Cotton Yarn Industry Set for Revival with 5-7% Volume Growth in FY24

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CareEdge RATINGS

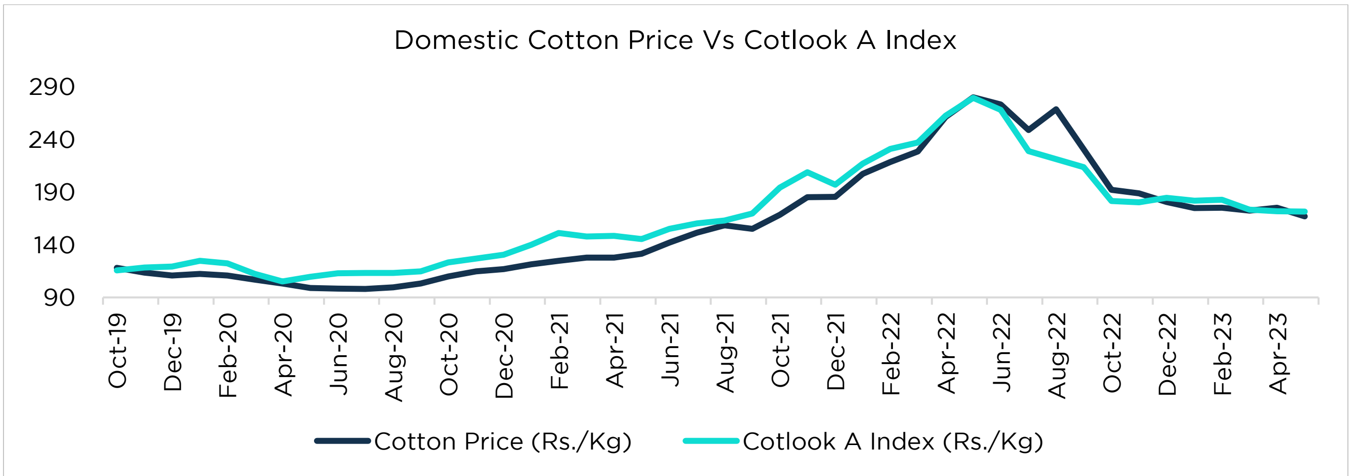
Synopsis

- In FY22, Indian cotton yarn manufacturers achieved record-high profitability due to strong demand, lower domestic cotton prices compared to international prices, and the USA's ban on cotton products from China's Xinjiang region, which redirected some demand to India.
- However, the industry faced several challenges in FY23. These included the disparity between domestic and international cotton prices, a decline in global demand due to high inflation and recessionary pressures in developed economies, and increased energy and supply chain costs. Consequently, India experienced its lowest cotton yarn exports in a decade, leading to a decline in sales volume and a contraction in the operating profitability margin for cotton yarn spinners in FY23, which remained below the historical average.
- While challenges are expected to persist in H1FY24, there are positive indications for the demand of Indian cotton yarn in H2FY24. Factors contributing to this improvement include the alignment of Indian cotton prices with international prices, a shift in demand from competing nations, gradual recovery in demand from China following the relaxation of its zero-covid policy, and a rebound in global demand from downstream industries.
- Indian cotton yarn industry is likely to witness 5-7% growth in sales volume, while the operating margin is expected to expand by 100-150 bps in FY24 over FY23.

Softening of Cotton Prices

Cotton production in India witnessed a decline from 352 lakh bales in Cotton Season (CS) 2020-21 to 311 lakh bales in CS 2021-22. However, it is expected to recover and increase by 6-9% to 330-343 lakh bales in CS 2022-23. This projected increase is supported by a 6% expansion in the cultivation area and a 2-3% rise in yield.

