Indian Spinning Industry

Stable with possible downside risk emanating from recent policy changes in China

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Summary Highlights and outlook

COTTON STOCK

Global stock levels expected to increase to all time high at the end of CY[1] 2014/15

- Global stock levels are expected to increase for the fifth consecutive year, despite an expected decline in global cotton production for CY 2014/15 and growth in consumption
- While the decline in cotton production in CY 2014/15 is expected to be driven by the top two cotton producing countries, China and India; the extent of decline will be partially offset by expected increase in the cotton production in the third largest producer, USA, which would keep the decline in total cotton production modest at ~1.4% to ~147.9 million bales
- The global cotton consumption, driven primarily by China, is expected to increase at a relatively higher rate of 2.2% to reach 143.2 million bales; however the consumption would still continue to be lower than the production which is likely to increase the cotton stock levels; though the increase will be modest by ~4%, whereby the closing stock is expected to reach all time high of ~130.3 million bales by end of CY 2014/15

Cotton policy in China changed from cotton procurement at support prices to one based on direct subsidy; however uncertainty in areas to be covered under the new policy could result in decline in acreage and production in China in CY 2014/15

- In April 2014, China has terminated its three year old cotton procurement policy. It would now shift to a direct subsidy based policy from CY 2014/15
- Under the new policy, farmers would sell the cotton at the market prices and in case the market price is lower than the government set target price, the difference (subsidy) would be paid directly to the farmers. China has set the target price of Yuan 19,800/ton for CY 2014/15 which is lower than the support price of Yuan 20,400/ton for CY 2013/14 and CY 2012/13, though it is equal to the support price for CY 2011/12
- Direct subsidy policy to be initially implemented only in Xinjiang region. Uncertainty on the market price and whether the policy would be extended to other regions as well are key reasons for expected decline in the acreage and cotton production in China in CY 2014/15

Shift towards direct subsidy would make cotton available at market rates to mills in China, thereby reducing the dependence on imported cotton as well as imported cotton yarn

- The shift towards the direct subsidy mechanism would improve domestic availability of cotton at market rates to the mills in China, thereby reducing the dependence on imported cotton
- Due to expected decline in China's cotton production and increase in consumption of its domestic cotton; unlike last three years, the cotton stock levels are not expected to increase significantly by the end of CY 2014/15
- Despite the increased availability of cotton to mills in China in CY 2014/15, given its sizeable requirement of cotton yarn, it would continue to meet its requirement either through cotton and/or cotton yarn imports; import duty structure on these product will be the driver

Import duty on cotton and cotton yarn in China can be a key determinant of cotton yarn exports from India

- Given the difference between China's cotton production and consumption of cotton yarn, China would continue to be dependent on cotton/yarn imports
- With change in the cotton policy, if the state reserves of cotton stock is not liquidated, continued duty free imports of yarn and/or sustained import duty on cotton imports will be key determinants for ensuring that the demand for yarn is met through import of yarn, rather than import of cotton
- Reduced import duty on cotton and/or levy of import duty on yarn, can partially shift the Chinese demand to cotton from cotton yarn as was the case prior to CY 2011/12

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[1] Refers to International Cotton Year, which commences from August and ends in July

Steady domestic consumption coupled with high level of cotton exports will continue to keep the stock position tight in India at the end of CY[2] 2013/14 despite record cotton production

- The domestic cotton stock position in India is expected to remain tight at the end of CY[2] 2013/14, despite expectation of record cotton production in CY 2013/14, which would be in contrast to the global stock position which is ruling at all-time high levels.
- ICRA's production estimates for CY 2013/14 remains same as earlier at ~36.5~37.5 million bales; however cotton exports are expected to be higher by ~25% at ~10.0~10.5 million bales from our earlier estimates as ~9.0 million bales have already been exported during till March 2014
- The cotton consumption is expected to increase by ~3~5% to ~29.2~29.7 million bales in CY 2013/14, which is similar to the earlier estimate
- Due to high level of cotton exports, the closing cotton levels are expected to be lower than our earlier estimates at ~1.8~2.3 million bales which would be equivalent to ~6~8% of stock to consumption ratio at the end of CY 2013/14 and could be the lowest level over the last two decades, unless the stock levels are revised as was done in CY 2012/13 by Cotton Advisory Board (CAB)

