ICRA

APPAREL AND FABRIC INDUSTRY

Threats loom for India's apparel exporters, even as growth in exports moves back to positive zone after two years

SEP 2019

Jayanta Roy
+91 33 7150 1100
jayanta@icraindia.com

Nidhi Marwaha
+91 124 4545 337
nidhim@icraindia.com

Annu Mendiratta
+91 124 4545 887
annu.mendiratta@icraindia.com

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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

FTA: 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 certain countries extending such benefits.

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)

RECP: Regional Comprehensive Economic Partnership; A proposed FTA between the ten member states of the Association of Southeast Asian Nations (ASEAN) (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam) and its six FTA partners (China, Japan, India, South Korea, Australia and New Zealand).

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 continued to expand in H1 CY2019, though the pace of growth moderated to ~2% YoY in US$ terms (compared to 6% YoY growth in CY2018) amid decline in imports by the European Union (EU, including UK), even as growth in apparel imports by the US picked up further.

Based on trends being witnessed, CY2019 is likely to be the third consecutive year of growth in the global apparel trade, after a 4% and 6% YoY growth reported in CY2017 and CY2018 respectively, as against a 5% and 2% YoY contraction reported earlier in CY2015 and CY2016 respectively. With the sequential increase in the global apparel trade in the past two years, the trade value reached an estimated US$ 472 billion in CY2018, crossing the US$ 464 billion level last seen in CY2014 by ~2%.

Recovery in CY2017 and CY2018 had been facilitated by a healthy recovery in demand from the EU, which accounts for two-fifth of the global apparel trade (including the trade within EU), aided by strengthening of the Euro currency from the lows seen in 2015 and 2016. The trend in EU has, however, reversed again during the current year, owing to a slowdown in demand as well as weakening of the currency (Euro depreciated by ~4% against USD in H1 CY2019 vis-à-vis CY2018).

Unlike the EU, apparel imports by the US – which accounts for a one-fifth share in the global apparel trade - grew at a stronger pace of ~6% YoY in H1 CY2019, supporting the overall growth. In CY2018, apparel imports by the US had grown by ~4% in value terms, following the flat imports in CY2017 and a ~6% decline in CY2016.

Trends in China, the leading apparel exporting nation, and other major/emerging suppliers: China, the world's largest apparel manufacturer and exporter, accounting for more than one-third of the global apparel trade, has been challenged by rising production costs because of which its apparel exports are now considerably lower than the peak level seen in CY2014, resulting in a decline in its market share from a peak level of 42% in CY2014 to 34% in CY2018. China has been shedding market share in both the US and the EU, with a more significant decline in the EU as the key competing nations are increasingly benefitting from duty-free access there.

Further, contrary to expectations of a decline in China's apparel exports to the US on account of an imposition of additional tariffs amidst ongoing US-China trade tensions, China's apparel exports to the US have grown at a steady pace. This could be partly explained by possible advancement of shipments in anticipation of higher tariffs. Further, there are exit barriers for large buyers in terms of compliance requirements as well as establishing a reliable supplier base for large quantities, which would have also prevented a sudden decline. Nevertheless, more clarity will emerge post release of trade data for Q4 CY2019, as additional tariffs at the rate of 15% have become effective from September 1, 2019 (raised from 10% imposed in August and in addition to base tariffs which were already applicable), which are estimated to cover more than 90% of China's apparel exports to the US.

Having said that, the growth in China's apparel exports to the US has remained lower than the growth in apparel imports by the US, which has translated into a significant loss of market share for China. Vietnam's apparel exports to the US, on the other hand, grew at a CAGR of 11% between CY2010 and CY2018, resulting in an expansion in its market share from 8% to 15% during the period. Apart from its competitive position owing to low-cost manufacturing, ongoing trade tensions between US and China as well as likely execution of a significant free trade agreement (CPTPP) between 11 nations including Vietnam, augur well for its apparel exports going forward. Further, the signing of the EU-Vietnam FTA (EVFTA) in June 2019 (pending ratification) is expected to support growth of Vietnam's apparel exports to the EU, thereby strengthening its position in the global apparel trade. Bangladesh, in the meanwhile, has been steadily strengthening its position in the EU market supported by a favourable duty structure (market share of 19% in CY2018 vis-a-vis ~8% a decade ago), while maintaining its share in the US imports at ~6%.