The lower cotton production in CS 2021-22 led to an upward trend in cotton prices. The average domestic cotton price, specifically Shankar-6, experienced a significant surge from ₹38,000 per candy (~356 kg; ₹107/kg) in CS 2019-20 to ₹47,000 per candy (₹132/kg) in CS 2020-21, and ₹81,500 per candy (₹229/kg) in CS 2021-22. After recording a peak of around ₹1 lakh per candy (₹280/kg) in FY23, domestic cotton prices corrected with the arrival of the new crop, and they are currently hovering around ₹56,000-57,000 per candy (₹157-160/kg), aligning with international prices.

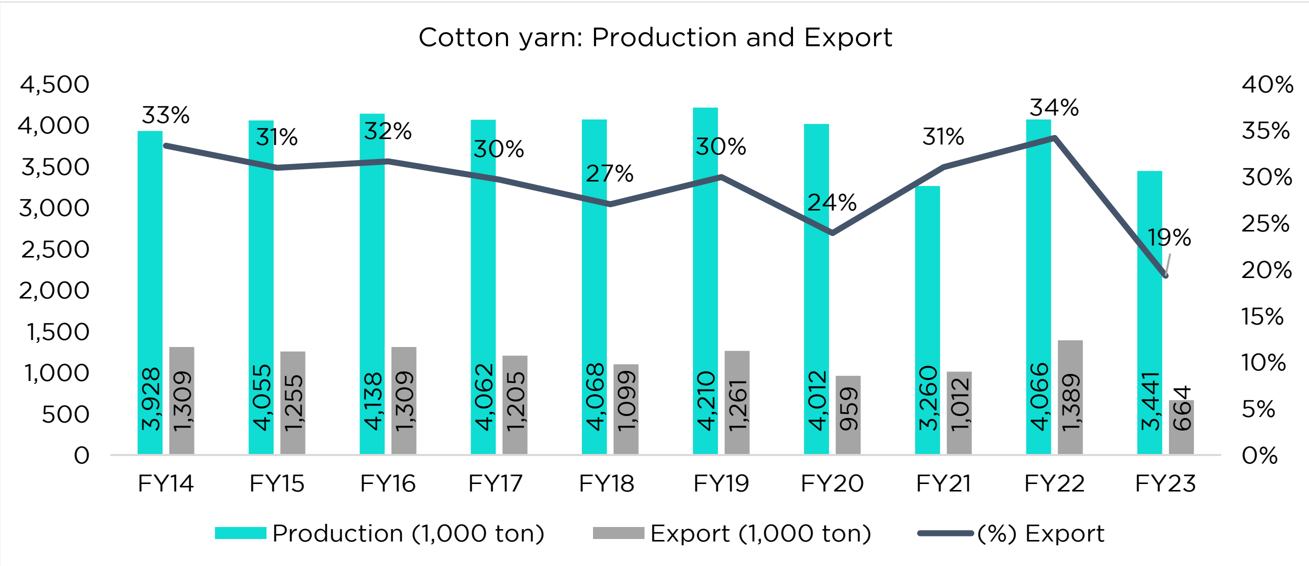


Source: CareEdge Ratings; CMIE

Historically, Indian cotton prices had largely remained at par or lower than international cotton prices. However, it remained 20-25% higher than international prices in FY23 resulting in decline in the competitiveness of Indian cotton yarn spinners amidst restrictions on cotton import.

