APPAREL AND FABRIC INDUSTRY

India's apparel exporters struggle to break through multiple barriers, even as exports appear to have bottomed out

FEB 2019

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LIST OF ABBREVIATIONS

CP TPP: Comprehensive and Progressive Agreement for Trans-Pacific Partnership; A free trade agreement between 11 nations including Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam.

CAGR: Compounded Annual Growth Rate

CY: Calendar Year; refers to the twelve-month period starting from January 1 and ending with December 31

EU: European Union

EVFTA: EU-Vietnam Free Trade Agreement

FY: Financial Year

GSP: Generalised Scheme of Preferences; the scheme allows vulnerable developing countries to pay fewer or no duties on exports to the EU, with the objective of giving them vital access to the EU market and contributing to their growth.

GST: Goods and Services Tax

H1: First half of a year (Calendar or Financial)

MMF: Man-made Fiber

Q1/Q2/Q3/Q4: Quarter of a Year (Calendar or Financial)

UAE: United Arab Emirates

US: United States of America

WTO: World Trade Organisation

YoY: Year on Year

Executive Summary

HIGHLIGHTS: Apparel Manufacturing Sector

Global Apparel Trade:

The global apparel trade expanded for the second consecutive year in CY2018 with YoY growth of ~3%, following a 2% growth in CY2017 in US$ terms and contractions reported earlier in CY2015 and CY2016. However, given the decline in two out of the last five years, the trade value in CY2018 stood only ~2% higher than the level seen in CY2013. The positive trend during the last two years has been led by the strong recovery in apparel imports by the EU, which accounts for two-fifth of the global apparel trade (including the trade within EU) and reported a growth of 5.8% and 3.9% in apparel imports in CY2018 and CY2017 respectively, following a muted growth of 1.9% in CY2016. Unlike the EU, apparel imports by the US remain muted with a 2% growth in CY2018, though the trend has improved during the past two years.

China – the world's largest apparel manufacturer and exporter, has been challenged by rising production costs in recent years. As a result, its apparel exports are now considerably lower than the peak level witnessed in CY2014. Although China managed to arrest the pace of decline in its apparel exports in CY2018, expanding global apparel trade resulted in a continued decline in its market share. Bangladesh and Vietnam remain the key gainers of the market released by China. Bangladesh's growth continues to be supported by the availability of low cost labour and competitive advantage in the form of lower import duties provided by some of the world's largest apparel importing countries. Bangladesh has been the key beneficiary of China's declining share in the EU. Vietnam, the third largest apparel exporter, on the other hand, has maintained growth in its stronghold market of the US. While Bangladesh hasn't been able to grow in Vietnam's key target market i.e. the US in the last few years, Vietnam continues to grow at a healthy pace in Bangladesh's key target market of EU also. In this context, signing of the proposed EU-Vietnam Free Trade Agreement (EVFTA) and full enforcement of the Comprehensive and Progressive Trans Pacific Partnership (CP TPP) would further strengthen Vietnam's positioning in the global apparel trade.

India's apparel exports:

After a double-digit de-growth for four consecutive quarters, India's apparel exports stabilised during Q3 FY2019, reporting a 14% YoY growth to US$ 3.6 billion. The growth is, however, mainly explained by a low base effect considering that India had reported a ~19% YoY decline in apparel exports during Q3 FY2018 following a downward revision in export incentives after the transition to the GST regime. Thus, even after a recovery, India's apparel exports in Q3 FY2019 remained lower than the average quarterly exports during the past five years. Further, FY2019 is expected to be the fourth consecutive weak year for India's apparel exports with a ~4-5% de-growth (vis-a-vis 6.5% de-growth in 10M FY2019) , following the 4% de-growth in FY2018 and modest growth rates of 1% and 3% in FY2016 and FY2017 respectively.

Besides intense competitive pressures from nations having a cost advantage over India and an inexplicable decline in exports to the UAE, concerns arising from the US's allegations against certain export subsidy schemes in India, seem to be constraining the overall momentum of the apparel export sector of India. Going forward, steps taken by the Government to address these concerns, besides impending developments in the international trade including the CP TPP and the EU-Vietnam FTA, remain crucial for the sector participants. Moreover, the movement in Indian currency vis-à-vis currencies of competing nations too will determine the relative competitiveness of the Indian players. This is particularly critical considering the cost advantages in terms of lower labor and financing cost that some of these nations enjoy. Nevertheless, ICRA notes that the Government's accommodative stance of reversing the reduction in export incentives has provided some interim relief to the apparel exporters.

HIGHLIGHTS: Apparel Manufacturing Sector

Financial performance of Indian apparel manufacturers:

Domestic-focused as well as exporters: ICRA's sample comprising 13 large, listed, garment-manufacturing companies grew by 13% (YoY) in Q3 FY2019, following the similar average growth rate during the previous four quarters. ICRA believes that presence in the niche and value-added product segments, together with access to an established client base has helped export-based companies to maintain revenue growth, despite the increasing competitive pressures from peer nations. This, together with a revival in domestic demand, post transitory pressures of demonetisation and GST, particularly in metros and tier-I markets where the larger listed players are predominantly present, translated into a healthy growth for ICRA's sample during the current financial year.

Besides, favourable currency movement and healthy growth in revenues facilitated an improvement in margins in the recent quarters, given the operating leverage inherent in the operations. Thus, despite higher raw material prices, the operating margins averaged ~14% in the past six quarters, compared to aggregate operating margins of 9-12% during the five-quarter period ending June 2017. Supported by better margins, the aggregate interest cover for ICRA's sample also improved, averaging ~5.7 times in 9M FY2019 vis-a-vis ~5.0 times in 9M FY2018.

