

A photograph of a textile factory showing rows of spinning spindles on a machine. The spindles are white and arranged in a grid pattern. A yellow diagonal banner is overlaid on the right side of the image.

SECTOR RESEARCH

COTTON YARN

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Growth momentum to continue for the Indian cotton yarn industry

Textile Sector Analysis

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Executive Summary

After having braved multiple headwinds in the last few years, viz., an unfavourable duty structure, volatile cotton prices and the Covid-19 pandemic, the Indian cotton spinning industry is finally enjoying its moment in the sun. The revival, which started in Q2FY21, was led by a surge in export orders, followed by recovery in domestic downstream demand. The first ten months of FY22 witnessed a healthy production increase of 32% y-o-y. Production during the period remained higher even compared to the corresponding period in FY20. A serendipitous mix of both internal and external factors have led to this growth. Factors such as comparatively lower domestic cotton prices, the United States' sweeping ban on cotton and cotton-based products originating from the Xinjiang area in China, an increased need for diversification in the vendor base felt by various brands across the world (China Plus One) have all led to increased demand for Indian cotton yarn.

Increased demand has translated into higher spreads (the difference in the price of cotton spun yarn and cotton fibre), which has significantly improved the profitability margins of players in the industry. Demand is expected to remain healthy in FY23, with the major impetus expected to come from the domestic downstream market, which is yet to reach the pre-Covid level. The opening up of the economy after a decrease in the number of Covid cases, the China-Plus-One factor and favourable government policies are all expected to support demand in the medium term.

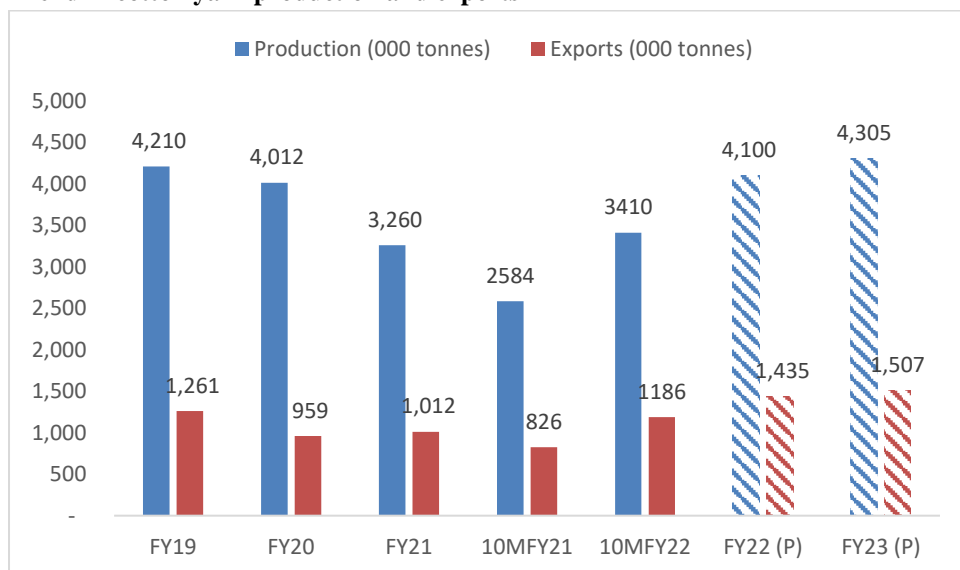
While the current levels of spreads and profitability margins may not be sustainable in the long run, the industry is expected to achieve higher-than-pre-Covid level margins, at least till FY23. This will subsequently result in healthy debt coverage indicators (though weaker than the levels achieved in FY22), despite companies announcing debt-funded capex to increase their capacities. However, the performance will remain contingent on the raw material price movement, possibility of subsequent Covid waves in India and other countries, and their impact, and the long-term efficacy of the vaccine. In addition, the recent development in the geopolitical space (Russia-Ukraine conflict), if it persists for a long time, has the potential to dampen demand. This, coupled with increased input costs, could result in lower-than-envisaged profitability margins for companies operating in this space.

