SPINNING SECTOR

An Overview

September 2020

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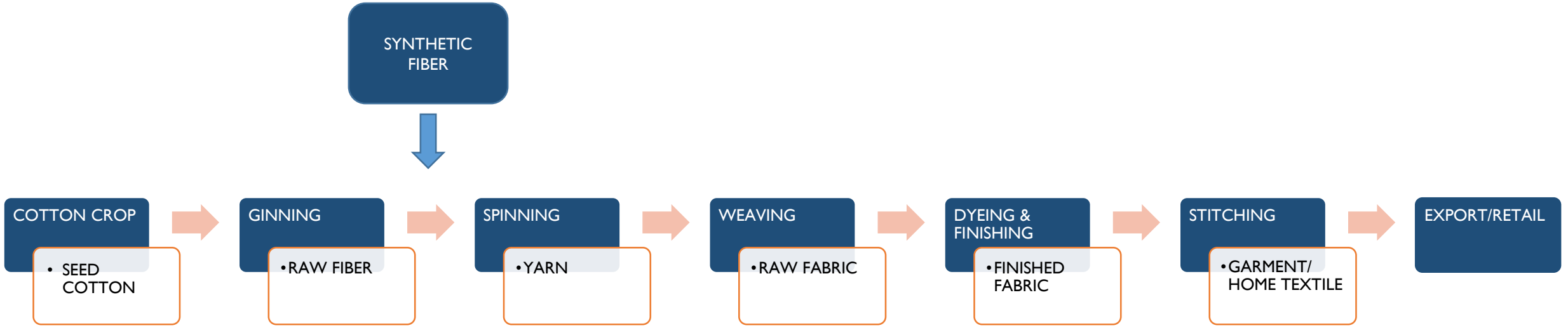
TEXTILE | VALUE CHAIN

- Textile cluster has one of the largest value chains in the manufacturing universe.
- The following flow chart depicts the major processes along with the output of every process of the textile cluster's value chain:

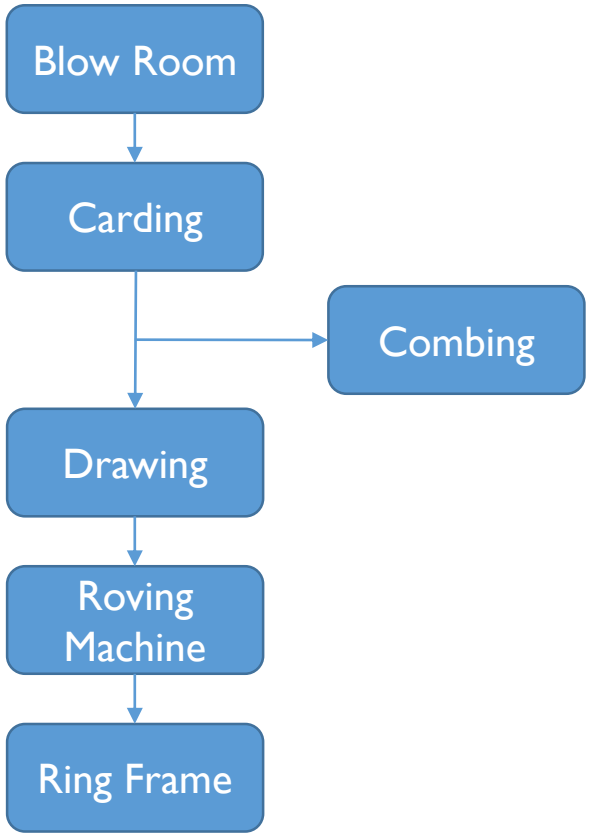


SPINNING | INTRODUCTION & PROCESS

- Spinning is the process of twisting together of drawn out strands of fibers to form yarn.

Process:

- Blow Room: To form a uniform lap from the cotton bale.
- Carding: Cleaning and intermixing of fibers to produce a continuous web.
- Combing: Separating long staple fibers from short staple fibers.
- Drawing: Strengthening fibers by passing them through rollers.
- Roving: Fibers are converted into low twist lea called roving.
- Ring Frame: Spinning and winding the fibers around a rotating spindle.



SPINNING | TECHNOLOGY & MACHINES

- Major manufacturers of spinning machines (i.e. spindles & rotor machines) and other textile machinery are based in Germany, Italy, Belgium, Switzerland, China, and Japan.
- Major manufacturing brands include Saurer Schlafhorst GmbH & Co., Toyota, Murata Machinery Limited, Savio Machine Tessilli, Rieter, RIFA Textile Machinery Co. Ltd. Lakshmi Machine Works Limited, among others.
- The efficiency of spinning machines is determined by the number of spindles installed on the machine and its RPM. More advanced machines have higher RPM, resulting in higher efficiency. The RPM of latest looms from major manufacturers can reach up to ~125,000 - 150,000RPM.
- Overall, spinning machines have low cost investments. The price ranges between USD ~300-800/spindle depending on the RPM, level of automation of back processes and country. The spindles are mounted on frames.
- Almost all machinery used in the sector is imported from Europe and East Asian Countries (mainly China). Further, there is a need for continuous technological BMR to improve efficiency to remain competitive in the international landscape.