India, which used to be the fifth largest apparel exporting nation after China, Bangladesh, Vietnam and Italy till CY2016, slipped one place and now ranks sixth after Germany, in its share in the global apparel trade. While internal developments (such as GST implementation and demonetisation) had a transitory impact in recent years, competition from Vietnam and Bangladesh which enjoy duty-free access to the leading buying nations, besides cost advantages, continues to pose a challenge for India.

HIGHLIGHTS: Apparel Manufacturing Sector

India's apparel exports: After two consecutive years of de-growth by ~4% and ~3% in FY2018 and FY2019 respectively, India's apparel exports have grown by ~4% in 4M FY2020. While exports to the key European markets and the UK declined by ~2-3% YoY in 4M FY2020 in line with the slowdown witnessed in EU's import demand, a healthy growth of ~7% in exports to the US supported the overall exports. Besides, exports to the third largest market, the UAE, declined by ~3% on a YoY basis mainly due to a steep fall in June 2019, after a recovery in the previous two months supported by the low base effect.

Intense competition from nations having a cost advantage over India as well as their access to FTAs continue to constrain the overall momentum of the apparel export sector of India. Besides, continuity of export incentives, in the backdrop of US' allegations against these at the WTO, pose another near-term challenge. In March 2019, the Government of India notified replacement of the existing Rebate of State Levies (ROSL) Scheme with the Scheme for Rebate of State and Central Taxes and Levies (RoSCTL) for export of garments and made-ups. ROSCTL, with a wider scope for rebates, has provided a temporary impetus to profitability of the Indian exporters. The said change was made in line with the Government's intent of streamlining the incentive structure, in compliance with the WTO norms and is to be followed by withdrawal of the existing MEIS Scheme, which is currently available till December 2019. Further in September 2019, the Government of India has announced introduction of a new scheme called Remission of Duties or Taxes on Export Products (RoDTEP), which will be made effective from January 1, 2020 onwards. While the details are still awaited, pending which its impact on profitability of apparel exporters remains uncertain, the Government aims to replace all existing export incentive schemes with this scheme and has assured that the new scheme will more than adequately incentivise exporters than the existing schemes put together. Going forward, steps taken by the Government of India to address the concerns on the continuance of export subsidy schemes and their timeliness will remain crucial for the Indian apparel exporters to maintain their competitiveness in the global trade arena.

Financial performance of Indian apparel manufacturers

Domestic-focused apparel manufacturers: ICRA's sample comprising seven mid-sized, listed, domestic branded apparel retail companies grew at a healthy rate of 12% (YoY) for the second consecutive year in FY2019, following a 14% growth reported in FY2018.

A revival in domestic demand post transitory pressures of demonetisation and GST, translated into a healthy growth for ICRA's sample during the previous two fiscals. Despite higher raw material prices, the operating margins remained almost stable at ~14% in FY2018 and FY2019, after a recovery from the lows reported in FY2016 & FY2017.

During Q1 FY2020, revenues of the sample set grew at a relatively lower pace of ~3% on a YoY basis, as muted consumer sentiment kept demand subdued. However, the operating margins improved to ~13% in Q1 FY2020, compared to ~8% in Q1 FY2019, partly explained by implementation of IndAS 116 on "Leases" from April 1, 2019 onwards, post which companies have reported a decline in rental expenses. Although interest cost also increased resultantly, interest coverage ratio remained adequate at over 2 times.

Export-focused apparel manufacturers: In contrast to an overall decline in India's apparel exports, ICRA's sample, comprising five large, listed, garment-exporting companies reported a healthy growth of 15% (YoY) in revenues during FY2019. Most of these companies focus on the key markets of the US and EU, offer niche and value-add products and have an established client base providing repeat business. As a result, demand remained comfortable, which together with higher realisations amid high cotton prices, is expected to have contributed to their turnover growth during the year, despite increasing competitive pressures from peer nations. Economies of scale together with favorable changes in export incentive structure (increase in MEIS rates and upward revision in duty drawback rates in Dec 2018), post the initial impact after GST implementation, facilitated revival in operating margins from ~9% in FY2018 to ~11.9% in FY2019, similar to the level last seen in FY2015 and FY2016.