Cotton Yarn Production and Export

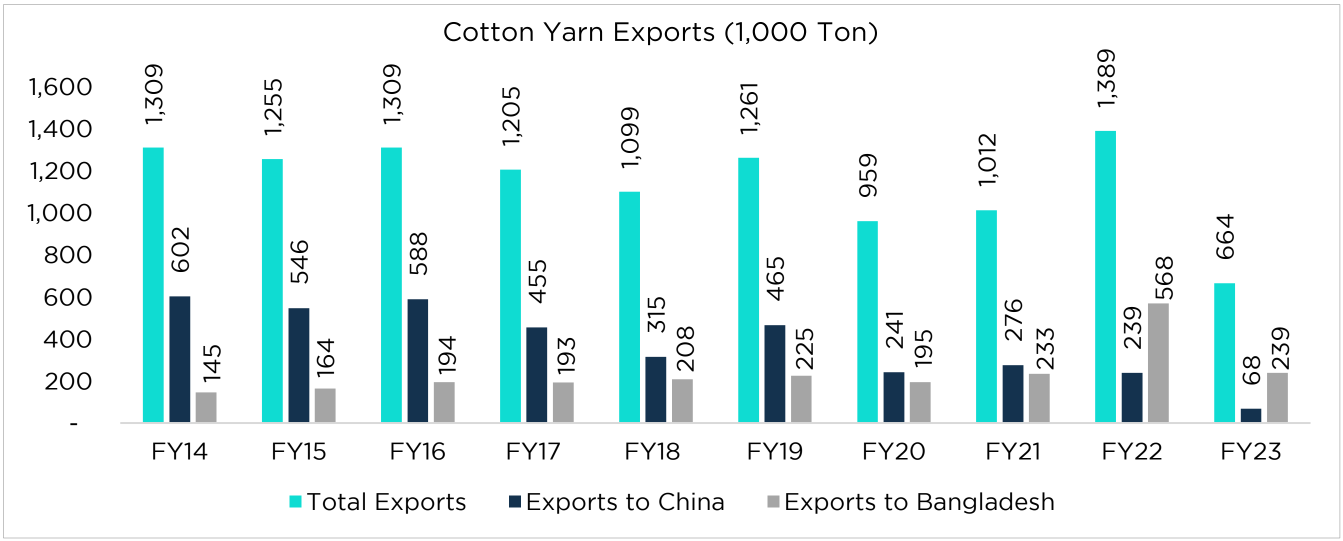
India's cotton yarn exports have a significant impact on its production, accounting for around 25-35% of the total production. The demand for cotton yarn in FY22 was strong, driven by downstream demand for home-textile products and the advantage of lower domestic cotton prices compared to international prices. Furthermore, the USA's ban on cotton products from China's Xinjiang region redirected some of the demand from China to other countries, including India. This increased demand led to an elevated cotton yarn spread of around Rs.125/kg in FY22, which was 25-30% higher than the historical average.



Source: CareEdge Ratings; CMIE

However, in FY23, Indian cotton yarn exports faced challenges due to the disparity between domestic and international cotton prices, affecting India's global competitiveness. The global demand slowdown resulting from high inflation and recessionary pressures in developed economies, such as the USA and the European Union, further impacted the industry. Retailers with excess inventories deferred new orders for home textiles and ready-made garments (RMG), negatively impacting the demand for cotton yarn.

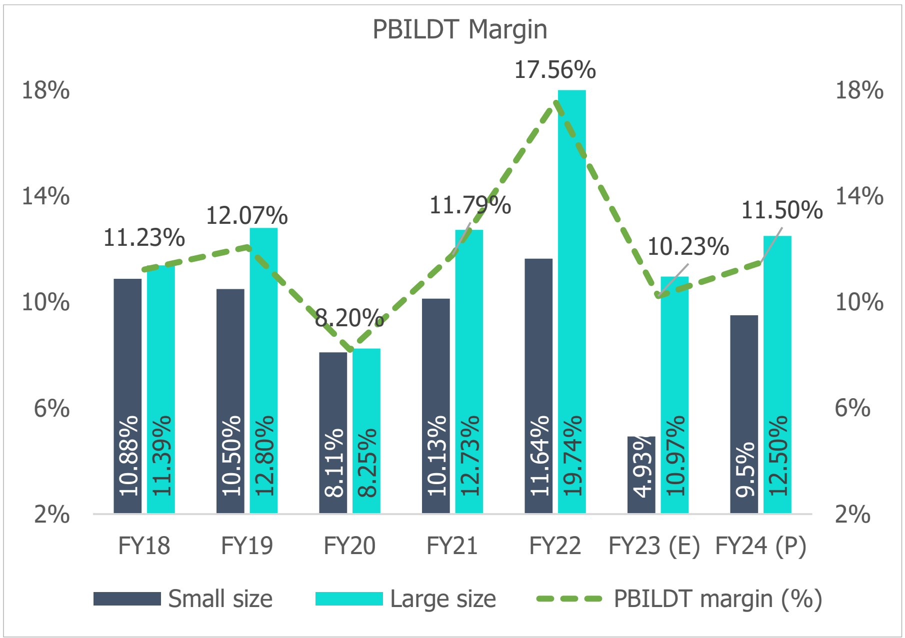
Indian cotton yarn exports hit a decade-low level of 664,000 tonnes in FY23, compared to the highest exports of 1,389,000 tonnes in FY22. Consequently, cotton yarn exports stood at 19% of cotton yarn produced in FY23. While spinning units were able to pass on the increase in cotton prices to some extent, the significant drop in sales volume, coupled with rising energy costs and freight rates, led to a contraction in operating profitability (PBILDT; profit before interest, lease, depreciation and tax) margins. The average spread of cotton yarn remained around Rs.100-105/kg, similar to pre-Covid levels.