Source: Manufacturers Websites

SPINNING | TYPES | YARN COUNT

Types of yarn are differentiated by the material used and/or yarn count;

- Cotton Yarn
- Synthetic Yarn (Polyester, Nylon, Acrylic, etc.)
- Blended Yarn

- Yarn count is a measurement which determines its fineness or coarseness.
- There are two methods of calculation of Yarn Count, Direct and Indirect, with Indirect method more widely practiced.
- The Direct Method uses weight per unit length to determine count with thicker/coarse yarn having higher count. There are various numbering systems as shown in the following table.
- The Indirect Method uses length per unit weight to determine count with finer yarn having higher count. There are various numbering systerms as shown in the table.
- The English numbering system is practiced in Pakistan. The unit length of 840 yards is also known as a hank. The number of hanks per lb. of yarn equals the yarn count.
- In Pakistan, yarn is divided between coarse, medium, fine and super fine categories based on count with **major production concentrated in coarse and medium count yarns**.
- Different dying and chemical processes adds value to the product.
- The higher count yarn attracts higher price.

Numbering System	Unit of Length	Unit of Weight
Tex System, Tt	1000 m	No. of grams
Denier, D or Td	9000 m	No. of grams
DeciTex, dtex	10,000 m	No. of grams
Millitex, mtex	1000 m	No. of milligrams
Kilotex, ktex	1000 m	No. of kg
Jute Count	14,400 yards	No. of lb.

Numbering System	Unit of Length	Unit of Weight
English cotton count, Ne/S	840 yards	1 lb.
Metric count, Nm	1000m / 1km	1 kg
Woollen Count (YSW)	256 yds.	1 lb.
Woollen Count (Dewsbury)	1 yd.	1 ounce (oz.)
Worsted Count Nek	560 yds.	1 lb.
Linen Count, NeL	300 yds.	1 lb

Yarn Type	Count
Coarse	1s - 20s
Medium	21s - 34s
Fine	36s - 47s
S.Fine	48s - 80s

Source: Yarn Counts & Calculations, Thomas Woodhouse (Oxford Technical Manuals), TCO

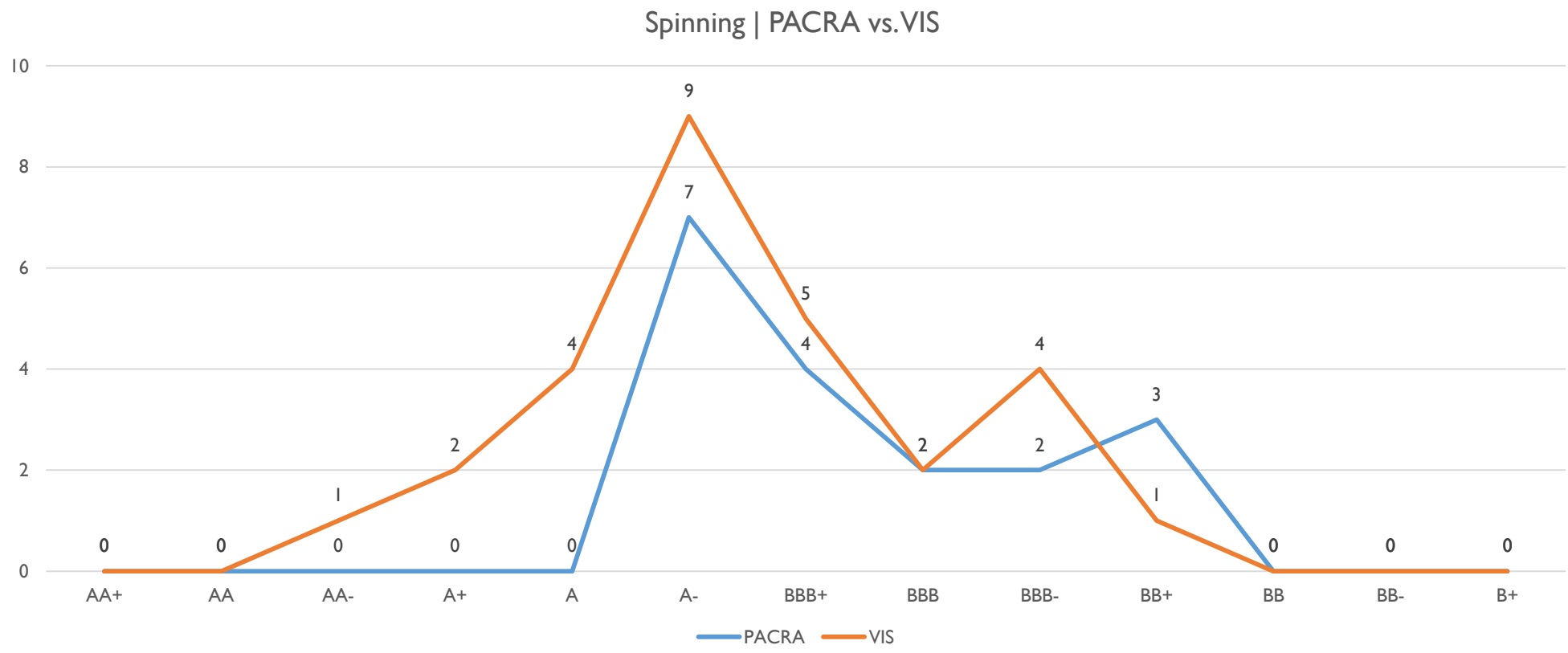
SPINNING | A BRIEF OVERVIEW

- The spinning sector is at mature stage and enjoys a long operating history in the country.
- The spinning sector is divided into two segments, i). Organized segment and ii). Unorganized segment.
- Unorganized segment roughly accounts for ~40-50% of total spinning capacity. No conclusive figures are available on the share of each of these sub-segments in the total spinning sector. Our focus is on organized segment in this sector study.
- Overall, the structure of the sector is competitive, represented by many players of different sizes making homogeneous commoditized products. The price variation in local yarn prices come from quality and some differentiation (dyed yar, blended etc.)
- The major export destinations of the sector are other China, Asian & South Asian countries which utilize yarn as an input in the manufacturing process.
- There are **~80-100 players** in the organized segment in operations. On average, players have installed capacity of ~40,000-50,000 spindles.
- Players having installed capacity of <30,000 spindles are considered small sized, between 30,000 to 60,000 are medium scale, and >60,000 are large scale manufacturers. Minimum installed capacity in organized segment is ~20,000 spindles. The large manufacturers enjoy economies of scale resulting in efficiency and higher margins than peers.
- Textile cluster represents ~20.9% weight in Large Scale Manufacturing (LSM) index with **spinning sector having ~13%** weight in LSM index. The spinning sector contributed an estimated **2.6% in the overall GDP** of the country.