The growth remained steady during Q1 FY2020, with the sample reporting a healthy 16% YoY growth during the quarter. However, the operating margins declined to 8.3% from 11.2% in Q4 FY2019 and 8.7% in Q1 FY2019. While the decline from the previous quarter is partly explained by seasonality, given the typically higher sales during Q4, other factors which constrained profitability included possible revision in export realisations for garments amid correction in international cotton prices and competitive pressures, as well as increase in air freight expenses, besides some company specific factors. Having said that, the margins remained better than Q1 FY2017 and Q1 FY2018. Interest coverage ratio for the sample also remained healthy at over 3 times.

HIGHLIGHTS: Fabric Sector

Trend in fabric production: Fabric production in India grew at a healthy pace, with a YoY growth of 11% in Q1 FY2020, after a steady 5% growth for two consecutive years. The growth since FY2018 particularly appears healthy, when seen in conjunction with a CAGR of less than 2% in India's fabric production during the ten year period ended FY2017. ICRA conjectures improved reporting by the unorganised segment post GST implementation as one of the reasons for growth since FY2018, which is also corroborated by the gradual increase in share of decentralised sector in India's fabric production to ~97.5% in Q1 FY2020, vis-a-vis an average of ~96% in the ten year period ended FY2017. Besides, the growth has also been supported by revival in domestic demand in the downstream segments.

Fabric exports and imports: Compared to a YoY growth of 4% in FY2018, cotton-woven fabric exports grew by 10% in FY2019 in US$ terms, while exports of man-made woven fabrics declined by 4% and 5% in FY2018 and FY2019 respectively. 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.

Further, the industry was challenged by a spurt in fabric imports driven by a downward shift in duty structure for fabric imports, post transition to the GST regime in July 2017. The imports of cotton-based woven fabrics as well as man-made fiber based woven fabric stood higher by 27% and 34% during FY2018 and 10% and 37% during FY2019 respectively. The government took a corrective measure, whereby import duty on key types of fabrics was doubled to 20% in August 2018. As a result, the pace of growth in imports of key fabrics (cotton and manmade, which account for majority of India's fabric imports, besides silk, woolen, flax, jute and pile fabrics) moderated to ~14% YoY between September and March 2019 vis-a-vis 49% YoY growth between April and August 2018.

Financial performance of Indian fabric manufacturers: In contrast with industry production trends, the aggregate performance of the six large, listed, fabric manufacturers in ICRA's sample remained unencouraging during FY2019. Although the aggregate revenues of ICRA's sample grew by 7% in FY2019 compared to a 4-5% growth in overall fabric production in the country during the year, it was primarily driven by an increase in realisations. Cotton yarn prices firmed up in FY2019, increasing by ~13% YoY during the year. Considering a corresponding increase in fabric realisations, this translates into an estimated 4-5% decline in sale volumes for the large companies in ICRA's sample. Pressure on volumes and higher raw material prices, resulted in a ~140 bps decline in operating margins of the sample during FY2019.

Thereafter, during Q1 FY2020, the aggregate revenues of ICRA's sample declined by ~7% on a YoY basis, while profitability remained almost stable. Besides rising fabric imports, the slowdown can be partly attributed to increased apparel imports and subdued retail demand for fabrics as well as apparels in the domestic market. Further, 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 is also corroborated from an increase in inventory holding for ICRA's sample from 70-85 days in FY2016 to more than 100 days in FY2018-19. This increased dependence upon debt, in turn explained the decline in interest cover to less than 3 times in FY2019 from more than 3.5 times in FY2016-18.

HIGHLIGHTS: Credit Outlook

Apparel Segment – Exports: While demand from the largest market of EU has remained subdued during the current calendar year, demand from the US has been supporting overall growth in apparel exports from India till date. Having said that, retail trends in US remain unencouraging, which is corroborated by flat retail sales of clothing and clothing accessories during 8MCY2019 vis-a-vis corresponding period last year, following a comfortable growth of ~4.6% during CY2018. Notwithstanding the slowdown in retail sales in the US, the comfortable order book position amid likely stocking by US retailers as well as a possible shift in favour of large Indian exporters owing to the ongoing US-China trade war is providing some support to the turnover growth for the sample. ICRA expects ICRA's sample of five large apparel exporters to grow at a lower pace of ~10% during FY2020, following a healthy 14-16% growth in FY2019 and Q1 FY2020 (translating into an estimated YoY growth of ~8% between Jul'19-Mar'20). Although renegotiation of apparel realisations by key buyers amid slowdown in retail demand and continued competitive pressures from peer nations together with high raw material costs and higher air freight charges are expected to put a pressure on margins, impact is expected to be cushioned by the transitory increase in export incentives. As a result, ICRA expects the sample to report range-bound operating margins vis-a-vis last year.