OUTLOOK ON COTTON PRICES

International cotton prices to remain range-bound during second half of CY 2013/14, however continue to remain exposed to downside risk in CY 2014/15 due to change in China's cotton policy

- Notwithstanding the record global cotton stock levels, the global prices had remained range-bound at ~USD 2/Kg on account of low stock levels outside China as the high support prices in China had kept most of the Chinese cotton stock unavailable to the mills, which had relied on import of cotton and yarn from other countries to meet its requirements
- As the global (ex China) stock to demand (including export demand) ratio is expected to remain tight and at similar levels for CY 2013/14 as those in CY 2012/13, the international cotton prices are expected to remain firm and range-bound for the balance of the cotton year CY 2013/14 as well. However, the key imponderable would be the extent of release of cotton by China which holds ~60% of global stock
- The moderation in global cotton prices as a result of changes in China's procurement policy could be felt in CY 2014/15 when the home grown cotton would be available to Chinese mills at the market price , thereby reducing their dependence on imported cotton and yarn

Range bound international prices and tight domestic stock position to keep the domestic cotton prices also firm for CY 2013/14, though they would also be driven by exchange rate

- The domestic cotton prices had also remained firm in line with the international prices; however due to depreciation of the rupee, the increase in the domestic prices had remained higher than the international prices, as the domestic prices are at international parity during period of unrestricted cotton imports/exports . As a result, the procurement cost for the spinning mills is higher in CY 2013/14 vs corresponding period in CY 2012/13
- With the tight domestic cotton stock position due to continued high levels of cotton and cotton equivalent yarn exports, the domestic prices are also expected to remain firm during the second half of CY 2013/14. However, appreciation of the rupee during this period could moderate the increase in domestic prices and may keep the domestic prices range-bound during the second half of CY 2013/14 which otherwise typically increase towards the end of the cotton season
- The domestic prices during CY 2013/14 till March 2014 have remained higher than the support prices; however they are close to the support price of Rs 113/Kg for the CY 2013/14. Given the tight fiscal position of the government, Kapas support price for CY 2014/15 has been increased marginally by Rs. 50/quintal for Kapas, that will translate into a hike of only ~Rs 1.5/kg for the ginned cotton
- The average domestic cotton prices were higher by ~20% during the harvest season (October-March) in CY 2013/14 over the previous period; however given the cautious approach being adopted by the mills for cotton stocking, the funding requirements of the mills has not increased significantly as the stocking levels (as on March end) were also lower by ~20% at ~57 days of consumption compared to ~72 days last year

[2] Refers to Indian Cotton Year, which commences from October and ends in September

OUTLOOK ON COTTON YARN & INDIAN SPINNING INDUSTRY

Domestic cotton yarn production likely to moderate in FY 2014-15

- The demand for cotton yarn continued to remain healthy with cotton yarn production increasing by 6% YoY during Jan-Mar 14 and by 1% QoQ, driven by steady domestic demand and strong export demand. The cotton yarn production for the full year FY 2013-14 had increased by ~9% to 3.9 million tons
- As a result, the capacity utilization of the spinning industry has also increased to a level of ~95% in FY 2013-14 compared to 87% in FY 2012-13, which given the substantial nature of fixed overheads have also contributed to improved profitability in FY 2013-14
- The export volume during Jan-Mar 14 was equivalent to ~36% of total production and had remained at similar levels during FY 2013-14 as compared to 31% level in FY 2012-13, and significantly higher than ~20%~23% levels historically. The incremental export demand continues to be driven by imports from China
- However, due to expected moderation in the export demand, the export volume during FY 2014-15 is expected to be lower compared to that in FY 2013-14 and consequently the yarn production may also decline during FY 2014-15, unless supported by pick up in domestic demand

Margins continue to moderate in Q4 FY 2013-14 on account of higher cotton prices and are lower compared to previous year

- The international price for Indian cotton yarn continues to remain lower compared to that in the corresponding period last year and the price of USD 3.17/Kg in March 2014 was lower by 10% YoY. The cotton price had however remained higher compared to that in the corresponding period last year, due to which the contribution margin for the Indian exporters continues to remain lower compared to that in the corresponding period last year. The contribution margin was USD 1.24/Kg in March 2014 which was lower by 21% YoY
- In contrast, due to rupee depreciation, the domestic cotton yarn prices had remained higher over previous year during most of FY 2013-14 and the decline in the contribution margin in rupee terms was also lower compared to the decline in the contribution margin in USD terms. The contribution margin of Rs. 78/Kg in March 2014 was lower by 7% YoY