Robust demand in the export market was the major reason for growth in the past

In the last few years, the Indian cotton yarn industry has grappled with various challenges such as demonetisation, the hasty implementation of the Goods and Services Tax (GST), volatile raw material prices, subdued demand in the domestic market and the emergence of other players in the export market. Even during the first wave of the pandemic in 2020, while on the one hand, restricted demand from the domestic downstream industry led to significant decline in revenue, subdued demand in the export market, on the other hand, ensured that the spreads and profitability margins remained in check. However, post the initial impact of the pandemic, recovery started in Q2FY21, led by increased export demand. The momentum continued in the remaining part of the year, with India registering export growth of 5.5% in FY21, despite a significant y-o-y dip of 22% in Q1FY21. It is pertinent to mention that even though exports increased by 5.5% in FY21, cotton yarn production declined by 19% y-o-y, implying that exports were the major demand drivers during the year. Increased export demand came to the rescue of domestic spinners in Q1FY22, also when India went into a semi-lockdown stage during the second wave of the Covid-19 pandemic. Exports registered healthy y-o-y growth of 20% on a sequential basis when the total production showed de-growth of 4% during Q1FY22. In 10MFY22, exports have grown at a healthy rate of ~44%, which has been the major reason for the 32% y-o-y increase in the overall production witnessed by the industry during this period.

Based on the surge in export orders and revival in domestic downstream demand, BWR expects Indian cotton yarn production to increase by more than 25% in FY22, with exports projected to grow by over 40% on a y-on-y basis. However, y-o-y growth is expected to moderate in FY23 to 5% mainly on account of the high base effect.

Trend in cotton yarn production and exports



P - Projected

Source: CMIE, BWR Research

In the medium term, increased domestic downstream industry demand, along with the factors mentioned below, will drive growth in the Indian cotton yarn industry.

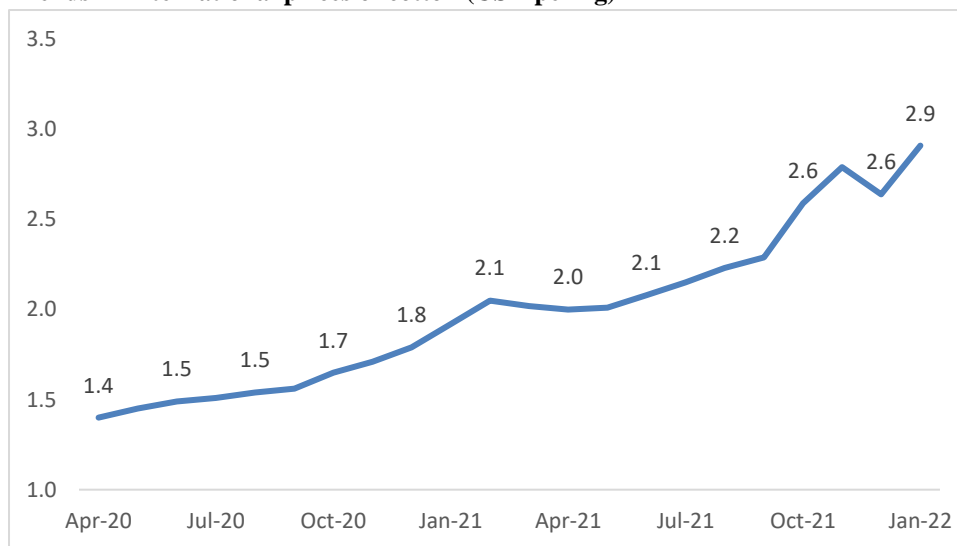
A. Lower domestic raw material prices compared to international market to support export demand

International cotton prices increased by ~3.5% (m-o-m) on average during the 16-month period from October 2020 to January 2022. The increase has been led by recovery in demand in the downstream industry post relaxations in lockdown restrictions across the globe, increased cotton imports by China for building its state reserves and the ban imposed by the US on cotton and cotton-based products manufactured in Xinjiang in China. Apart from this, in cotton season 2020-21 (the world cotton season is from August to July), while global cotton production declined by 7.4% y-o-y, consumption increased by a healthy 16.4%, with the mismatch in demand and supply also contributing to the spike.

In the Indian market, however, despite a recovery in demand, cotton prices have remained lower than international prices during this period. Though the procurement cost for various spinners remained higher than the Minimum Support Price (MSP) decided by the government, prices were relatively lower than those in the international market. Average international cotton prices remained ~7% higher than average local Shankar-6 variety prices in the October 2020 to January 2022 period. Lower raw material prices had kept Indian cotton yarn prices competitive in the export market.