Further, slowdown in retail sales in the US could translate into an elongated receivable cycle for exporters and increased working capital borrowings. Even though capex towards infrastructure upgradation is expected to be limited, and that too supported by capital subsidy benefits under the ongoing subsidy schemes, ICRA expects a slight correction in sample's capitalisation and coverage metrics owing to a moderation in profitability and higher working capital borrowings. Nevertheless, these are expected to remain comfortable. Smaller companies in the sector, which have limited bargaining power and are reliant on smaller retailers in the US facing performance pressures, are more prone to the slowdown and may face pressures on profitability as well as liquidity, amid renegotiation of prices and payment terms.

Apparel Segment – Domestic: Given the weak consumer sentiment amid current economic slowdown, turnover growth for the domestic branded apparel players is expected to remain muted in the near term. ICRA expects its sample in the domestic apparel category to grow at a subdued pace of ~2-3% in FY2020 following a healthy growth of ~12% in FY2019. This, together with an elongated discounted sales period, IndAS 116 implementation and higher discounts likely to be offered to push sales are expected to result in a correction of ~75-100 bps in operating margins vis-a-vis last year. Although companies continue to invest in capital equipment supported by access to subsidies under the Central as well State subsidy schemes, scale of investment in capacity expansion is expected to be limited in the near term, given the prevailing demand scenario. Further, ICRA expects internal accruals of companies in the sample to be adequate to fund a sizeable proportion of incremental capital investment requirements as well as working capital requirements of the business. Accordingly, leverage is expected to remain low (Debt/OPBDITA less than 1 time) and debt coverage metrics comfortable, despite moderation from current levels.

Fabrics: Muted growth in the domestic retail segment, given the prevailing weak consumer sentiment, is affecting retail demand for fabrics as well as demand from the downstream segment. This is expected to pull down the growth for the fabric segment during the current financial year. As a result, ICRA's sample is expected to report a moderation in growth to an estimated 2-3% vis-a-vis 7% growth reported during FY2019. This, together with continued imports of fabrics, is expected to result in a marginal correction of 25-50 bps in operating margins for the sample during FY2020. Although a stretch in working capital cycle amid pressure in downstream segments could result in increased reliance on working capital borrowings, capex spends and long-term funding requirements in the business are expected to remain limited. As a result, capitalisation and coverage metrics are expected to remain range-bound in the near term. Similar to other segments, smaller players which account for a majority in the sector, may however face relatively higher pressure on profitability and liquidity. It is pertinent to note here that a large proportion of entities in the fragmented fabric sector (excluding home textile players) already have weak credit profiles and fall in the non-investment grade categories. Accordingly, credit outlook for the sector remains stable.

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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ICRA

Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
Tel: +91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: communications@icraindia.com
Tel: +91 124 4545 860

Registered Office:

1105, Kailash Building, 11th Floor,
26, Kasturba Gandhi Marg,
New Delhi - 110 001
Tel: + 91 11 2335 7940-45

Corporate Office:

Building No.8, 2nd Floor,
Tower A, DLF Cyber City Phase II,
Gurgaon- 122 002
Tel: +91 124 4545300

Ahmedabad

1809-1811, Shapath V,
Opposite Karnavati Club
S.G. Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/01

Bengaluru 1

'The Millenia', Tower- B, Unit No. 1004,
10th Floor,1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber,
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre,
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

No. 7-1-58, 301, 3rd Floor, 'CONCOURSE',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Hyderabad 2

4A, 4th Floor, SHOBHAN,
6-3-927, A&B Somajiguda,
Raj Bhavan Road,
Hyderabad – 500082
Tel: +91 40 40676500

Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 020
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony,
S. No. 210 CTS 3202 Range Hills Road,
Shivajinagar,Pune - 411 020
Tel: +91 20 2556 0194, 020 6606 9999

Email: info@icraindia.com
Helpdesk: 9354738909
Website: www.icra.in/ www.icraresearch.in