# RATING METHODOLOGY - TEXTILES (FABRIC MAKING)

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in April 2020. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the Textiles (Fabric Making) sector remains materially similar.

## Overview

The Indian fabric industry is highly fragmented, dominated by a large number of small-scale units in the unorganised sector due to the Government's policy of promoting the small-scale sector through tax and fiscal incentives and favourable labour policies. The extent of fragmentation is evident in the organised sector's estimated share of less than 3% of the total domestic fabric production.

Fabric manufacturing is capital intensive and requires significant investment in plant and machinery. A typical modern fabric-manufacturing (weaving) unit with ~100 looms will have a capital cost of Rs. 80 crore to Rs. 100 crore, depending on the nature of expansion, i.e. greenfield or brownfield. The high fixed capital intensity is also reflected in the operating income/gross block, which typically remains at 1.5-1.7 times for fabric manufacturers. In addition, fabric manufacturing operations are working capital intensive with a gross operating cycle (receivable + inventory turnover period) of 4 to 5 months, with a receivable turnover period of 1.5-2 months and an inventory turnover period of 2.5-3 months typically.

This rating methodology aims to help entities, investors and other interested market participants understand ICRA's approach to analysing quantitative and qualitative risk characteristics that are likely to affect the rating of fabric-making entities. This methodology does not include an exhaustive treatment of all factors that are reflected in the ratings but enables the reader to understand the rating considerations that are usually the most important.

For analytical convenience, the risk factors analysed by ICRA are classified under four segments viz., Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment, and select other elements of credit risk assessment. In addition to these considerations, an entity's credit rating may also be influenced by its management quality, and the relevant environmental, social and governance risks.

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## Industry Risk Assessment

### Cyclicality

As the demand for fabric is mainly driven by demand for apparels and home textiles, besides the direct demand for branded/ unbranded fabrics, the growth potential of the fabric manufacturing industry is linked to the growth potential in the end user industries. Accordingly, performance of fabric-making entities tends to be linked to macro-economic conditions, consumer confidence and spending patterns, considering the discretionary nature of the end use products, from a demand perspective. While the broader fabric segment is fragmented and dominated by small scale units, the denim fabric manufacturing industry, which is a small segment of the weaving industry, is relatively more organised and dominated by a few larger players. Cyclicality in the denim segment tends to be driven by capacity additions as strong growth incentivises capital investments, leading to over-capacity and depressing the capacity utilisation and realisations.

### Competitive Intensity

The domestic fabric manufacturing industry is fragmented with ~85% of the fabric production concentrated in the small-scale units in the unorganised sector. The share of large mills which comprises integrated composite mills is only 3-4% in the total domestic fabric production (with the balance accounted for by the handloom sector). High level of fragmentation and commoditised nature of product results in intense competition and limited pricing power. However, players in the branded and premium fabric segment, enjoy some pricing flexibility and thereby better margins.

Further, due to the small size of most units and obsolescence of the machinery in most of the units, the global competitiveness of the Indian fabric manufacturers is modest.

## Business Risk Assessment

### Scale and capacity utilisation levels

Given the intense competition and limited product differentiation, larger capacities in fabric manufacturing offer benefits of economies of scale, thereby resulting in a better cost structure.

Further, with access to various fiscal incentives, such as capital and interest subsidies from the Central and state governments, and given the capital-intensive nature of operations, the tendency of entities in the industry to assume debt is high, resulting in sizeable interest and repayment burden. A fabric manufacturer's ability to consistently operate at high capacity utilisation levels and rapidly ramp up production from a newly-commissioned unit is of utmost importance because of the high financial leverage. Besides ensuring comfortable debt coverage metrics, the ability to operate at healthy capacity utilisation levels is crucial for reducing the capital cost per unit of production.

The production level of fabric units with a similar installed capacity (in terms of number of looms or knitting machines) can vary significantly based on the specification or quality of the fabric manufactured (in terms of gram per square meter (GSM), picks per inch[1], etc). Accordingly, ICRA uses the capacity derived at the average gsm/picks per inch of fabric being produced by the entity (as assessed by the issuers) as a reference for calculating the capacity utilisation levels. The inability to operate consistently at healthy utilisation levels, which could be a function of various parameters like machinery vintage and condition, labour-related issues, and inadequate order book position, is a negative factor.

