ICRA

Indian Tile Sector

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Challenges remain on domestic tile demand, albeit buoyancy in exports and limited capacity addition to support margins in FY2020

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HIGHLIGHTS – KEY INDUSTRY UPDATES

India continues to be the second largest tiles producer and consumer in the world

Global consumption of tiles stood at 13270 million square metre (msm) in CY2017, which grew at a CAGR of ~4% over CY2012-CY2017. India continues to be the second largest producer and consumer of tiles in the world after China. India's production volumes grew at a CAGR of ~9% over 2012 – 2017, from 691 msm in CY2012 to 1080 msm in CY2017. On the other hand, the consumption growth of India over the years has remained subdued, which grew at a CAGR of ~4% from 681 msm in CY2012 to 760 msm in CY2017. The increasing gap between production and consumption has been largely neutralised by rising exports and consequently falling imports. The export volumes grew at a robust CAGR of ~47% from 33 msm in CY2012 to 186 msm in CY2017, thereby pushing India to the position of the fourth largest exporting nation from the eleventh in CY2011.

Domestic tile industry grew at a CAGR of ~11% over FY2008-FY2018

The domestic industry size was estimated at around Rs. 28000 crore for FY2018, with the share of organised and unorganised players (majority of them based out of Morbi cluster) at ~50% each. The Morbi cluster in Gujarat is the largest tiles manufacturing zone in India, accounting for ~75-80% of India's tiles and sanitary-ware products in volume terms, with more than 800 tile factories in the region. The industry is further classified into two broad product segments - ceramic tiles and vitrified tiles, the share of which was 41% and 59% respectively. The overall competitive intensity for the industry remains high because of the fragmented industry structure with a large number of unorganised players, resulting from low entry barriers with respect to easy access to the latest technology and moderate regulatory requirements. Further, the domestic tiles industry had been significantly affected by cheaper Chinese imports with ~15-20% price differential. Imports from China peaked in FY2016; however, with the levy of anti-dumping duty (ADD) by the Government in the year 2015, the price differential contracted, resulting in a decline in imports from China.

Slowdown in domestic real estate sector impacted industry growth in the last two fiscals

The Indian tiles industry grew at a CAGR of ~11% in the last 10 years period over FY2008-FY2018, with an increase in real estate construction activity and overall infrastructure development, in line with the rising urbanisation. However, industry growth slowed down in the last two to three years, primarily due to a slowdown in real estate, its key consuming sector. The domestic demand has been impacted further in FY2018 and FY2019, with the implementation of the Goods and Services Tax (GST) and the Real Estate Regulation and Development Act (RERA), which resulted in a significant drop in new launches in residential real estate for the period. In volume terms, domestic consumption declined by ~3% from 785 msm in CY2016 to 760 msm in CY2017, while in CY2018 it is estimated to remain almost flat on a YoY basis. Despite poor housing demand, the industry managed to arrest any significant downturn, because of the rising exports, replacement demand and spending by government on infrastructure under various schemes. The revenues of the tile players were also affected due to a decline in sales realisations, especially in the vitrified tile segment, owing to large capacity additions in the recent past and muted domestic demand. Nevertheless, the industry players are now cautious and going slow on new capacity addition. As per Morbi Tile Association, the number of upcoming units in the region are down to ~20-25 in FY2020 as compared to ~120 units in FY2017-FY2018.

Exports continued to grow at a healthy rate

In value terms tile exports grew at a CAGR of 42% from Rs. 158 crore in FY2008 to Rs. 7544 crore in FY2019 on account of increased competitiveness due to large investments in technology upgradation by domestic tile players and imposition of anti-dumping duty on Chinese imports by some European countries and North and South American countries. India exports to more than 150 countries, with the Middle East being the key export market for Indian tile manufacturers. In the recent years exports to the Middle East countries, European countries, Africa and the North and South America has increased at a robust rate. The top 10 export destinations accounted for 56% of the total exports. Among top export destinations, the share of Saudi Arabia was the highest at 17% in FY2019, followed by the UAE at 7% and Mexico at 6%.

