hectare)	Production (in '000 tonne)
Maharashtra	4,213 (~10.5% increase)	368 (7% decrease)	1,550 (~3% increase)
Gujarat	2,658 (11% increase)	645(4% decrease)	1,714 (6% increase)
Andhra Pradesh and Telangana	2,802 (49% increase)	408 (6% decrease)	1,144 (39% increase)

The above states together account for ~75% of overall cotton acreage

Media contacts
Saman Khan

Media Relations

CRISIL Limited

D: +91 22 3342 3895

M: +91 95940 60612

B: +91 22 3342 3000

saman.khan@crisil.com

Khushboo Bhadani

Media Relations

CRISIL Limited

D: +91 22 3342 1812

M: +91 72081 85374

B: +91 22 3342 3000

khushboo.bhadani@crisil.com

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