

COVID-19 - Impact Analysis

Indian apparels sector faces turbulence amidst the demand-supply shock



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Indian apparels sector witnesses turbulence

Indian apparel market ~US\$ 75-80 bn (2018-19)

Domestic apparel market
~US\$ 60-65 bn. (~80%)

Exports
~US\$ 16-17 bn. (~20%)

Exhibit 1: Domestic Apparel Market

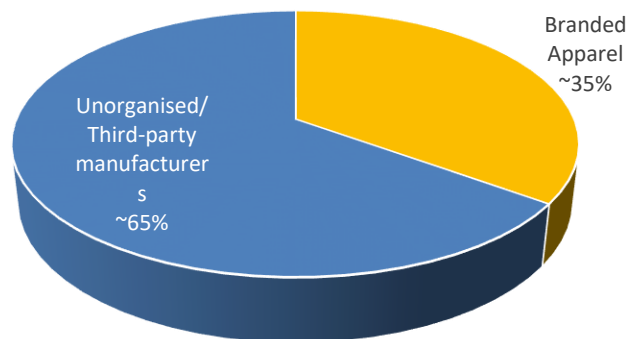
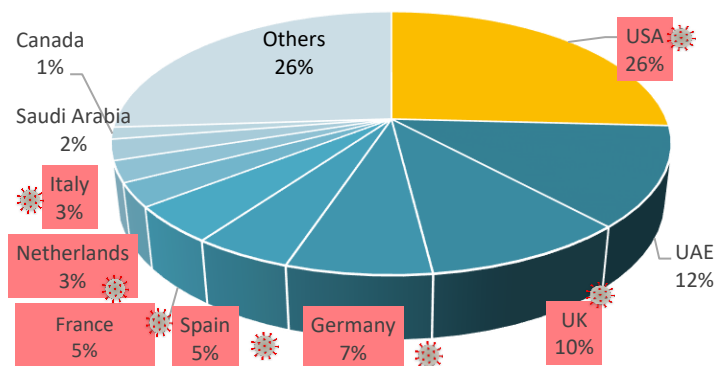


Exhibit 2: India's Apparel Exports - Key Markets



Being sensitive to consumer discretionary spending and supply chain disruptions, the Indian apparel sector's performance is expected to be adversely affected by the rapid spread of the Covid-19 pandemic across countries, including India.

The domestic apparel market is estimated to be ~US\$75-80 bn, with ~80% being focused on the domestic market and the balance ~20% based on exports. With the 21-day domestic lockdown announced by the Government of India from March 25, 2020 onwards to combat the spread of the virus, domestic apparel sales have come to a complete halt. Further, seven of India's top apparel export destinations (refer Exhibit 2) which account for nearly half of India's total apparel exports, are among the worst-affected regions globally. With most of these regions also resorting to lockdowns and social distancing, export demand for apparels has also fallen significantly. There are reports of international buyers deferring shipments and cancelling orders, till further notice. As a result, the domestic apparel sector is witnessing significant turbulence and the ongoing Spring-Summer Season 2020 (which typically ends in August) is likely to suffer a major setback.

On the supply side as well, social distancing and lockdowns have disrupted production in recent weeks, given the non-essential and labour-intensive nature of operations. This apart, logistical issues are now affecting shipment of material ready for dispatch. While the lockdown in India has just started, some pockets saw supply-chain disruptions in the past few weeks as well, because of the shutdowns in China. While India is an export surplus apparel economy, it remains dependent on imports of some inputs from China such as manmade fibre-based fabrics and trims and accessories.