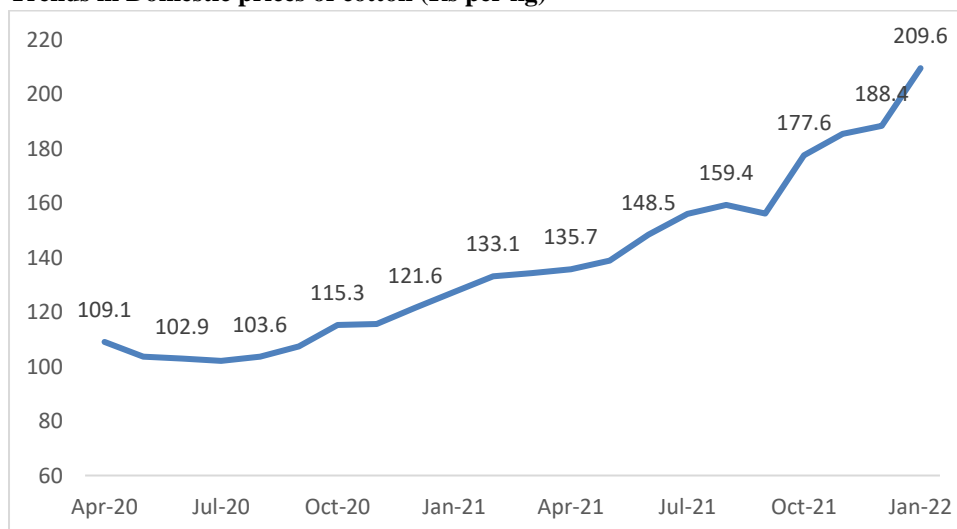
However, the gap between domestic and international cotton prices has narrowed in the last few months, with domestic prices levelling up with international cotton prices in the later part of March 2022. Primary reasons for the increase in domestic prices include the slow arrival of raw cotton in the Indian markets (with the farmers holding on to the inventory in anticipation of better prices) and revised estimation on the cotton crop for CS 2021-2022 (lower than previous estimates) by the Cotton Association of India (CAI), apart from high demand. Although the prices are expected to normalise with improved supply in the market in the medium term, spinning companies may have to shed a part of their profitability to stay competitive in the short term. Having said that, many spinning mills across India had been increasing their inventory holdings (compared to the normal levels), bracing themselves for the impact of rising cotton prices. This is expected to help them tide over the impact of the present high raw material price scenario.

Trends in International prices of cotton (USD per kg)



Source: Cotlook A Index, BWR Research

Trends in Domestic prices of cotton (Rs per kg)