Source: PBS, SBP, TCO, PACRA Database

SPINNING | RATING CURVE

- **PACRA rates ~2,141,000 spindles or ~19% of the total operational spindles.**



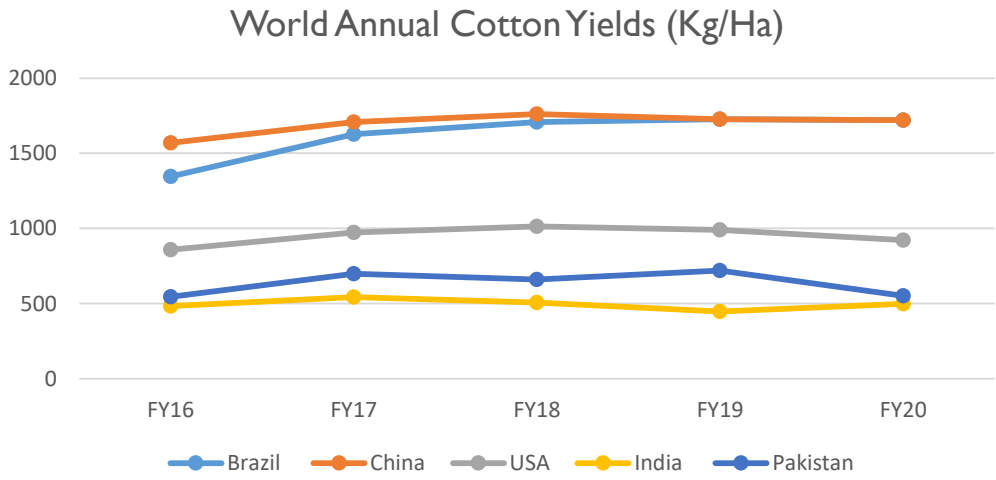
Source: PACRA Database

SPINNING | WORLD COTTON DYNAMICS

PRODUCTION & YIELD

- World cotton production stood at **26.8mln MT** in FY20, showing a CAGR of ~6.5% since 2016.
- India & China remain two of the largest cotton producers in the world, representing ~47% of total output.
- All major cotton producing countries have shown positive growth in the last 5 years. On the contrary, Pakistan experienced contraction in its cotton output by ~3%pa.
- Pakistan's cotton production represents ~5% of total world output.
- Annual cotton yields remained relatively stable since FY16 around the world.
- Among the major cotton producers, China & Brazil have the highest cotton yield per hectare.
- Pakistan's cotton yield clocked in at ~550kg./ha, one of the lowest in the world.

World Cotton Production (000 MT)					
Country	**FY16**	**FY17**	**FY18**	**FY19**	**FY20**
India	5,639	5,879	6,314	5,617	6,641
China	4,790	4,953	5,987	6,042	5,933
United States	2,806	3,738	4,555	3,999	4,336
Brazil	1,289	1,528	2,007	2,830	2,874
Pakistan	1,524	1,676	1,785	1,655	1,350
Rest of World	4,889	5,452	6,341	5,691	5,640
Total	**20,937**	**23,226**	**26,989**	**25,834**	**26,774**



Source: Trade Map, USDA

CONSUMPTION & ENDING STOCK

- Total world cotton consumption stood at **~22mln MT** in FY20, showing a negative CAGR of ~2.5% since FY16.
- China & India are two of the largest cotton consumers in the world, representing ~52% of total world consumption.
- Despite low contribution in world output, Pakistan stands as the third largest cotton consumer and consumes ~9% of total output.
- The world held ~22mln. MT of cotton as at June 20.
- China & India hold ~56% of the world's cotton inventory.
- China has steadily reduced its cotton inventory since FY16. On the contrary, India & Brazil have significantly increased their holdings.
- Pakistan's cotton stock remained relatively stable over the last few years.

World Cotton Consumption (000 MT)

Country	FY16	FY17	FY18	FY19	FY20
China	7,838	8,382	8,927	8,600	7,185
India	5,389	5,302	5,258	5,225	4,355
Pakistan	2,243	2,243	2,373	2,330	1,960
Bangladesh	1,372	1,481	1,633	1,611	1,350
Turkey	1,459	1,426	1,622	1,502	1,393
Vietnam	980	1,176	1,437	1,524	1,328
Rest of World	5,374	5,280	5,475	5,407	4,779
Total	**24,655**	**25,290**	**26,725**	**26,199**	**22,350**

World Cotton Ending Stocks (000 MT)

Country	FY16	FY17	FY18	FY19	FY20
China	12,345	9,998	8,272	7,766	8,109
India	1,534	1,716	2,009	2,028	4,140
Brazil	1,243	1,509	1,885	2,668	3,022
United States	827	599	914	1,056	1,589
Pakistan	569	504	616	543	630
Rest of World	3,118	3,149	3,922	3,460	4,404
Total	**19,636**	**17,475**	**17,618**	**17,521**	**21,894**