With the 21-day domestic lockdown, and with seven of India's top export destinations (accounting for nearly half of India's apparel exports) being among the worst-affected regions globally, the domestic apparel sector is witnessing significant turbulence

Sector witnessing a demand-supply shock

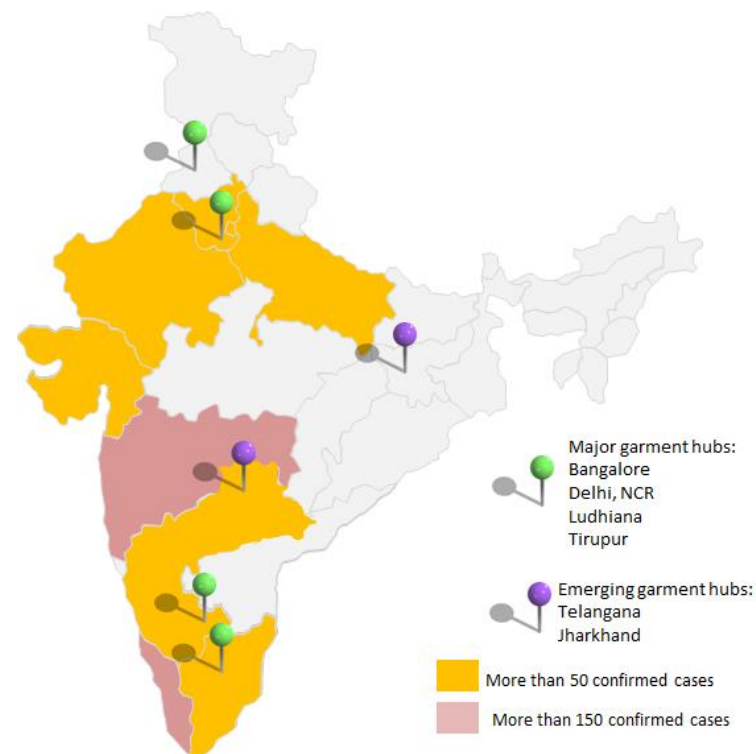
The immediate impact aside, even after the spread of the virus is contained and the recovery begins, ICRA expects a more prolonged impact on the sector. On the demand side, consumer skepticism to visit crowded places initially could keep footfalls subdued in offline retail, even after the lockdown ends. Also, overall pressure on corporate performance, which could trigger further job losses and pay cuts across sectors, as well as the overall stress in the economy is likely to affect buying power, which would affect discretionary consumer spending in the near term, resulting in deferment of purchases, affecting demand for apparels, besides increasing possibility of downtrading.

Similar to consumer-side concerns, worker skepticism to return to jobs could play out on the supply side. Moreover, disintegration of labour, particularly the unskilled and contractual labour, who have started moving from production hubs to their hometowns and villages, could result in a prolonged disruption on the supply side, even after the operations resume. This apart, liquidity issues at the manufacturer level are likely to crop up which could affect the manufacturers' ability to ramp up production for the subsequent seasons. Further, for an effective pick-up, the recovery will have to be broad-based across countries, from demand as well as the supply perspective, given the trade linkages.

Exhibit 3: Impact Matrix – Indian Apparel Sector

	Demand	Supply
Immediate	<ul style="list-style-type: none"> Lockdowns and social distancing, impacting domestic as well as major export markets International buyers deferring shipments/ cancelling orders, till further notice 	<ul style="list-style-type: none"> Lockdowns and social distancing, disrupting production, given the labour- intensive nature of operations Logistical issues affecting shipping of ready materials China shutdowns created supply-chain disruptions, affecting production in past few weeks also
Later	<ul style="list-style-type: none"> Consumer skepticism to keep footfalls subdued in offline retail, even after the lockdown ends Job losses/ pay cuts, as announced by several corporates, besides overall stress in the economy, to adversely affect discretionary consumer spending 	<ul style="list-style-type: none"> Worker skepticism, labour disintegration, liquidity issues of entities to affect ability to ramp up production for subsequent seasons Recovery crucial in international supplying regions as well, to address supply chain disruptions

Exhibit 4: India Apparel Manufacturing Hubs and Covid-19 Map



Source: ICRA research; Note: Map is for illustrative purpose only and may not reflect exact position as on date; cases include deaths/ cured/ discharged etc.