*[1] Picks per inch is the number of weft threads per inch of woven fabric; the higher the picks per inch, the finer the fabric*

**Assessment of Scale**
**[Relative assessment from the perspective of the industry]**

| Strongly positioned | Weakly positioned |
|---|---|
| **Entity is among the largest players in the industry**<br>*For instance, entities having more than 500 looms (more than 250 looms, if majority is jacquard looms or terry towel capacity) or more than 200 knitting machines* | **The entity is a marginal player in the industry in terms of scale of operations**<br>*For instance, entities having less than 50 looms (less than 25 looms, if majority is jacquard or terry towel capacity) or less than 25 knitting machines* |

## Diversification – Products, customers, sales channels and geographies

For a fabric unit, diversification relates not only to fibre content and type of yarn (spun vs filament) but also to the GSM range, pick range, width, variety and finishing of the fabric manufactured. Diversification also holds relevance in terms of the customer profile (concentration of top customers), sales channels (dealers vs direct sales) and geographies (domestic vs exports).

*Products:* The ability to manufacture and market a diversified product range is a positive attribute, as it improves the flexibility to shift the product offerings as per the market demand and maintain capacity utilisation levels.. A diversified product portfolio includes a presence across the type of fabric manufactured (knitted/woven), product category (suiting, shirting, denim, towels, bed sheets etc.), material used (cotton, polyester, rayon, blends, etc), and finishes (grey, yarn dyed, dyed, value-add finishing such as wrinkle free, water/oil resistant, etc)

**Assessment of Product Diversification**

| Strongly positioned | Weakly positioned |
|---|---|
| Company is favourably placed in terms of diversification across category (suitings, shirtings, towels, etc.), type of fabric manufactured (knitted/ woven), material used (cotton, polyester, rayon, blend etc.) and finishes (grey, yarn dyed, dyed etc.) | Single product line |

*Customers:* While entities focusing on the business-to-consumer (B2C) model have a diversified customer base given their nature of operations, a diversified customer profile (comprising multiple end customers) for an entity operating under the business-to-business (B2B) model is a positive attribute. This protects an entity from the vagaries of any adverse development at the customer's end as any reduction in demand from a large customer can impact sales. Dependence of sales on a large customer will also lead to receivables concentration. Accordingly, a decline in sales from the customer can jeopardise the receivables position of the entity.

**Assessment of Customer Diversification**

**Strongly positioned**

Top 5 clients accounting for <= 30% of revenues

**Weakly positioned**

Top 5 clients accounting for >60% of revenues

ICRA notes that dealers also play an important intermediary role in sales for fabric units like order aggregation, customer service and sometimes financing as well by making faster payments to the units. Dealers also add value by sharing the fabric player's credit risk. As a result, sometimes, even direct sales are routed by the entities through dealers for client servicing, faster payments and for managing the credit risk. Nevertheless, direct relationships typically act as positive attributes and result in better profitability by saving on dealer commissions.

*Geographies:* ICRA assesses an entity's geographical mix in terms of the share of exports in overall sales as well as the entity's concentration towards a particular overseas market. Diversity in exports to multiple countries can protect against adverse outcomes, which may arise by way of trade restrictions (such as imposition of import duty) or a decline in demand in a particular importing country, or a reduction/removal of export incentives for exports to a particular country.

Market diversification aside, ICRA also considers the geographical presence of the fabric-maker's manufacturing facilities. Proximity to the raw material sources and/or the target market helps in saving on transportation costs, besides ensuring the entity's access to an uninterrupted supply of raw materials and/or orders, thereby supporting its profitability. Further, a geographically diversified manufacturing base reduces an entity's exposure to risks emanating from adverse developments in any particular unit or region, such as on account of strikes, labour unrests, etc.