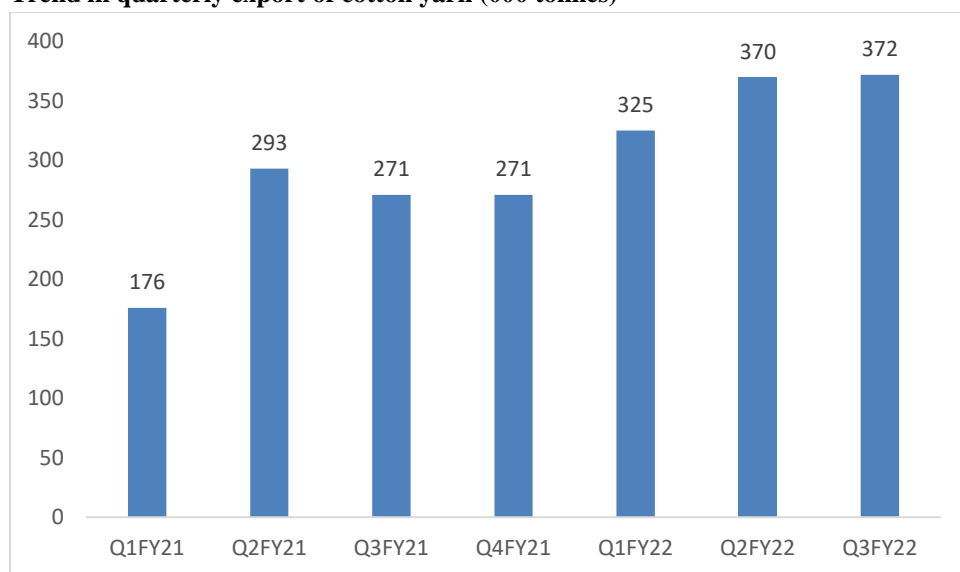


Source: The Cotton Corporation of India; Textile Excellence, BWR Research

B. Ban imposed on Xinjiang cotton products by the US

In January 2021, the US imposed a blanket ban on products containing cotton originating from the Xinjiang area of China, citing forced labour issues in the region. Both fabric and apparel mills (including made-ups) in and outside China used to rely heavily on Xinjiang cotton as it was home to ~85% of the total cotton produced in China and ~20% of the world's cotton. The ban imposed by the US has led demand for both cotton and cotton yarn to shift to other destinations, including India. Many fabric and garment manufacturers within and outside China who fulfilled their cotton yarn requirements from Xinjiang cotton have been forced to shift their supplier base from Xinjiang to other destinations. Indian cotton spinners have benefited immensely from the ban, as reflected in the increased exports originating from India, post the move.

Trend in quarterly export of cotton yarn (000 tonnes)



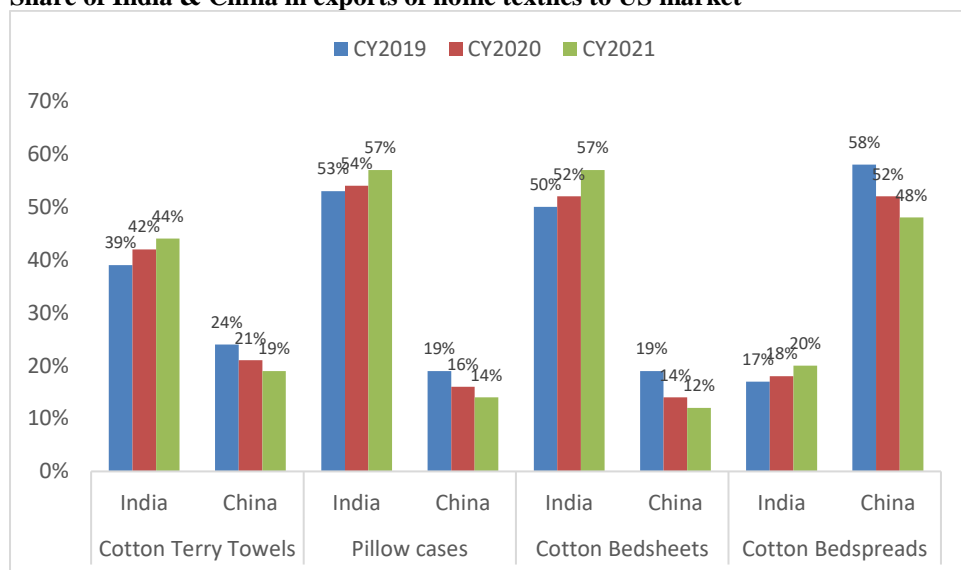
Source: CMIE, BWR Research

C. Recovery in demand in domestic downstream industry, with China Plus One trend catching-on

India is the second largest exporter of home textile in the world, after China, with the major product categories constituting bed sheets, terry towels, bedspreads and pillow cases. The US and Europe are the two major markets for the home textile segment, accounting for more than 50% of the total imports in the world. Although India remains a dominant player in the US, imports to European countries are skewed more towards Pakistan and Bangladesh (two other important players in the segment) as these nations enjoy duty-free benefits under the Free Trade Agreement (FTA) with the region. In the US, however, India has the highest share in most product categories (bed sheets, terry towels, pillow cases).

In CY20 and CY21, India's market share in the US home textile segment had gradually increased. This came on the back of China losing its market share to other players. Orders that were hitherto going to China, were routed to India, Bangladesh, Pakistan and Vietnam. China Plus One is being adopted by most global aggregators and retailers and is one of the major reasons for the shift. To reduce their dependence on China and broaden their supply chains, post the covid-19 pandemic, most players across the globe have been making deliberate efforts to decrease their reliance on China. This has been further helped by the ban imposed by the US on cotton and cotton products originating from Xinjiang in China, which has encouraged the shifting of orders from China to other preferred nations, including India. Furthermore, depreciation in the Indian rupee against the US dollar, since the onset of the pandemic in India in March 2020, has also been a positive for exporters. At the same time, demand in both export and domestic home textile markets has increased owing to increased consumer focus on home decor due to the work-from-home scenario. The increase in export orders, coupled with an uptick in local demand, has improved the capacity utilisation levels of local home textile mills, resulting in higher demand for cotton yarn for domestic consumption. Home textile demand is expected to remain robust in the near to medium term on the back of the aforementioned factors, which will consequently lead to higher cotton yarn consumption by mills.