Credit impact expected to be Negative

Impact on Profit & Loss Account: ICRA expects revenues of domestic apparel players to fall by ~10-15% across the sector in FY2021. Although companies are likely to undertake some cost rationalisation measures such as employee base optimisation, rental renegotiations and promotional budget cuts, ICRA expects operating leverage, renegotiation of contracts with customers/ discounted sales to clear inventory backlog and bad debts, to shrink their profit margins (refer Exhibits 8 and 10).

Impact on working capital intensity and liquidity: Receivable turnover period and bad debts are likely to expand, for third-party manufacturers and exporters. Inventory pile-ups are likely with retailers as well as third-party manufacturers, because of market lockdowns. Additionally, order cancellations and prolonged impact of Covid-19 beyond the running season could result in inventory obsolescence, necessitating write-offs and discounted sales.

Most of the work-in-process and finished goods inventories with the domestic players at present would be for the Spring-Summer Season 2020, which typically runs from Jan/ Feb to July/ August, varying across locations. While domestic retailers typically have about ~2.5-3 months of finished goods inventory and about two to three weeks of work-in-process inventory in March every year, apparel exporters have about a month of raw material and work-in-process inventory each and ~2-3 weeks of finished goods (Exhibits 5 and 6). With sales halted, companies face the threat of inventory obsolescence risk for their finished goods and part of the work-in-process inventory. While the companies are negotiating with the customers on a likely delivery schedule and not all orders are likely to get affected, the extent of the impact will depend on the developments on the Covid-19 front, and its economic impact on the companies across regions.

Having said that, these factors are likely to add to liquidity pressures for companies in the near term. As a result, the cushion in drawing power and working capital limits is going to be crucial. Because of the liquidity pressures in the near term, apparel entities are expected to rely on increased borrowings to tide over immediate liquidity pressures. Together with pressure on revenues and profits, these are likely to translate into moderation in debt coverage metrics (refer Exhibits 9 and 11).

Exhibit 5: March Inventory for Domestic Retailers

	Days to Store*	In Store, by	Season**	Typical Inventory, in days
Raw material	105-130	Jul-Aug'2020	AW-20	~20-25
Work in process	40-60	May'2020	SS-20	~15-20
Finished goods	7-15	Apr'2020	AW-19, SS-20	~75-90

Exhibit 6: March Inventory for Apparel Exporters

	Days to Store*	In Store, by	Season**	Typical Inventory, in days
Raw material	120-180	Jul-Sep'2020	AW-20	~25-30
Work in process	60-90	May-Jun'2020	SS-20	~30-35
Finished goods	40-50	May'2020	SS-20	~15-20

* Estimated number of days it takes from a particular inventory stage to reach a Retail Store. For instance, it is estimated to take ~105-130 days for raw material inventory to get processed and reach a retail store, for a domestic retailer; and about ~120-180 days for raw material inventory with an apparel exporter to reach an international client's retail store

** SS: Spring-Summer; AW: Autumn-Winter collections

Source: ICRA research

In this context, RBI announced a relief package on March 27, 2020 to ensure continuity of viable businesses. Besides others, these included allowing lenders to extend three-month moratorium on payment of term loan instalments and interest on working capital to entities, and recalculate drawing power by reducing the margins and/or by reassessing the working capital cycle. These are likely to provide some much-needed cushion to the companies. These steps will also give some time to companies to plan and react to the recent developments as well as recover from the immediate impact.

Overall, we expect the immediate impact of Covid-19 to be Negative. The timing and the extent of the recovery are uncertain as of now and will remain a key monitorable for the sector.