**Assessment of Geographic Diversification**

**Strongly positioned**

Diversified geographic footprint with top 3 countries accounting for <60% of revenues;

Presence in atleast 2 states, with each state accounting for atleast 25% of installed capacity

**Weakly positioned**

Single country (domestic/international) accounting for >90% of sales;

Single location/ plant

## Customer profile

For fabric manufacturers, the customer profile is an indication of their operational strength as well as the likelihood of stretched payments/bad debts. Supply to large and reputed garment manufacturers/apparel brands, directly or indirectly, with regular repeat orders underscores the manufacturer's adherence to international best practices for manufacturing and various compliances as well as the consistency in the product quality and delivery. Given these attributes and the relationships that are developed over the years with a customer, an entity is likely to continue to get regular and repeat orders. In addition, these attributes reflect the competitiveness of the entity and its ability to add other reputed customers to scale up the business. Entities that mostly supply to the unorganised sector and local brands generally do not enjoy much of a competitive advantage or an enduring relationship with the customers. Additionally, the orders are mostly on a per transaction basis with limited long-term visibility on future orders. Moreover, sales to reputed and strong customers provide comfort on timely payments, which is a positive attribute as it reduces the working capital cycle of the manufacturer, resulting in superior return indicators.

## Brand strength

In addition to being sold to garment manufacturers, the fabric is sold directly to customers who prefer customised stitching over ready-made garments. Thus, entities focusing on the B2C model, which are able to establish their brand in the markets by virtue of their designs, quality, product range and other requisites, are able to command superior pricing power and higher realisations. Thus, they have higher profit margins compared to entities which are mostly present in the unbranded commoditised segment.

For strong brands, the demand is relatively less price elastic, which provides the flexibility to pass on the increase in input costs to maintain the profit margins. Moreover, given their premium pricing, strong brands have the cushion to lower their prices during economic downturns to sustain demand, both from existing as well as latent customers who were earlier restricted by the higher prices.

## Financial Risk Assessment

While ICRA believes that a strong business profile drives a strong financial profile in the long term, the financial profile of an entity is also governed by the risk appetite and growth plans of the management. ICRA analyses the long period past financial performance trends and estimates future financial performance to assess the financial risk exposure of an entity. The financial metrics provide a useful reference not only to evaluate the performance trends of an entity over a given time horizon, but also enable a comparison with its peers. Since the prime objective of the rating exercise is to assess the adequacy of the entity's debt-servicing capability, ICRA draws up projections on the likely financial position of an entity under various scenarios. This is done to assess the impact on contribution margins/ profitability, cash flows and coverage metrics in the event of volatility in key variables such as capacity utilisation, raw material prices (particularly for entities which are backward integrated) as well as product realisations. Thus, the financial risk assessment is not done in isolation but in conjunction with the business and the industry risks that the entity is exposed to. An entity with low exposure to business and industry risks would generally have stable cash flows and would have a higher tolerance to operate with a relatively modest financial risk profile. In contrast, entities that are exposed to increased business and industry risks need to maintain a stronger financial risk profile to have adequate cushion to manage cash flow volatility. The various financial metrices assessed by ICRA could be divided into five categories viz., Profitability, Working Capital Management, Leverage, Coverage, Liquidity and Cash Flows. This document provides a summary of these ratios.

For a more detailed description, readers may refer to the document titled, 'Financial Ratio Analysis' published on ICRA's website. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis to assess the impact of the key variables on the various financial metrics.

### Profitability

The profit margins, in terms of ratios like OPBDITA/OI (Operating profits before depreciation, Interest and amortization/ Operating Income) and PAT/OI (Profit after tax / OI), are seen in relation to the changes in the contribution margins. A mere decline in profit margins with stable per unit contribution or OPBDITA (Rs/Kg or Rs/MT) is not necessarily seen negatively, as the same could be because of a higher realisation base. The analysis focuses on assessment of the key cost and realisation drivers and the movement in these factors.