Source: USDA, Trade Map

IMPORTS & EXPORTS

- Total world cotton trade remained relatively stable over the last few years and stood at USD ~11.5bln in FY20. In volume terms, ~8.6mln MT cotton was traded in FY20.
- China, Vietnam and Bangladesh remained top 3 cotton importers in the world. Pakistan was the fifth largest importer of cotton in FY20. India has drastically reduced its cotton imports during last 5 years.
- United States is the largest exporter of cotton and represents ~50% of total cotton exports. US has almost doubled its share in world exports since 2016.
- Other than US, Brazil, Australia and India account for ~25% of world cotton exports.
- Pakistan's cotton imports grew by ~6.5% p.a. in quantity terms since 2016. The country's imports increased due to declining local production. Pakistan imported 536,000MT of raw cotton in FY20.
- During 2MFY20, Pakistan imported ~75,000MT (2MFY19: ~20,000MT) of cotton amounting to USD ~120mln (2MFY19: USD ~34mln), a ~317% rise. The extraordinary increase came on the back of cotton shortage in local market due to heavy rains.

World Cotton Imports (USD mln)

Country	FY16	FY17	FY18	FY19	FY20
China	1,315	1,803	2,820	3,302	2,720
Vietnam	1,384	1,924	2,429	2,063	1,699
Bangladesh	869	1,474	1,732	1,690	1,392
Turkey	1,043	1,383	1,243	1,456	1,199
Pakistan	750	805	1,078	767	880
Indonesia	916	1,093	1,285	1,035	852
Rest of World	2,846	3,242	3,479	3,641	2,752
Total	**9,122**	**11,723**	**14,065**	**13,955**	**11,494**

World Cotton Exports (USD mln)

Country	FY16	FY17	FY18	FY19	FY20
United States	3,113	5,760	6,587	5,891	5,601
Brazil	1,429	956	1,505	2,093	2,032
Australia	922	1,320	1,612	1,823	660
India	1,874	1,657	1,958	1,554	544
Greece	306	380	399	522	490
Benin	232	266	406	487	111
Rest of World	1,246	1,384	1,598	1,585	2,056
Total	**9,122**	**11,723**	**14,065**	**13,955**	**11,494**

Source: Trade Map, USDA, PBS

SPINNING | PAKISTAN COTTON DYNAMICS

AREA UNDER CULTIVATION | COTTON ARRIVALS

- Cotton crop competes directly with rice, a major export crop, and sugarcane. The support price by government coupled with its high disease resistance makes sugarcane a strong competitor. Resultantly, Pakistan's area under cultivation for cotton crop has declined by ~375,000 (13%) hectare since FY16. Meanwhile, cotton yield remained stagnant over the last few years.
- In line with above-mentioned factors, Pakistan's cotton arrivals declined to 8.6mln bales in FY20 from high of 14.8mln bales in FY15.
- Pakistan achieved ~96% (i.e. ~2.2mln hectare) against proposed sowing target of ~2.3mln hectare in FY20. The cotton crop has been impacted by abnormal weather conditions so far. Hence, the quantity and quality of output is expected to deteriorate. Pakistan is expected to produce ~7-8mln bales in current harvesting season.

Area Under Cultivation (000 Hec.)

Province	FY16	FY17	FY18	FY19	FY20
Punjab	2,243	1,815	2,053	1,888	1,889
Sindh	621	637	612	448	599
KPK	0	0	0	0	0
Baluchistan	38	37	35	37	39
Total	**2,902**	**2,489**	**2,701**	**2,373**	**2,527**

Pakistan Cotton Arrivals (Mln. Bales)

Region	FY16	FY17	FY18	FY19	FY20
Punjab	6	6.9	7.3	6.6	5.1
Sindh	3.8	3.8	4.3	4.1	3.5
Total of Pakistan	**9.8**	**10.7**	**11.6**	**10.7**	**8.6**

Cotton Unit Conversion

Unit	Conversion
1 Bale	170kg
1 MT	1,000kg

Source: PCGA, PCCC

SPINNING | PAKISTAN COTTON DYNAMICS

COTTON ENDING STOCK

- In order to meet its consumption requirements, Pakistan has increased its reliance on imports as local production reduced.
- Pakistan's major import destination remains United States. Pakistan also imports cotton from Brazil, Turkey & Australia.
- The prices of Pakistan cotton are in parity with prices in international market.
- However, the country's ending stock has shown steady growth, clocking in at 308,000 MT in FY20.

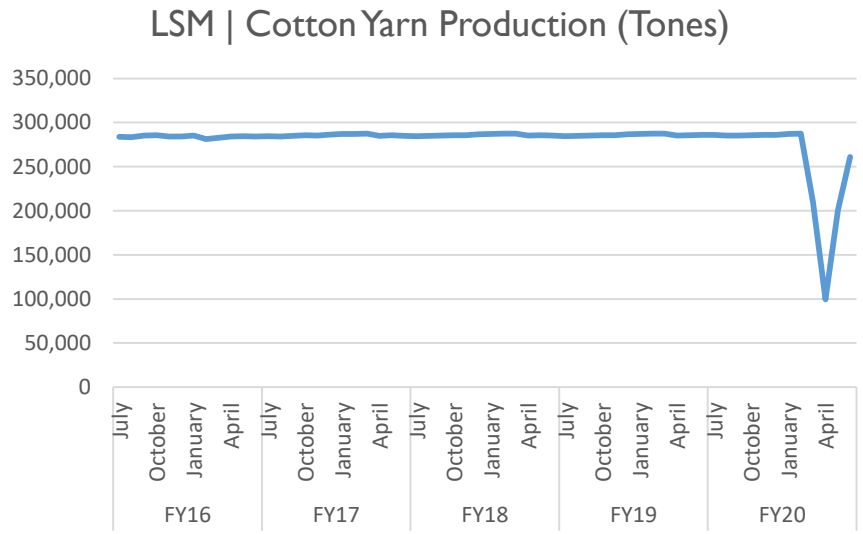
Pakistan Cotton Ending Stocks (000 MT)					
	FY16	FY17	FY18	FY19	FY20
Opening Stock	93	0	75	162	185
Production	1,686	1,814	2,031	1,676	1,560
Imports	417	506	599	415	536
Consumption	2,147	2,220	2,508	2,055	1,960
Exports	49	25	35	13	13
Ending Stock	**0**	**75**	**162**	**185**	**308**