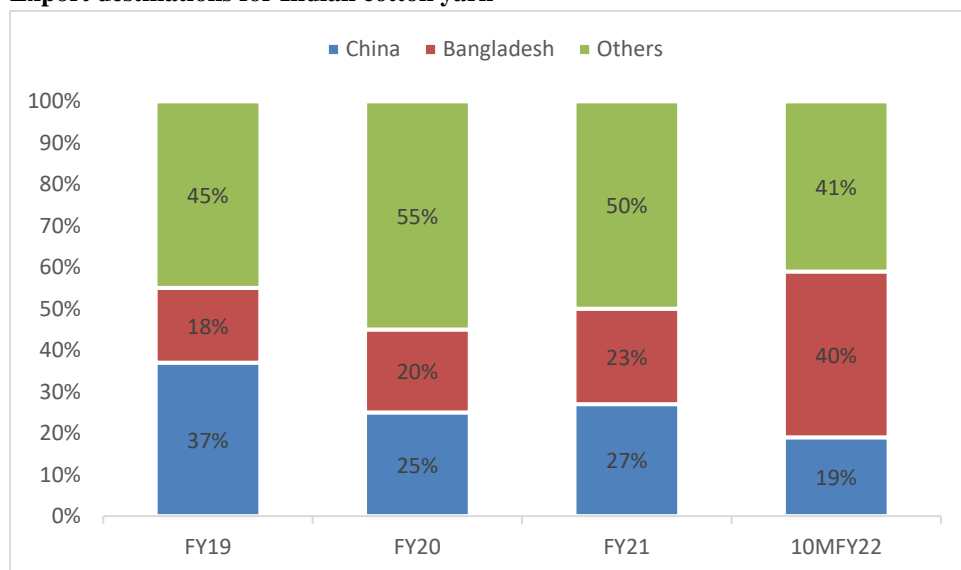
Share of India & China in exports of home textiles to US market



Source: OTEXA (Office of textiles and apparels), BWR Research

On the other hand, China Plus One has also helped Bangladesh's Ready-Made Garment (RMG) industry immensely as orders that were earlier served by Chinese garment players are now being routed to other geographies. This has resulted in increased cotton yarn demand from Bangladesh, which has now surpassed China to become the biggest destination for cotton yarn exports originating from India.

Export destinations for Indian cotton yarn



Source: CMIE, BWR Research

The Indian RMG industry has also been one of the beneficiaries of this shift, which has lent support to its production levels, especially at a time when the local offtake continues to remain muted due to the pandemic (especially the weaving segment). However, with the number of Covid-19 cases in India coming down and with the opening-up of the economy, RMG demand for local consumption is also expected to witness an uptick in the medium term, which in turn will support the cotton yarn offtake.

D. Favourable government policies to lead to increase in production

In the last few months, the Government of India (GoI) has announced various measures that will give a much needed boost to the textile sector. The outlay of Rs.4,445 cr given by the GoI, to create seven textile parks in the next 5 years, will help increase investment and

production levels in the industry. At the same time, the inclusion of cotton yarn exports under the Remission of Duties and Taxes on Exported Products (RODTEP) scheme from January 2021 (as notified in August 2021) has also rendered Indian cotton yarn competitive in the export market. In addition, the recent FTA signed between India and the UAE will also boost apparel exports, which will further lend support to cotton yarn consumption in the domestic market.

E. Revival of the capex cycle to result in increased production levels

On the back of healthy demand, spinning companies have been operating at optimal utilisation levels for the last few quarters, which has necessitated an increase in capacities. Healthy cash accrual generation and positive demand outlook have led many large companies to announce their capex plans, either towards increasing their spindle capacities or investing in downstream capacities (fabric and garmenting). An increase in installed capacities is expected to result in higher production levels, going forward.

On the back of the factors mentioned above, the credit profile of players operating in the sector is expected to remain healthy.

Textile companies to witness continued healthy credit profile backed by robust revenue and profitability; albeit, margins to taper after peaking in FY22

After India was hit by the pandemic in March 2020, the subsequent quarter saw significant decline in the operating income for textile companies. The margins of the companies were also severely impacted because of the low capacity utilisation levels and declining sales realisations of cotton yarn. Apart from that, since cotton is a seasonal crop, major procurement by the spinning mills had already been done till February/March 2020, which fixed the raw material procurement cost. However, with a sudden dip in cotton and cotton yarn prices, yarn manufacturers also suffered inventory losses which further dented their margins. However, supported by increased demand (especially exports) from Q2FY21 onwards, the industry registered significant growth in the operating income, along with healthy profitability margins.