The fabric industry is raw material intensive with yarn cost accounting for nearly 60% of the total operating costs, followed by manufacturing expenses (like repairs, store & consumables etc.) and power cost, which account for 10-15% of the operating costs. Manpower cost, selling expenses (packing costs, outward freight, discounts, etc.) and general and administrative expenses further form 20-25% of the total operating costs. Given the cost-intensive nature of the product, the ability to control costs at all levels becomes crucial for the overall profitability of an entity. Following are the key cost drivers for a fabric-making entity.

*Raw Material Costs:* Yarn cost tends to vary as per the domestic and international demand-supply scenario for the fibre as well as the yarn. The susceptibility of a fabric-maker's profitability to fluctuations in raw material prices is generally low because of the limited yarn stocking by the units, as yarn is readily available throughout the year. Moreover, manufacturing is generally undertaken against confirmed orders with the pricing taking into account the prevailing prices of yarn, which limits the exposure to raw material price risks. Nevertheless, the vulnerability to raw material price fluctuations increases if the entity accepts long-term fixed price orders without adequate yarn stocking to cover the orders or if it undertakes excess yarn stocking in relation to the order book position. The profit margins, in these scenarios, can be impacted by an increase or decrease in yarn prices.

*Production Yields:* The production yields, in terms of yarn loss and final fabric production, determine the production efficiencies. The minimisation of yarn loss improves the overall revenues and the contribution margin of the fabric-making units. While fabric production is a function of the type of fabric manufactured, the level of modernisation of the manufacturing unit also governs it to an extent. A modernised unit offers lower downtime, better quality fabric and better production yields with lower manpower deployment, contributing further to a better cost structure and, hence, profitability. Since modern machinery improves the ability to offer better and consistent quality fabric, it improves the ability of the players to supply value-added fabric to apparel brands, both in the domestic and the export markets. This leads to better sales realisations and profitability. Players with old machinery generally supply commoditised fabric to the domestic unbranded apparel segment, which results in lower sales realisation as well as lower profitability.

*Power Costs:* The cost of grid power can vary from state to state. Further, captive power costs can vary depending on the source, viz. coal, liquid fuel, solar or wind. In effect, the overall power costs for fabric units can vary significantly depending on the location of the unit and the source of power. Units, which have the flexibility to source power through open access, can benefit in scenarios of lower prices in the merchant power markets.

*Manpower Costs:* The manpower cost of a unit is governed by its level of modernisation, with manpower costs, as a proportion of revenues, being lower in modern units. However, at the same time, new units have associated capital costs (such as interest and depreciation/repayments), which are not there for older units. It may be noted that the paucity of labour in certain locations or situations might affect the capacity utilisation levels and might negatively impact the ratings.

The cost drivers apart, the profit margins are also seen in relation to the degree of backward or forward integration (which requires more capital) and, hence, in relation to the overall return on capital employed (RoCE[2]). For instance, an entity with an operating profitability similar to or better than the industry average may have a lower RoCE because of factors such as backward/forward integration, lower fixed asset turnover or longer working capital cycle compared to the industry average. ICRA notes that though the RoCE is typically moderate for fabric-making companies, it compares favourably with the average cost of capital as most of the domestic fabric-making mills have received capital subsidies under the Technology Upgradation Fund Scheme (TUFS) of the Government of India (interest subsidies discontinued for new loans for fabric-making entities with effect from January 2016) and/or interest/ capital subsidy benefits from state governments under their respective textile policies.

## Working Capital Management

Fabric-manufacturing entities are required to stock yarn as well as fabrics. While yarn is stocked to cover confirmed orders, fabric stocks include material in transit to distributors/customers or awaiting shipment pending the completion of the entire lot size. Typically, the inventory-holding period for fabric-manufacturing entities averages 2.5-3 months. If an entity's inventory levels are significantly higher than that of its peers, ICRA analyses the inventory mix in terms of raw material, finished goods and work-in-process, which can vary depending on the level of integration and product range.

In addition to inventory holding requirements, the level of working capital for fabric-making entities is driven by the receivables position and the turnover period, which typically remains 1.5 to 2 months for fabric-making entities[3]. The overall receivables position is analysed for its ageing (which determines its eligibility for drawing power estimation) and concentration. Receivables concentration towards a few entities with weaker credit profiles could be an area of concern. For export receivables, credit risk mitigants such as export credit risk insurance cover or letter of credit (LC)-backed receivables are taken as comfort factors.