Source: PCCC

SPINNING | INSTALLED CAPACITY & UTILIZATION

- There are ~13 million spindles and ~200,000 rotors installed in the country.
- Out of this capacity, ~11 million spindles (~85%) and ~127,000 rotors (~64%) were operational as at end of June 2020.

		FY16	FY17	FY18	FY19	FY20
Punjab	Spindles Installed	9,546,468	9,546,468	9,546,468	9,546,468	9,546,468
	Spindles Worked	8,108,030	8,108,030	8,164,270	8,164,270	8,164,270
	Rotors Installed	85,480	85,480	85,480	85,480	85,480
	Rotors Worked	59,038	59,038	59,038	59,038	59,038
Sindh	Spindles Installed	2,661,701	2,661,701	2,661,701	2,661,701	2,661,701
	Spindles Worked	2,150,328	2,150,328	2,169,328	2,169,328	2,169,328
	Rotors Installed	85,400	85,400	96,942	96,942	96,942
	Rotors Worked	45,782	45,782	57,324	57,324	57,324
KPK	Spindles Installed	838,376	838,376	838,376	838,376	838,376
	Spindles Worked	698,309	698,309	698,309	698,309	698,309
	Rotors Installed	2,690	2,690	2,690	2,690	2,690
	Rotors Worked	2,452	2,452	2,452	2,452	2,452
Baluchistan	Spindles Installed	269,208	269,208	269,208	269,208	269,208
	Spindles Worked	225,260	225,260	225,260	225,260	225,260
	Rotors Installed	13,689	13,689	13,689	13,689	13,689
	Rotors Worked	7,769	7,769	7,769	7,769	7,769
Pakistan	Spindles Installed	13,409,420	13,409,420	13,409,420	13,409,420	13,409,420
	Spindles Worked	11,263,025	11,263,025	11,338,256	11,338,256	11,338,256
	Rotors Installed	187,259	187,259	198,801	198,801	198,801
	Rotors Worked	115,041	115,041	126,583	126,583	126,583



- The country's yarn production remained stable at ~285,000 Tones per month since FY16 as focus was on BMR rather than expansion.
- However, there was a significant decline from March to May 20 on the back of countrywide lockdown to contain the spread of COVID-19.

Source: PBS, SBP, TCO

SPINNING | YARN PRODUCTION

- Pakistan produced ~3,059mln kg yarn of different varieties during FY20.
- Majority of the yarn produced is of coarse or medium count (~23% and ~24%, respectively), for which local cotton is more suitable.
- ~39% of yarn produced is synthetic or blended yarn.

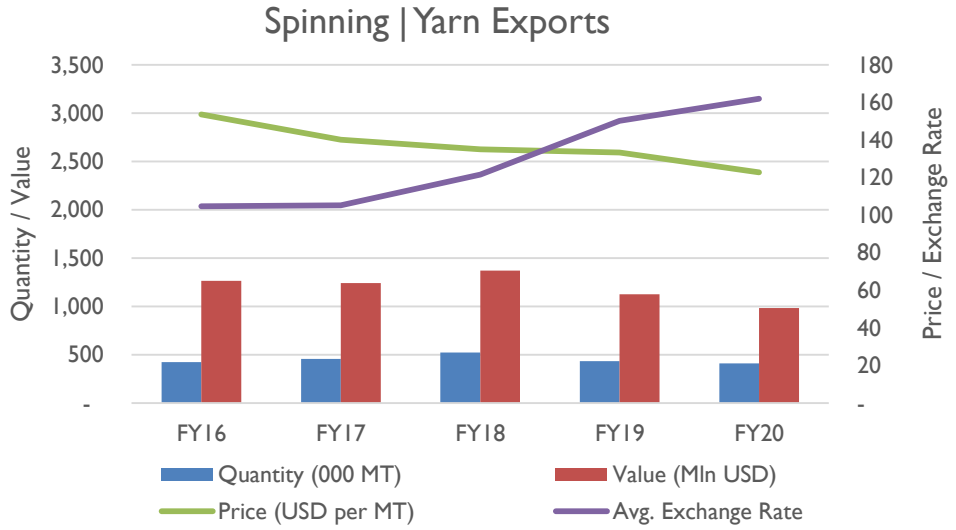
Production of Yarn (000 Kgs)	FY16	FY17	FY18	FY19	FY20*
Coarse (1s – 20s)	781,388	835,510	787,376	790,223	704,575
Medium (21s – 34s)	815,361	702,144	826,399	823,784	734,499
Fine (36s – 47s)	390,694	424,822	393,126	395,655	352,772
S. Fine (48s – 80s)	84,933	114,876	88,406	85,699	76,411
Synthetic/Blended	1,324,963	1,344,974	1,334,743	1,335,929	1,191,135
Total	**3,397,339**	**3,422,326**	**3,430,050**	**3,431,290**	**3,059,392**