Anti-dumping duty of Gulf Cooperation Council may impact the export volumes, profitability

The Gulf Cooperation Council initiated an anti-dumping investigation on imports of ceramic tiles from China, India and Spain on November 05, 2018, which is still ongoing. The investigation followed complaints received from the local ceramic players in the Gulf nations who cited severe pricing pressure and market share loss due to cheaper imports. India, under its foreign trade policy, provides incentives to tiles exporters – 3% under the Merchandise Exports from the India Scheme (MEIS) and 2% duty drawback under the Export Promotion Capital Goods (EPCG), which the companies in the Gulf consider to be heavily subsidising the exports. Exports to the GCC countries formed 43% of India's tile exports in FY2018 and 35% in FY2019 in value terms and imposition of anti-dumping duty and/or countervailing duty is expected to impact the volumes as well as margins of domestic ceramic companies. Any dent in export volumes and profitability could lead to diversion of the production to the domestic market, causing a supply glut.

Sustained decline in tile imports over the last three fiscals; recent hike in basic custom duty to further improve industry competitiveness

Till FY2016, the cheaper imports from China was a major threat for the domestic tile industry. Domestic manufacturers paid high custom duty on importing raw material of tiles, while, finished tiles from China had a lower custom duty. This inverted duty structure provided an incentive to import tiles, vis-a vis discouraging local manufacturing, restricting manufacturers and fresh investments. In 2015, India levied anti-dumping duty (ADD) of US$1.87/sqm on imports of tiles, thereby boosting the competitiveness of the Indian manufacturers. From FY2008 there was a sustained increase in imports and it peaked at Rs. 1438 core in FY2016, wherein the contribution of Chinese imports was at 85%. However, the total imports declined significantly by ~77% to Rs. 334 crore in FY2019 from its peak level, post the imposition of anti-dumping duty on Chinese imports. The imports from China fell from Rs. 1226 crore in FY2016 to Rs. 227 crore in FY2018 and Rs. 136 crore in FY2019, with the share of Chinese imports out of overall imports falling from 54% to 40% in FY2018 and FY2019 respectively. Moreover, the basic custom duty was hiked from 10% to 15% in the 2019 Budget, which will further improve the competitiveness of the domestic tile industry.

Brand building, distribution network primary focus

Major players have, over the years invested in brand establishment, expanding the distribution network and on research and development. Strong brand equity has helped the players increase their presence in the retail segment, which in turn keeps them immune from any project-specific risk. Leading tile companies like Kajaria Ceramics Limited, H & R Johnson (India), Somany Ceramics Limited and Asian Granito India Limited had expanded organically by entering into joint ventures or outsourcing their requirements to smaller unorganised players. However, in the recent past Kajaria and Somany have divested their stake from some of the JVs/subsidiaries and focused on improving their own capacity utilisation to support the cost structure amid muted demand conditions.

Profitability susceptible to fluctuation in raw material prices and fuel cost

Raw material and power & fuel costs are key cost determinants for a tile manufacturing company forming ~40%-50% and ~15%-20% respectively of the total operating income of a typical tile player. With limited control over the input costs, a company's ability to pass on any adverse movement in prices to its customers remains important, considering the heightened competitive pressures. The industry has, in the past, witnessed a turmoil in the wake of the rising cost of natural gas, which led the players to shift from natural gas to gasification plants, which burn coal to generate producer gas. Piped Natural Gas (PNG) prices witnessed an uptrend, in line with the increase in international LNG prices and rupee depreciation, with the prices having increased from Rs. 24-25/scm in December 2017 to reaching a peak of Rs. 41/scm in H2 FY2019. The rising fuel costs, in the light of heightened competitive pressures and subdued domestic demand, were detrimental to the profitability of the companies operating on natural gas in FY2018 and FY2019. With the softening of international LNG prices, the prices have lowered again, although they continue to remain high, and are currently at ~Rs. 35/scm.