## Liquidity and Cash Flows

Liquidity is the measure of an entity's ability to meet its short-term cash obligations from various internal or external resources. Internal resources include fund flow from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or equity capital. Short-term obligations include committed as well as contingent claims on an entity's cash, including the debt - servicing obligations, working capital requirements, capital expenditure and other investment outlays, dividend and share

[2] RoCE is defined as profit before interest and taxes/average capital employed for the year

[3] For entities focusing on the B2B model

buyback-related outflows, besides the sudden demand arising from crystallisation of discrete events such as litigation penalty. The higher the cushion between available resources (especially internal resources) and obligations, the better the liquidity profile of an entity.

Also, for liquidity assessment, ICRA compares the fund-based working capital limit utilisation with the sanctioned fund-based working capital limits or drawing power, whichever is lower, and assesses the cushion available in the working capital limits. The drawing power can be a function of the inventory valuation and is, therefore, seen in relation to the realisable value, especially in a declining price scenario.

While an entity may have a debt service coverage ratio (DSCR) >1 over the projected period, ICRA assesses the sufficiency of the balance cash accruals (after meeting the scheduled repayment) to fund the equity margin required for planned capital expenditure. If the projected levels of cash accruals (after repayments) are lower than the equity funding requirement for capital expenditure and enhanced working capital requirements, then despite a satisfactory projected DSCR, the entity may find itself stretched on liquidity. In such a situation, the financial flexibility of the entity to fund its growth requirements is seen as an important factor

## Leverage and Debt Coverage Indicators

Entities that pursue an aggressive financial policy, including heavy reliance on debt financing, are likely to be more vulnerable to downturns than entities that employ a lesser degree of financial leverage in their business.

Given the fixed capital as well as working capital-intensive nature of the fabric-making business, the funding requirements are typically high in the sector. Access to fiscal incentives from the Central as well as state governments, which provide for capital as well as interest subsidies, reduce the interest burden on fabric-making entities. Over the years, access to low-cost debt has incentivised fabric-making entities to operate at a high financial leverage, increasing their vulnerability to downturns. While interest subsidies under TUFS are not available any more for new loan sanctions (from January 2016 onwards), some of the fabric-making entities continue to get incentives from state governments. This, together with the presence of the older TUFS loans and capital subsidies on new loans, keeps their average cost of debt low.

Some of the key indicators considered by ICRA include –

- <u>Leverage indicators:</u> Total Outside Liabilities/Tangible Net Worth (TOL/ TNW), Total Debt/OPBDITA

**Assessment of Leverage**
**[Indicative Metrics[4]]**

| | Strongest | Weakest |
|---|---|---|
| **Indebtedness Ratio** | **<=0.9x** | **>3.0x** |
| **Debt-to-Profit Ratio** | **<=0.5x** | **>5.0x** |

[4] *The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrices on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrices on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it.*

- Debt coverage ratios: Interest Coverage, Debt Service Coverage Ratio (DSCR)

**Assessment of Coverage**
**[Indicative Metrics]**

| | Strongest | Weakest |
|---|---|---|
| Interest Coverage | >=18.0x | <2.0x |
| DSCR | >=4.0x | <1.1x |

Low leverage improves the financial flexibility of an entity during downturns, besides keeping the fixed financial expenses low. Moreover, the tenure of the term debt is a key driver for the debt coverage as entities with longer tenure debt and similar levels of leverage will be more comfortably placed compared to entities with shorter tenure debt. Even earlier, when entities used to avail of loans under the TUFS where interest subsidy used to be available for seven years from the date of sanction of the loan, there were entities that availed of a longer tenure loan to spread out the debt repayment liability over a longer duration.

## Other Elements of Credit Risk Assessment

### Level of Integration

Fabric units can have backward integration into spinning and forward integration into garment manufacturing, apart from adding value through fabric processing like fabric dyeing, printing, finishing, etc. However, given the high degree of fragmentation and the small scale of operations of the industry players, backward/forward integration is mostly limited to a few large mills.