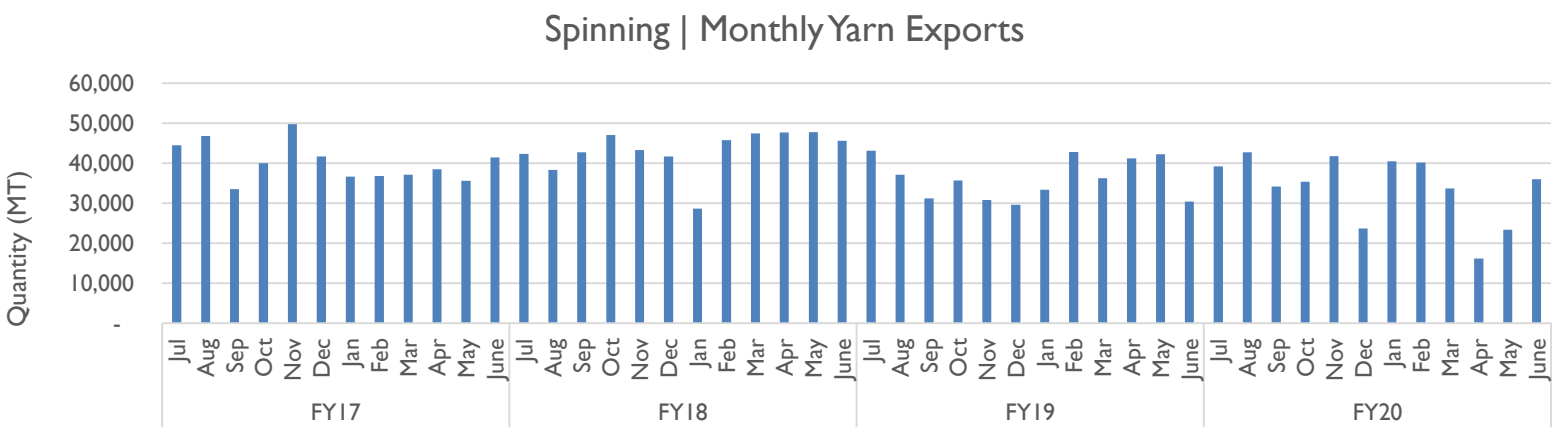
**FY20 figures have been prorated using FY19 data*

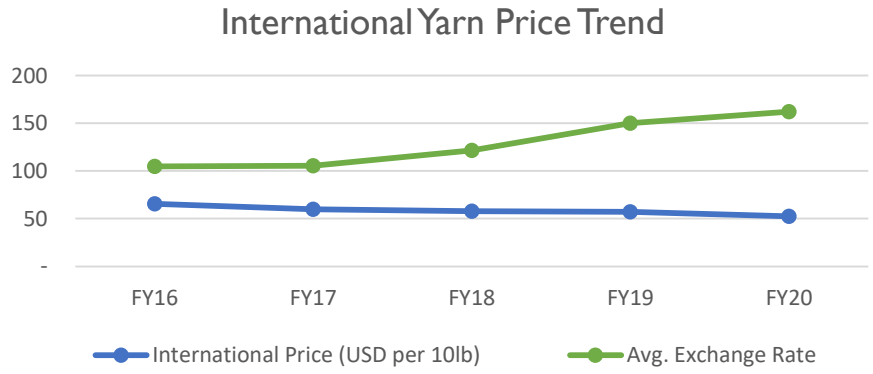
Source: TCO, Pakistan Bureau of Statistics (PBS)

SPINNING | YARN EXPORTS

- Pakistan's yarn exports have experienced decline in both quantitative and value terms in the last two financial years, mainly because of lower local cotton production and better local prices. Exports were of USD 985mln in FY20 (FY19: 1,125mln)
- There has been a decline in the per unit price of yarn exported by ~5.5% p.a. since FY16.
- The cyclical nature of the demand can be observed with lower exports during winter months and peak exports taking place between March and August.







Source: Pakistan Bureau of Statistics (PBS), SBP

SPINNING | TOP EXPORT DESTINATIONS

- Exports to China constitute ~67% of total cotton yarn exports during FY20, reflecting a high level of export concentration.
- Other export destinations include European and East Asian countries.

FY18	000 USD	%	FY19	000 USD	%	*FY20	000 USD	%
China	869,780	63%	China	707,923	63%	China	662,586	67%
Bangladesh	83,602	6%	Bangladesh	83,508	7%	Bangladesh	58,494	6%
Turkey	72,540	5%	Turkey	44,442	4%	Turkey	51,974	5%
Portugal	56,472	4%	Portugal	42,808	4%	Portugal	38,828	4%
Hong Kong	35,399	3%	Japan	30,854	3%	Japan	23,330	2%
Rep. of Korea	34,004	2%	Rep. of Korea	26,602	2%	Rep. of Korea	22,004	2%
Japan	33,191	2%	Italy	24,554	2%	U.S.A	20,263	2%
Italy	30,091	2%	U.S.A	22,457	2%	Italy	16,793	2%
U.S.A	13,532	1%	Hong Kong	21,693	2%	Hong Kong	10,799	1%
Germany	12,346	1%	Germany	11,502	1%	Germany	10,347	1%
Other	130,962	10%	Other	109,076	10%	Other	69,485	7%
Total	**1,371,919**		**Total**	**1,125,419**		**Total**	**984,903**	