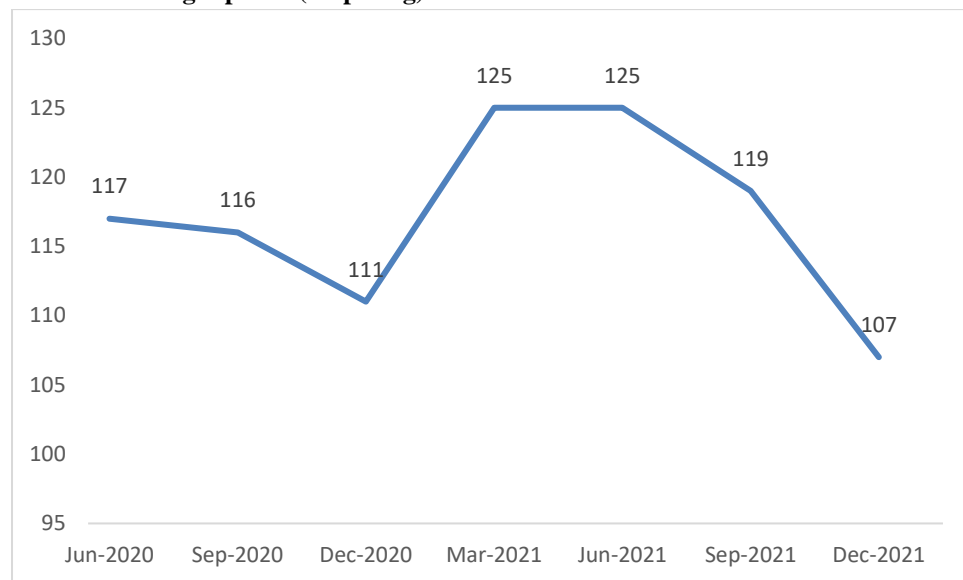
BWR has taken a sample of mid/large listed entities in the segment that derive the majority of their income from cotton yarn. The operating income for BWR's sample entities declined by ~3% y-o-y in FY21. This was mainly on the back of tepid demand in the first quarter. However, better demand and improved sales realisation (which was also supported by an increase in the raw material prices) led to recovery in the subsequent quarters. The profitability margins showed a considerable improvement to multi-year high levels in FY21, on account of higher capacity utilisation (leading to better optimization of fixed costs), healthy spreads (per unit sales), and various cost saving measures implemented by companies. Access to low-cost cotton from the previous season has also supported the contribution margins of the companies operating in the segment. These factors have continued to support the operational and financial performance of these companies in FY22 also, with the income of the sample companies increasing by a healthy 65% in 9MFY22, over the same period last year. The profitability margins are at an all-time high level for some of these entities with the 9MFY22 average PBILDT margins at ~27%. Furthermore, with limited capex incurred by these companies in the last few years and reduced reliance on outside working capital limits, owing to healthy cash accrual generation, the interest coverage ratio stood at a healthy level of 24x.

BWR expects income for the sample players to improve further in FY23. However, owing to the high base effect, growth is expected to remain moderate at ~5% during the year. The major growth drivers will be recovery in demand in the domestic consumption (which is yet to reach the pre-covid level) and continued demand in the export market. However, high raw material prices are likely to play a deterrent, going forward, and lead to diminished spreads and consequently a moderation in the profitability margins from the present levels (from 25% projected in FY22 to 18-20% in FY23); although the same are expected to remain better than the levels achieved in pre-Covid times.

Reckoning increased demand and comfortable debt coverage indicators, some companies have already announced their capacity expansion plans for the near term, while many others are expected to do so, going forward. However, the leverage ratios for the companies undertaking capex are not expected to deteriorate much owing to low reliance on outside debt, with the major requirements expected to be met through the accruals generated. As per BWR's expectations, with a projected increase in debt and moderation in profitability margins, the debt coverage indicators for the companies operating in the sector are expected to moderate, though remain healthy, in FY23, with the ISCR expected to deteriorate to ~13x from ~20x projected for FY22, for the BWR sample companies.