With backward and forward integrated operations, an entity is typically able to capture a larger share of value addition. This, together with captive yarn availability for in-house consumption (fabric-making) and the in-house consumption of fabric for garment manufacturing, results in savings of transportation, packing and selling costs and supports the return metrics.

While integration is a positive, it poses challenges as well, such as reduction in operational flexibility in responding to market conditions and heightened business risks, which could result from unrelated diversification in a segment in which the promoters and management do not have relevant experience and track record. The risk to profitability is particularly higher in the case of backward integration into cotton spinning. Profit margins are typically steady in the case of fabric manufacturing compared to spinning because of limited raw material stocking. This mitigates the impact of volatilities in raw material prices while the profit margins for spinning, specifically cotton spinning[5], are susceptible to fluctuations in cotton prices leading to the risk of inventory loss. Hence, the overall profit of an integrated fabric manufacturer is exposed to the risk of inventory loss in times of declining cotton prices, whereas non-integrated fabric manufacturers would benefit from the procurement of lower-cost yarn from the market in such times. However, the profit margins are generally protected for players, which maintain cotton stock in accordance with the order book. Hence, a balanced level of backward integration, which matches the requirement for fabric manufacturing, along with a cotton stocking policy, which is in line with the order book position, is considered a positive. In contrast, integration which heightens the operational and financial risks for an entity is a negative rating attribute.

[5] *While man-made fibres are available throughout the year and can, accordingly, be stocked based on the millers' order book position, the seasonality of cotton (as it is available from October until March) requires the mills to stock cotton to meet the fibre requirements during the non-harvest period as well. Hence, cotton fibre-based mills typically have higher peak working capital requirements than mills using man-made fibre, and are, thus, more exposed to the risk of inventory loss on account of volatilities in raw material prices*

### Foreign Currency Risks

Foreign exchange risk for fabric-manufacturing entities arises by virtue of foreign currency receivables from export orders. With most of the cost being rupee-denominated, the scope of a natural hedge remains limited for the entities. To hedge these risks, an entity may choose to avail of a working capital facility in foreign currency, like packing credit in foreign currency/bill discounting in foreign currency, which should be equivalent to the export order value or forex receivable position. Alternatively, an entity may also fund its current assets by rupee-denominated working capital borrowings and take a forward position equivalent to a pending export order book and forex receivables. The outstanding forex position by way of forwards or working capital borrowings in foreign currency is compared with the export orders and forex receivables position to check the overall unhedged exposure.

### Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an entity to significant refinancing risks, especially during periods of tight liquidity. The ratings factor in the existence of adequate buffers of liquid assets/bank lines to meet the short-term obligations and the extent to which the entity could be impacted by interest rate movements on such borrowed funds.

### Financial Flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access capital or money markets at short notice, attract diverse and marquee investors and enjoy the confidence of banks, financial institutions, and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones in quick time, whenever required. Financial flexibility could arise from factors such as an entity's large scale of operations with strong financials, large, unencumbered cash flows, unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group.

In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital raising ability.

### Debt Servicing Track Record

The debt-servicing track record of the entity forms an important rating consideration. Any history of past delays or defaults in meeting the interest and principal repayment obligations by the entity or the group, reduces the comfort level with respect to the entity's future debt-servicing capability and willingness. Nevertheless, the reasons behind past defaults are also analysed, which could also be due to adverse demand situations in the underlying industry. The company's ability to honour its debt obligations during the period of cyclical stress is also factored in.

### Accounting Quality

ICRA relies on the entity's audited financial statements to analyse its financial performance during the rating process. It interacts with the Statutory Auditors and studies the Auditors' Report and other Notes to Accounts disclosed by the entity in its Annual Report. Some of the key factors looked at include - auditor's qualifications with respect to internal control systems, debt servicing and asset liability mismatches. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the entity are adjusted to reflect the impact of such deviations.