**FY20 figures have been prorated using 1HFY20 data*

Source: PBS, Trade Development Authority of Pakistan (TDAP)

SPINNING | BUSINESS RISK

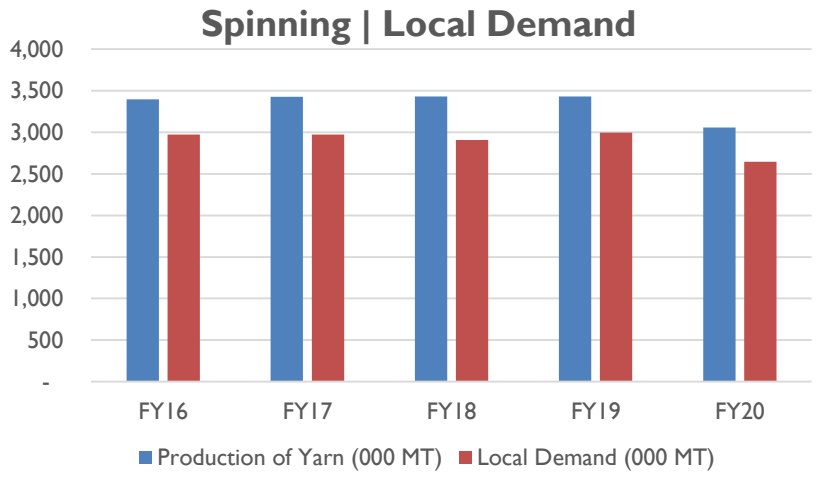
- The business risks of the sector have been categorized as sales risk and operating risk (i.e. Cost structure).
- The spinning sector's sales comprise both export & local sales.
- Pakistan exported yarn amounting to PKR ~155bln in FY20 (FY19: PKR 153bln). The sector's exports are facing pressure for a few years due to low value addition and competition. This is reflected in relatively lower prices. Export prices declined by ~5.6% in last 5 years. This has resulted in declining exports in dollar terms, although exports remained relatively stable in volume over these years. The demand was further impacted during the COVID-19 pandemic and subsequent lockdowns.
- The demand for local sales also remained relatively stable over the years except for FY20 due to COVID-19. The prices of local yarn increased on average by ~70-80% since FY16 on the back of robust local demand as rupee depreciated, improving margins on local sales.
- The gross and operating margins of the sector remain low (~5-6 % gross margin), reflecting commoditized nature of the products and low economies of scale. Large manufacturers enjoy better gross margins ranging between 8-12%.
- The sector is protected by favorable duty structure with yarn imports subject to up to 16% duty. With commoditized output and protection by duty structure, the duty withdrawal will impact the sector significantly although its probability remains low.
- Overall, the business risk of the spinning sector remains moderate on the back of declining export prices but stable export quantity, stable local demand and improving local yarn prices, resulting in better margins lately. However, the impact of COVID outbreak can impact demand and margins.

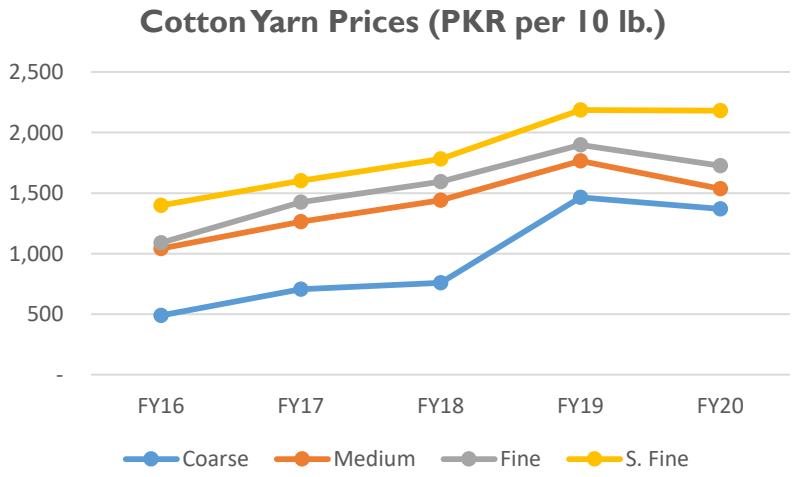
Source: PBS, PACRA Database

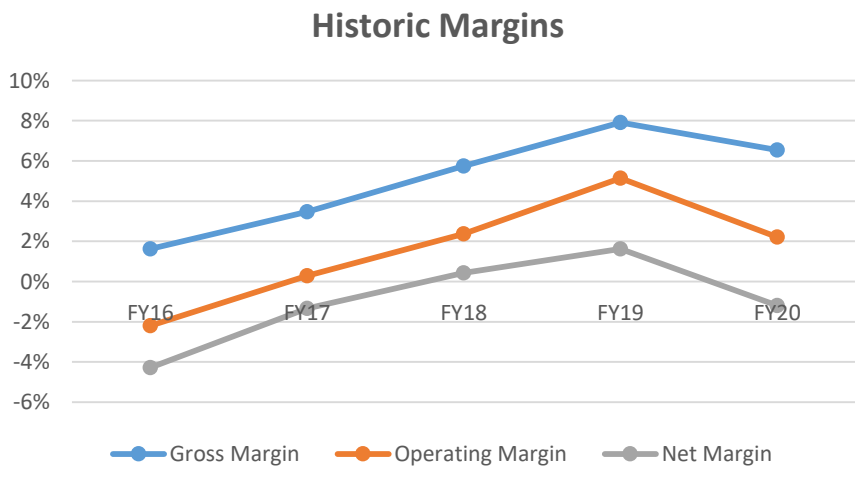
SPINNING | SALES RISK

- Over the years, production level and local demand have remained stable except in FY20, where there was significant decline due to COVID-19 lockdown.
- The prices of local yarn increased on average by ~70-80% since FY16. However, this was partially countered by higher cotton prices, which increased by ~12% since FY16.
- The gross and operating margins have shown an increasing trend in last few years on the back of improving yarn prices due to robust local demand and significant rupee depreciation. However, the margins remain relatively low.