Source: CareEdge Ratings; CMIE

Historically, China was the largest buyer of cotton yarn from India. However, post the USA's ban, Bangladesh took its place and became largest importer of Indian cotton yarn during FY22 and FY23. Despite de-growth in export of cotton yarn to Bangladesh, it remained higher than historical level while exports to China declined to historical low in FY23 on the back of its zero covid policy which affected its domestic consumption.

Large-size Companies Show Resilience



Large scale of operations not only fetches better operating margin through economies of scale but also rewards company substantially in favourable times and exhibit resilience in challenging times. On a normal market condition during FY18-FY21, PBILDT margin of large size companies remained better than that of small size companies by nearly 0.5%-2.5%. However, the margin of large size companies outperformed significantly by around 800 bps in favourable industry scenario during FY22 while it continued to outperform by 600 bps during FY23 when industry faced several headwinds.

Source: Ace Equity; Compiled by CareEdge Ratings
Note 1: The study represents cotton yarn spinners accounting for over 40% of the industry.
Note 2: Classification by revenue; Large size > ₹500 crore; Small size < ₹500 crore.

Despite near-term challenges, large-size companies continued to show resilience while smaller-size companies are vulnerable to unfavourable market conditions.

Demand Revival Likely in H2FY24

After facing numerous challenges, the Indian cotton yarn industry is poised for improvement in FY24. This recovery is expected to be supported by several factors. Firstly, the parity with international cotton prices will enhance the competitiveness of Indian cotton yarn. Secondly, there is a shift in demand from competing nations, which can create opportunities for Indian exporters. Additionally, the gradual relaxation of China's zero Covid policy is anticipated to improve demand from China. Moreover, the recovery in global demand from downstream industries will further contribute to the growth of the cotton yarn sector. The significant decline in cotton arrivals in Pakistan during CS 2022-2023, caused by floods, may create an opportunity for Indian cotton yarn manufacturers to cater to the gap in the market. Furthermore, the trade agreements with Australia and UAE are expected to benefit the Indian cotton yarn industry, opening up new avenues for export.

In addition to export demand, the domestic consumption of cotton yarn is expected to contribute to its growth. India is projected to experience an increase in order flow for RMG and home textiles in H2FY24, as retailers begin restocking their inventories. This resurgence in demand from the domestic market will positively impact the demand for cotton yarn.

CareEdge Ratings View

"Slowdown in demand is expected to continue in H1FY24 amidst macro-economic headwinds while demand is expected to improve in H2FY24, thereby limiting growth in FY24. Overall, the Indian cotton yarn industry is expected to witness 5-7% growth in sales volume during FY24 while average sales realisation of cotton yarn is expected to fall by 12-17% followed by a decline in cotton prices. Subsequently, the Indian spinning industry to register a revenue de-growth of around 8-10% while the operating margin is expected to expand by 100-150 bps aided by higher capacity utilization, softening of cotton prices coupled with the benefit of lower freight and power cost," said Krunal Modi, Associate Director at CareEdge Ratings.

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