Outlook:

Domestic-market: A large population base, rising disposable incomes, and increasing share of organised retail present significant growth opportunities for the domestic garmenting and retailing industry in the long term. However, the extent of growth for the domestic companies will be partly determined by their competitiveness vis-a-vis the international suppliers and the level of imports in the country. Although on a low base, apparel imports have risen by more than 50% in the current year, highlighting a potential threat to the domestic industry. However, large garment manufactures would continue to benefit from the economies of scale in a fragmented industry, which would also enable them to cater to the organised apparel sector, resulting in better realisations. Also, strong apparel brands would be in a better position to achieve growth in a fragmented industry and command premium pricing.

Export-market: While India has a large fibre base, the share of Indian garment exports has remained low at 3-4% in the global apparel trade. Going forward, steps taken by the Government of India to address the concerns on the continuance of export subsidy schemes, will remain crucial for the Indian apparel exporters to capitalise on revived global apparel trade and loss of market share by China. Besides, the full implementation of the CP TPP as well as developments on the EVFTA will remain key determinants of the opportunities likely to be available to the Indian apparel exporters in the global market. Also, competitiveness of the Indian apparel exporters will remain contingent upon the movement in foreign exchange rates. Nonetheless, benefits under the Central schemes as well as several state textile policies, relaxed labour norms, and sharing of the Employee Provident Fund (EPF) burden as introduced under the textile policy, augur well for the competitiveness of the Indian apparel exporters.

HIGHLIGHTS: Fabric Sector

Trend in fabric production:

Fabric production in India increased by ~4% YoY to 51.9 billion sq. mtrs in 9M FY2019. Even though the growth appears moderated vis-a-vis 5% growth reported in FY2018, this is better than the average ~2% growth reported during the past decade. There is a possibility that the growth during FY2018 and 9M FY2019 has been partly driven by improved reporting by the unorganised segment post GST implementation. Besides, the growth has also been supported by revival in domestic demand in the downstream segments.

The growth in some of the recent years had been constrained by multiple headwinds. Besides demand-side pressures arising from subdued exports of apparels and fabrics, the sector experienced challenges owing to demonetisation as well as transition to the GST regime. The headwinds faced by the weaving segment were particularly strong, as the segment is highly fragmented and consists primarily of the unorganised segment. ICRA notes that the structural challenges for the Indian fabric industry remain, including very high fragmentation and lack of modernisation. Thus, the sustainability of the recent trend remains to be seen.

Fabric exports and imports:

The Indian fabric industry continues to cater primarily to the domestic requirements with fabric exports (excluding the supplies to apparel exporters) accounting for only ~6% of the domestic production as against a much higher proportion of exports in other segments of the textile value chain like cotton yarn and apparels. Large domestic requirements, limited growth in production levels and low share of high-quality fabric, given the fragmented nature of the industry and old vintage of the machinery, explain the continued low share of fabric exports from India. Nevertheless, despite the low share of fabric exports with respect to production, the share of the fabric segment in India's total textile exports continues to be higher at ~12%.

Similar to exports, India's fabric imports also account for only 2% of the domestic production. Nevertheless, the industry has been challenged by a spurt in fabric imports post the transition to the GST regime. The imports of cotton-based and man-made-fibre based woven fabric stood higher by 27% and 34% respectively during FY2018. While the government has thereafter taken a corrective measure, whereby import duty on key types of fabrics was doubled to 20% in August 2018, fabric imports continue to increase at a high rate. The pace of growth, however, moderated to ~15% YoY between September and December 2018 vis-a-vis 49% YoY growth between April and August 2018.

HIGHLIGHTS: Fabric Sector

Financial performance:

In contrast to the industry production trends, the aggregate performance of 12 large fabric manufacturers in ICRA's sample has remained weak during the past nine quarters. The pressures on performance started with the demonetisation drive in Q3 FY2017 and intensified during the transition to the GST regime. Thereafter, while the overall fabric production in the country is reported to have grown at a healthy pace, the growth in aggregate revenues of ICRA's sample remained tepid. In fact, the aggregate revenues in Q3 FY2019 remained close to the five-year average quarterly revenues, despite raw material prices being significantly higher. Hence, the implied sales volumes of ICRA's sample in 9M FY2019 are estimated to have remained lower than the five-year average.

The weakness in sales coupled with high cotton yarn prices over the past four quarters has brought the profitability of fabric manufacturers under pressure. As a result, the aggregate operating margins of ICRA's sample declined to 8.0% in Q2 FY2019 and further to 7.6% in Q3 FY2019, compared to the level of 11-12% during the pre-demonetisation period.

Even though doubts on the production metrics reported by the sector remain, possibility of an inventory build-up cannot be ruled out given the significant gap between industry-wide production trajectory and implied trend in sale volumes of ICRA's sample. This could have in turn increased the dependence upon debt, in turn explaining the movement in interest cover, which declined to 2 times in 9M FY2019 from 2.4 times in FY2018.

Outlook:

Fabric Sector: Notwithstanding the multiple challenges faced by the Indian weaving industry in the recent past, the growth in fabric demand and hence production over the long term is expected to remain steady. This is expected to be driven by growth in the end-user industries of apparels and home textiles, which in turn would stand to benefit from India's large population base, rising disposable incomes, increasing share of organised retail and also the export opportunities. Within the highly fragmented weaving sector, the players in the organised segments are likely to outperform the overall growth in the sector. For the unorganised segment, the small scale and obsolescence of the machinery remain the primary constraining factors which have impacted the productivity of the sector and quality of the fabric manufactured. Modernisation and increase in the scale of operations would be critical to improve productivity, quality and cost competitiveness of the domestic fabric, which, besides improving the direct fabric export opportunities, would also improve the availability of quality fabric at competitive prices for the domestic consuming industries and help them increase their share in global exports.

ICRA

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.

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