## Contingent Liabilities and Off-balance Sheet Exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures as disclosed by the entity in its Annual Report and evaluates the likelihood of their devolvement and the financial implications of the same.

## Project Risk

To ascertain the project risks, ICRA endeavours to understand the entity's rationale for undertaking new investments. The risk profile could be different, depending on whether the new project is a case of a related diversification or an unrelated diversification. The risk is heightened if the expansion is in a new/unrelated segment wherein the promoters/ management do not have a demonstrated track record or experience. Some of the other factors that are assessed include: (i) track record of the management in project implementation; (ii) experience and quality of the project implementation team; (iii) extent to which the capital cost is competitive; (iv) presence of financing arrangements; (v) demand outlook; (vi) competitive environment; and (vii) marketing arrangement and plans. The impact of the project risk on the rating is influenced by the scale of the projects being undertaken or planned to be undertaken in relation to the size of the assets and the cash flows of the entity's existing operations.

## Event Risk

ICRA recognises the possibility of events, such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin offs, capital restructuring; and litigations, which could have a material impact on the credit profile of a company. Incorporating the impact of such discrete events in the credit rating, from the beginning, is often difficult. Depending on whether and when such events occur, the rating opinion could be substantially different. To take rating decisions in such cases, ICRA applies its analytical judgment based on the rated entity's track record, the credibility of the management and the experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

## Parentage/ Group Support

While the credit rating of an entity is a function of its standalone credit profile, in certain cases, the entity's credit quality can also be driven by the relationship with its parent or the promoter group (henceforth referred to as the parent).

All debt ratings necessarily incorporate an assessment of the quality of the entity's promoters as well as the strengths/weaknesses arising from the entity's being a part of a "group". Also of importance are the entity's likely cash outflows arising from the possible need to support other group entities, in case the entity is among the stronger entities within the group. Some key factors considered include:

- Strength of the other entities belonging to the same group
- Ability and willingness of the group to support the entity through measures such as capital infusion, if required

If the parent's credit profile is relatively stronger than the rated entity, ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here refers to financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period and advances in times of credit or liquidity stress on the entity. Support here does not mean operational support in the form of new business opportunities, technology sharing, distribution network sharing and so on, as these aspects are factored in the standalone credit profile assessment. If the parent's credit profile is relatively weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited, given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile[6].

[6] *For more details on this, readers may refer to the document titled, "Impact of Parent or Group Support on an entity's Credit rating", available on ICRA's website*

## Management Quality

In addition to the business and financial risk analysis, all debt ratings incorporate an assessment of the quality of the entity's management and its financial policies. An experienced management is considered a positive factor.

In addition, the likely cash flow impact on the rated entity, from the possible need to support other group entities are of importance, in case the rated entity is among the stronger ones within the group. Usually, a detailed discussion is held with the management of the rated entity to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the rated entity's industry.

Some of the points assessed are:

- Experience of the promoter/ management in the industry
- Commitment of the promoter/ management to the concerned line of business
- Risk appetite of the promoter/ management and risk mitigation plans
- The rated entity's plans regarding new projects, acquisitions, and investment in non-core business segments
- The rated entity's policies on leveraging, interest risk and currency risks

Periodic interactions with the management also help to estimate the possibility of the management's tendency to deviate from its core philosophy in times of stress.

## Assessment of Environmental, Social and Governance (ESG) Risks

The assessment of ESG risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the environmental and social (E&S) risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the governance risks are largely entity driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally pull down the ratings, but generally the ratings are not pushed up even when the ESG context is favourable.

### Environmental (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly, if not precisely. Further, it is not always feasible to fully or precisely disaggregate the sub - components of E&S risks in credit analysis since these considerations often tend to overlap. That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differs widely across sectors and entities. In some cases, while the E&S risks could be material but their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future and, hence, these considerations do not necessarily weigh on the rating today — with the expectation that when these risks manifest in the distant future, the rated entity by then would possibly adapt itself by realigning its business model. While evaluating E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile.