Financial Outlook for ICRA's sample of companies in the apparels sector

Apparel exporters: Amid shrinkage of profit margins and stretched operating cycles, dependence on debt is expected to increase and coverage metrics are likely to correct

Exhibit 8: Projected revenues and profitability for ICRA's sample of apparel exporters

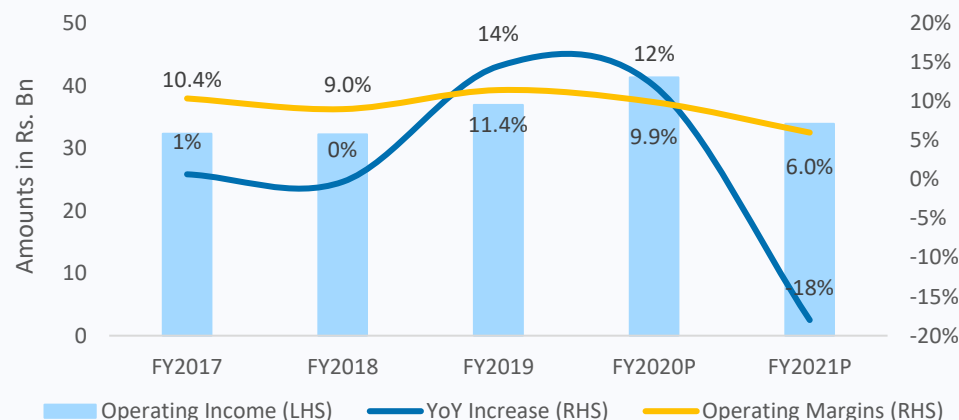
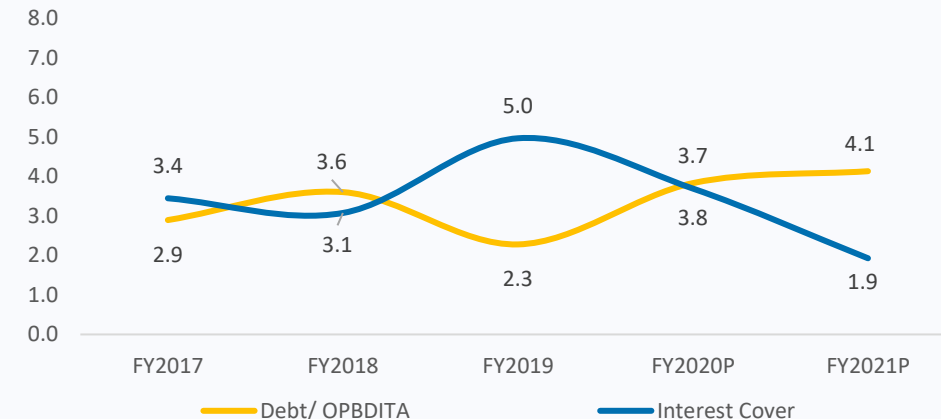


Exhibit 9: Projected debt-metrics for ICRA's sample of apparel exporters



Domestic branded retailers: Similar to exporters, coverage metrics for domestic apparel retailers are likely to be at multi-year lows, amid de-growth and profitability pressures

Exhibit 10: Projected revenues and profitability for ICRA's sample of branded apparel retailers