Outlook on the Indian spinning industry is stable for FY 2014-15; upside potential is limited with downside risk emanating from policy changes in China

- The outlook on the Indian cotton spinning industry is stable for FY 2014-15, though the upside potential is limited with risks emanating from the recent policy changes undertaken by China for cotton procurement for CY 2014/15
- The impact of the policy change may start having impact from October 2014, i.e. the commencement of the CY 2014/15, which may reduce the cotton price in China, thereby improving its domestic yarn production and hence reduce export demand of Indian yarn
- While China would likely continue to be dependent on imports to meet its cotton requirement, even after change in the cotton policy if the current high levels of cotton stock is not liquidated, continued duty free imports of yarn and sustained import duty on cotton imports by China will be critical to ensure that the Chinese yarn demand is met through import of yarn, rather than import of cotton

FY 2013-14 was one of the best years for the Indian spinning industry; however the financial profile is expected to moderate in FY 2014-15 as also evident in moderation since Q3 FY 2013-14 onwards

- In-line with the production growth of ~6% and ~5% increase in the yarn realization for the industry in Q4 FY 2013-14 over the corresponding period last year, the revenues of 24 listed cotton spinning companies in ICRA's sample-set have grown by 14% (YoY) and 1% on QoQ basis. This is lower than 21% growth in Q3 FY 2013-14 on YoY basis. The lower revenue growth in Q4 FY 2013-14 was due to moderation in the production growth due to capacity constraints as the industry operates at high utilization levels. The revenues in FY 2013-14 for the companies in ICRA sample set increased by 19%, which is attributable to ~10% increase in the yarn production and ~7% increase in the yarn realization for the industry. While the volumetric growth may not be significant in FY 2014-15 due to capacity constraints, however ability to prevent a de-growth in the backdrop of expected moderation in export demand will remain a key challenge for domestic industry
- The profitability margin remained comfortable in Q4 FY 2013-14 at 14.9%, though it has declined from ~16.4% in Q3 FY 2013-14 and is at the lowest level since Q1 FY 2012-13, due to increase in cotton price in CY 2013/14 and modest increase in the yarn realization. For FY 2013-14, the profitability was at 16.8% compared to 16.1% last year. ICRA expects the profitability to be lower at ~14~15% in H1 FY 2014-15 compared to 18.1% in H1 FY 2013-14 due to expected pressure on exports as well as higher cotton prices

- In-line with declining profitability, the interest coverage had moderated to 3.5 times in Q4 FY 2013-14 compared to 4.2 times in Q3 FY 2013-14. However given the overall improvement in profitability during FY 2013-14, the interest coverage improved to 3.9 times from 2.9 times, as healthy accruals over the last two years, lower capital expenditure and similar level of working capital borrowing had reduced the debt levels, which is also evident in 6% decline in the interest expense during the year despite 19% growth in the revenues
- With profitability pressures expected to continue in FY 2014-15, the interest coverage as well as other debt protection metrics are expected to weaken from FY 2013-14 levels

Revival of capital expenditure expected in the industry with availability of benefits under RR-TUFS, state investment subsidies and improved financial position

- The total value of the projects approved under RR-TUFS is estimated to have increased to ~Rs. 75 billion till May 2014 compared to ~Rs. 23 billion till January 2014 indicating steady revival of capital expenditure supported by improved financial profile of companies during last two years
- Due to reduction in incentives available to standalone spinning projects under RR-TUFS, the incremental investment in the standalone spinning projects has slowed down. The share of standalone spinning projects approved under RR-TUFS was ~34% of the total projects approved as on May 2014, though it has improved from a share of 23% as on January 2014
- The moderation is also evident in only 24% of the total subsidy earmarked for standalone spinning projects utilized till May 2014 (increased from 5% as on January 2014) compared to utilization of 43% of the total subsidy earmarked for other sectors
- ICRA expects that given the improvement in the financial profile of most of the companies in spinning sector and steady demand; the investments in the sector to maintain momentum in near to medium term with incentives available under RR-TUFS and various state investment schemes

Please contact ICRA to get a copy of the full report

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