Shift to natural gas to impact working capital cycle and profitability of players operating on coal-based gasifiers, albeit the latter may be protected by the upward revision in prices

In March 2019, the National Green Tribunal passed an order for immediate shutdown of the captive coal gasifier plants in the Morbi region, citing environmental concerns. The Morbi cluster in Gujarat is the largest tiles manufacturing zone in India and accounts for ~75-80% of India's tiles and sanitaryware products in volume terms, with more than 800 tile factories in the region. Almost 450-500 units of the total units were impacted as their operations were largely dependent on coal gasifiers. Among these units, those most affected were the wall tile and soluble salt tile manufacturers as they were meeting nearly their entire thermal energy requirements through coal gasifiers. ICRA believes that switching to PNG as a fuel source will increase the fuel expenses by 10-15%. The extent of the impact remains to be seen as industrywide upward price revision across product categories by 10%-20 in April 2019 may protect the profitability to an extent. The price hike may even augur positively in the near term for the profitability of the players already operating on natural gas. The contention, though, remains on the sustenance of such an industrywide hike, given the surplus capacity in the industry. Moreover, the shift is anticipated to impact the working capital cycle of the affected players, given the contraction of credit period extended by the suppliers from 30-45 days credit extended by coal suppliers to the current 15 days by PNG suppliers. The resultant additional burden may exert pressure on the liquidity of affected players, given the working capital-intensive nature of the industry.

GST implementation to augur well in the longer run

The implementation of GST/E-way bill and the recent shift from the coal gasifier to natural gas has increased the compliance for the unorganised players, which may augur positively for the organised players in the industry. With the removal of inter-state barriers and the improvement in the supply chain the price differential between organised and unorganised players is expected to lower, thereby resulting in increased market share of organised players. In the pre-GST regime the manufacturers were subject to ~27% indirect taxes. In July 2017, tiles were classified as luxury goods and thus were subject to a GST rate of 28%, the rate was subsequently lowered in November 2017 to 18% which has been beneficial for the industry.

Credit Outlook- Stable

The outlook on Indian tile industry is stable. While continued slowdown in the real estate sector due to subdued consumer sentiment will keep the domestic tile demand tepid over the next three to four quarters, however in the medium to longer run, the expected recovery in the residential real estate sector, replacement demand, rising exports and increasing budgetary allocation for various Government initiatives like Housing for All and the Smart Cities project are likely to support the volumes and industry growth. Exports grew by ~20-25% in last two fiscals and the growth momentum is likely to continue in FY2020 as well, owing to improved competitiveness of Indian tile players following large investments in technology upgradation and imposition of ADD on China by some importing countries. ICRA notes that the exports to the GCC countries formed ~35-40% of India's ceramic exports in the last two fiscals in value terms and any imposition of anti-dumping duty on tile imports from India may adversely impact the export volumes as well as margins of domestic tile players and is a key credit monitorable.

The large capacity addition over FY2016-FY2018 along with muted demand, intensified the price based competition in the industry leading to a dip in sales realisations. Further, the upward movement in input cost - gas prices and limited flexibility to pass on increase in the cost due to stiff competition, resulted in decline in profit margins of the tile players in FY2019. The industry players are now cautious and going slow on new capacity additions. The number of upcoming units in the Morbi cluster are down to ~20-25 in FY2020 as compared to ~130 units in FY2017-FY2018. ICRA believes that the industry-wide upward price revision in Q1FY2020 across product categories by 10%-20% to counter the increase in fuel expenses and limited capacity additions, will improve the overall sales realisations. This, coupled with the cost optimisation measures undertaken by the players and softening of gas prices in the recent past, is expected to support the margins in FY2020. Moreover, absence of any major capex plans and steady working capital cycle should result in lower debt levels and support the debt protection metrics as well on YoY basis. Nevertheless, any sustained increase in gas prices and/or imposition of anti-dumping duty by GCC countries on tile imports from India may adversely impact the profit margins and thereby the credit metrics of the industry players.

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