Therefore, in FY23, the growth momentum is expected to continue for the companies operating in the sector, with profitability margins and debt coverage indicators expected to remain healthy. However, the same will be subject to favourable raw material prices and the likelihood and impact of other Covid waves. Additionally, developments on the Russia-Ukraine war front will remain a key monitorable, going forward.

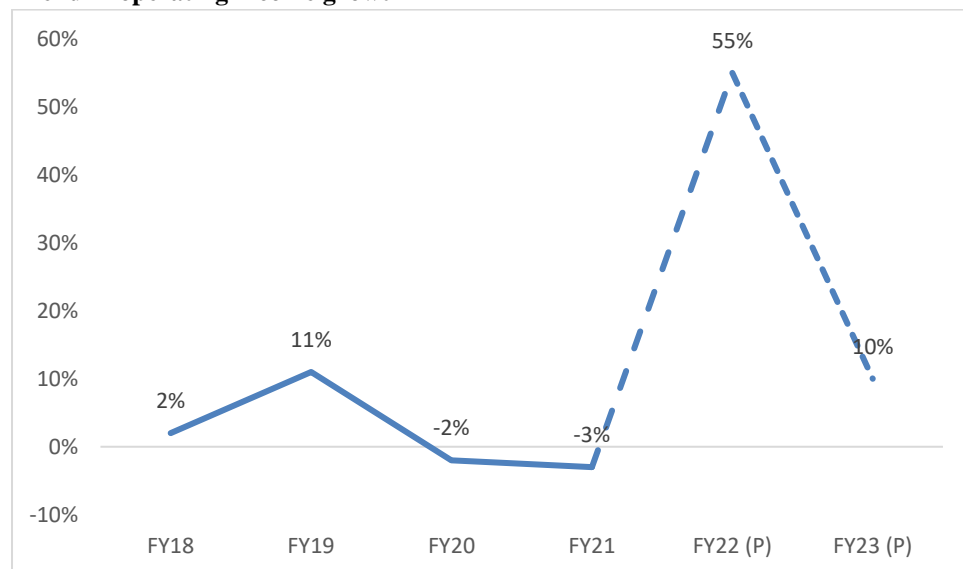
Trend in average spread (Rs per kg)



Note: It has been calculated considering J-34 variety of cotton and 40s combed spun yarn

Source: The Cotton Corporation of India; Textile Excellence, BWR Research

Trend in operating income growth

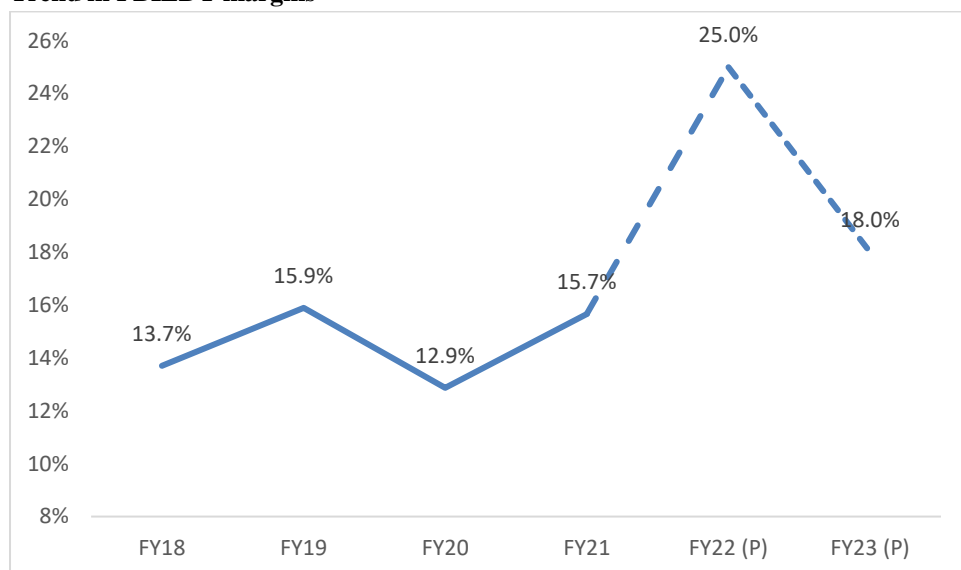


Note: The above data is derived from the sample companies in the cotton spinning industry as listed on stock exchange