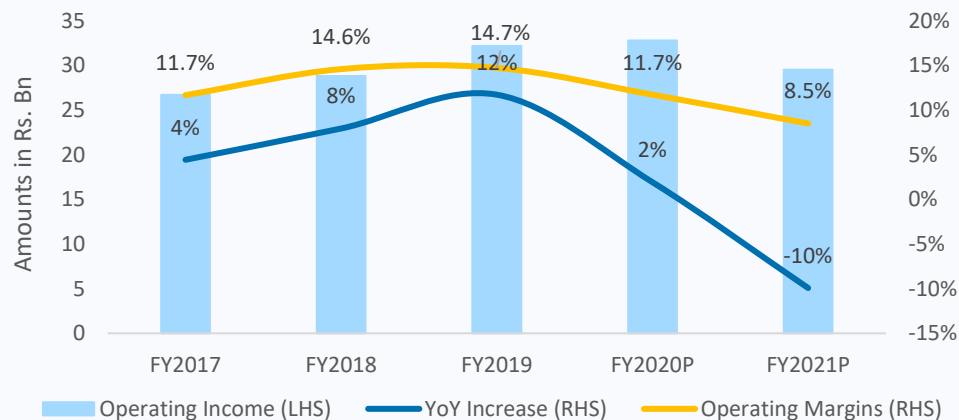
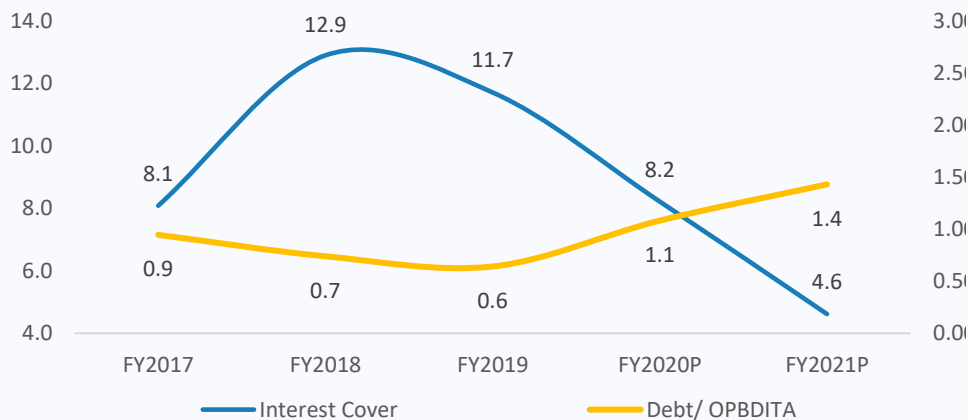


Exhibit 11: Projected debt-metrics for ICRA's sample of branded apparel retailers



Source: ICRA research, Ace Equity database, Financial statements of companies

Note: ICRA's sample for apparel exporters and domestic branded retailers comprises five large, listed companies each

Factors that could cushion the impact

ICRA notes that operations of apparel entities are primarily working capital intensive and typically require low fixed capital investments. Accordingly, reliance of these entities on term borrowings is generally seen to be lower, which provides some cushion on their balance sheet to absorb the impact.

Additionally, there are some factors which could cushion the impact on the apparel entities. Most of the established branded apparel retailers in India have a healthy capital structure, given the strong private equity funding received in the past. Further, even though the impact is likely to be a prolonged one with recovery likely to happen gradually over several months starting Q2 FY2020 onwards, pent up demand which supports a faster-than-expected recovery, cannot be ruled out. For exporters, these could also include an established customer base with healthy credit profiles, who may continue to honour their contractual commitments. Further, companies having insured receivables, lower inventory turnover period and limited reliance on debt would fare better.

Accordingly, ICRA expects the impact to vary across companies, depending on several factors such as balance sheet strength, liquidity and financial flexibility, which would warrant a case-by-case assessment. This is corroborated from the sample assessment undertaken by ICRA on a few large, listed apparel entities (Exhibits 8 to 11). Considering relatively strong profitability and healthy capital structure of these companies, their coverage metrics are expected to remain adequate despite the virus outbreak. Nevertheless, it is pertinent to note that even for the companies in the sample, debt coverage metrics are likely to touch multi-year lows in FY2021.

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

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The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The participation of Moody's is supported by a Technical Services Agreement, which entails Moody's providing certain high-value technical services to ICRA. Specifically, the agreement is aimed at benefiting ICRA's in-house research capabilities, and providing it with access to Moody's global research base. The agreement also envisages Moody's conducting regular training and business seminars for ICRA analysts on various subjects to help them better understand and manage concepts and issues relating to the development of the capital markets in India. Besides this formal training programme, the agreement provides for Moody's advising ICRA on Rating-products strategy, and the Ratings business in general.

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- Assist the regulators in promoting transparency in the financial markets;
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