**Environmental considerations**

Environmental risks indirectly affect the industry, primarily through water, land use, and the climate impact of production as well as post-consumer waste. While these risks have not resulted in material implications so far, policy actions towards waste management and environmental impact such as to recycle the textile as well as packaging waste being generated, could have cost implications for the companies. This apart, dyeing and processing of fabrics cause water pollution and result in significant waste-water generation. Lack of a proper system to ensure appropriate pre-treatment of wastewater and avoid leakages etc. could result in significant penalties, while also causing prolonged disruptions to operations due to strict action by the authorities.

**Social considerations:**

The social risk for the sector arises from high labour involvement, despite increasing mechanisation. The sector is exposed to labour-relation risks and risks of protests/social issues with local communities, which might impact expansion/modernisation plans. Entities are also exposed to risks of disruptions due to inability to properly manage the human capital in terms of their safety and overall well-being. Additionally, shortage of skilled workers could also affect operations/ growth plan and remains a key concern. Entities also remain exposed to any major shift in consumer preferences or developments affecting discretionary consumer spending, which may result in losses on non-moving inventory and may necessitate efforts to update product portfolio.

### Governance Risks

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the board of directors and the management. The constitution of an entity's board and the board of directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, its level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related-party transactions and instances of supporting group entities at the expense of debt holders are assessed.

## Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at after conducting a detailed evaluation of the entity's business and financial risks, its competitive strengths, the likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt-servicing obligations and other funding requirements. The credit profile of fabric-manufacturing entities involves the assessment of the business strengths and weaknesses as reflected by their scale of operations, , diversification in terms of product profile, customers and geographical presence, customer profile and brand strength in a highly competitive product segment. The operational strengths are typically reflected in the financial performance. However, the financial risk profile of the entities in the industry is also governed by their growth plans (given the high leveraging in the sector) and their ability to fund growth at a lower cost.

## ANNEXURE

**Summary of rating factors and an example to illustrate the key building blocks of a credit rating for a fabric-making company**

| | | Strong | | | Comfortable | | | Adequate | | | Moderate | | | Weak | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Industry Risk** | Industry Position | | | | | | | | | | | | | | | |
| **Business Risk** | Scale (Installed capacity) | | | | | | | | | | | | | | | |
| | Capacity utilization | | | | | | | | | | | | | | | |
| | Presence in branded segment | | | | | | | | | | | | | | | |
| | Nomination/ approval from apparel brands/ global retailers | | | | | | | | | | | | | | | |
| | Vintage of machinery | | | | | | | | | | | | | | | |
| | Backward integration | | | | | | | | | | | | | | | |
| | Product diversification | | | | | | | | | | | | | | | |
| | Customer diversification | | | | | | | | | | | | | | | |
| | Geographic diversification – Markets | | | | | | | | | | | | | | | |
| | Geographic diversification – Manufacturing Base | | | | | | | | | | | | | | | |
| **Financial Risk** | Leverage | | | | | | | | | | | | | | | |
| | Coverage | | | | | | | | | | | | | | | |
| | | Enhance | | | | | Support/ Neutral | | | | | Hinder | | | | |
| **Do these factors enhance or hinder the credit profile?** | Diversification | | | | | | | | | | | | | | | |
| | Refinancing Dependence, Liquidity and Financial Flexibility | | | | | | | | | | | | | | | |
| | Currency Risk | | | | | | | | | | | | | | | |
| | Financial Policy | | | | | | | | | | | | | | | |
| | Management, Governance and Reporting | | | | | | | | | | | | | | | |
| | | Very High | | | | High | | | | Moderate | | | | Low | | |
| **Parent Support** | Likelihood of Parent Support | | | | | | | | | | | | | | | |
| | Rating of Parent | AAA | AA+ | AA | AA- | A+ | A | A- | BBB+ | BBB | BBB- | BB+ | BB | BB- | B/ C category | |
| | **Final Rating** | **AAA** | **AA+** | **AA** | **AA-** | **A+** | **A** | **A-** | **BBB+** | **BBB** | **BBB-** | **BB+** | **BB** | **BB-** | **B/ C category** | |

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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ICRA 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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