P: Projected

Source: NSE, BSE, BWR Research

Trend in PBILDT margins

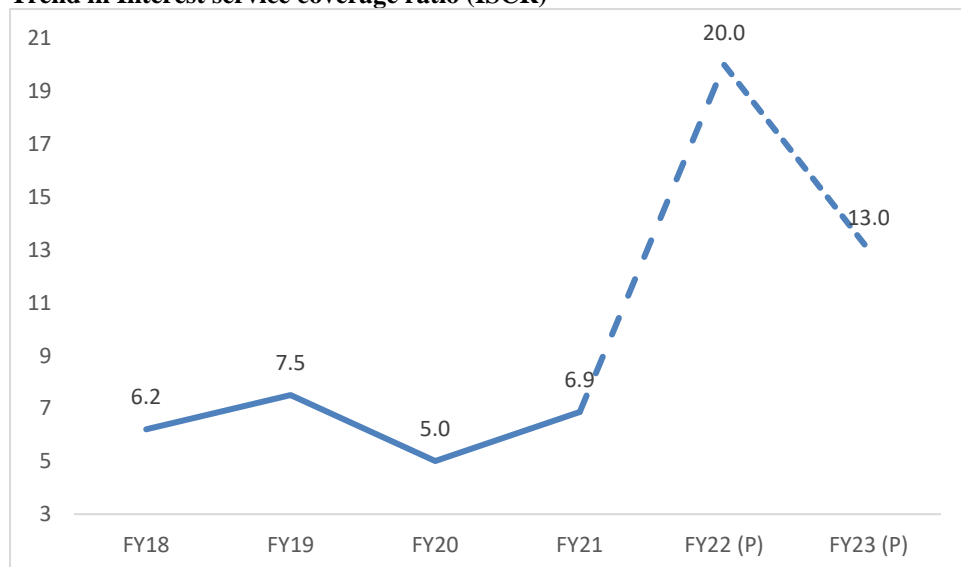


Note: The above data is derived from the sample companies in the cotton spinning industry as listed on stock exchange

P: Projected

Source: NSE, BSE, BWR Research

Trend in Interest service coverage ratio (ISCR)

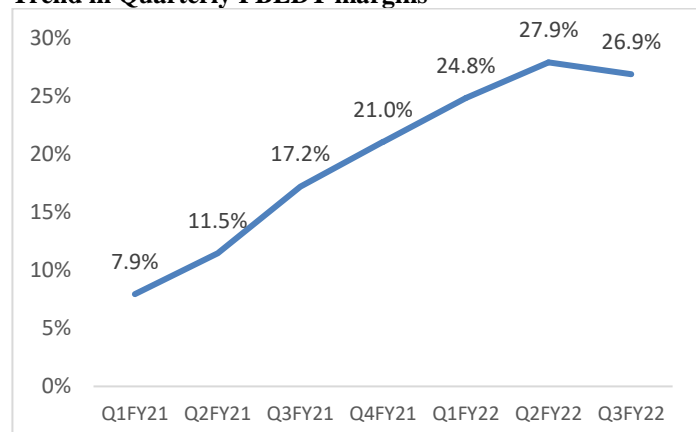


Note: Note: The above data is derived from the sample companies in the cotton spinning industry as listed on stock exchange

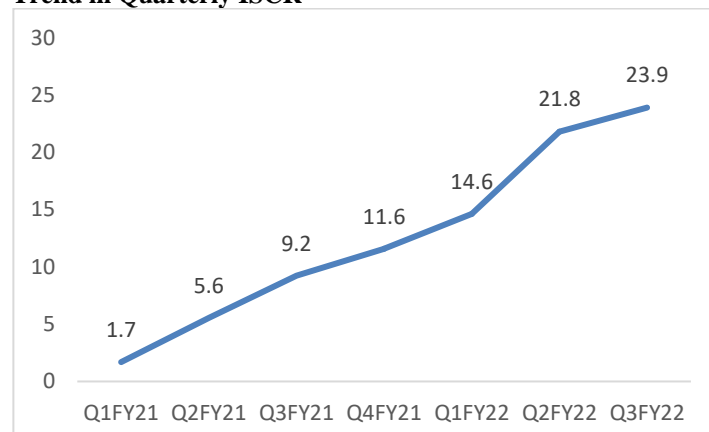
P: Projected

Source: NSE, BSE, BWR Research

Trend in Quarterly PBLDT margins



Trend in Quarterly ISCR



Note: Note: The above data is derived from the sample companies in the cotton spinning industry as listed on stock exchange

P: Projected

Source: NSE, BSE, BWR Research

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