- The sales risk of exports is high on the back of low value addition, declining unit prices and increasing international competition.
- Further, the sales risk of local demand is moderate due to stable demand, partially countered by improving output prices.



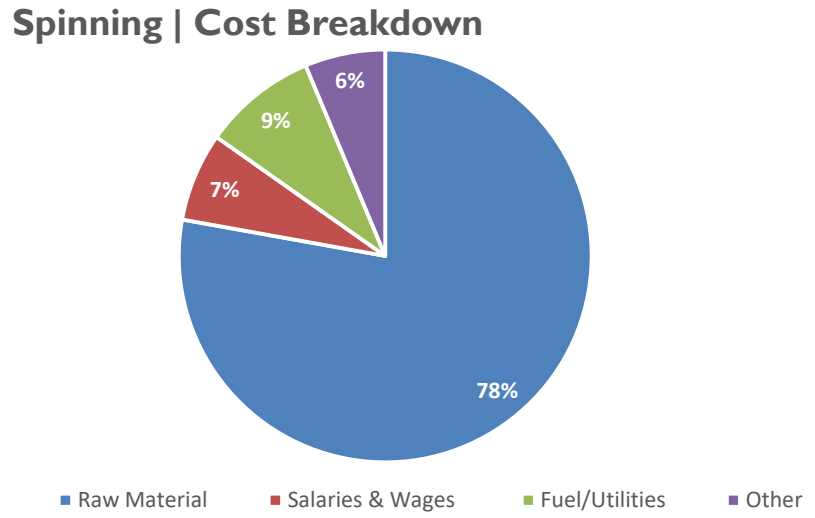


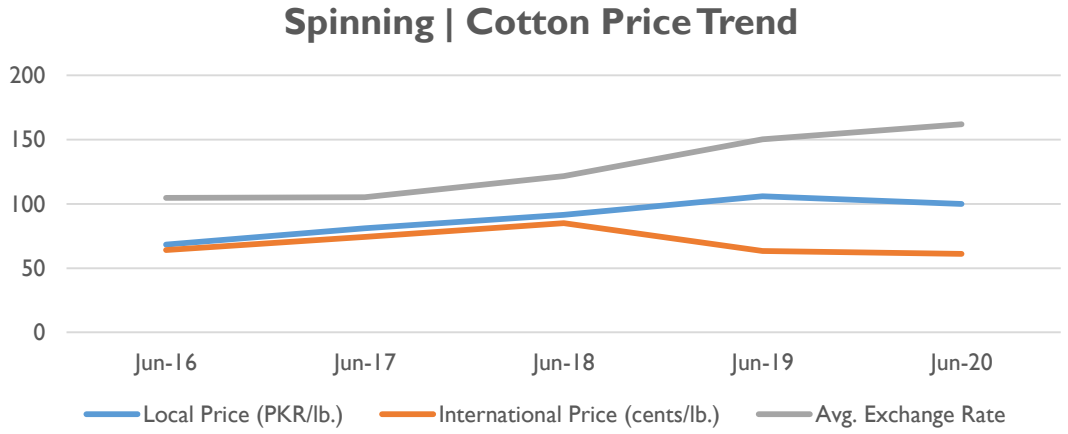


Source: Pakistan Bureau of Statistics (PBS), PACRA Database

SPINNING | COST STRUCTURE

- The cost structure of spinning sector is mostly variable with ~90% variable cost. Resultantly, the sector has low operating leverage.
- On average, the sector spends ~78% of its total production costs on raw material, i.e. cotton.
- The prices of local cotton remain in parity with international prices.
- The prices of yarn in international market have declined by ~30% since FY18. However, the yarn prices have increased in local market by ~70-80% due to significant rupee devaluation.
- Other major costs include Salaries and Wages as well as Fuel and Utilities which both consist of ~16% of the total production cost.
- Remaining ~6% is attributable to other costs such as depreciation, repairs, maintenance, insurance, packing and chemicals.

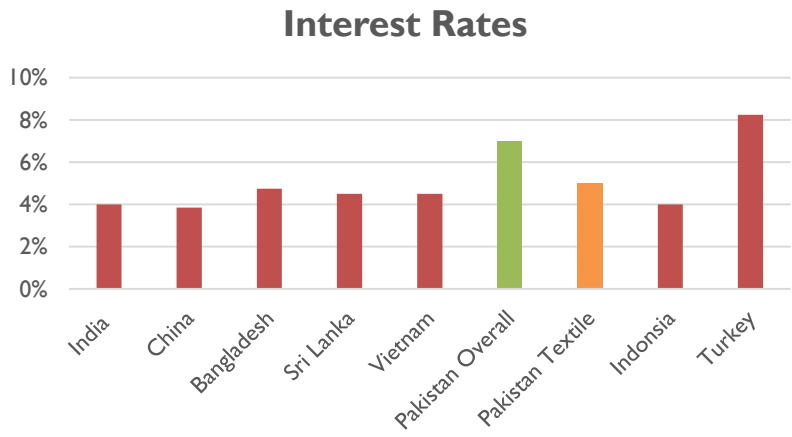


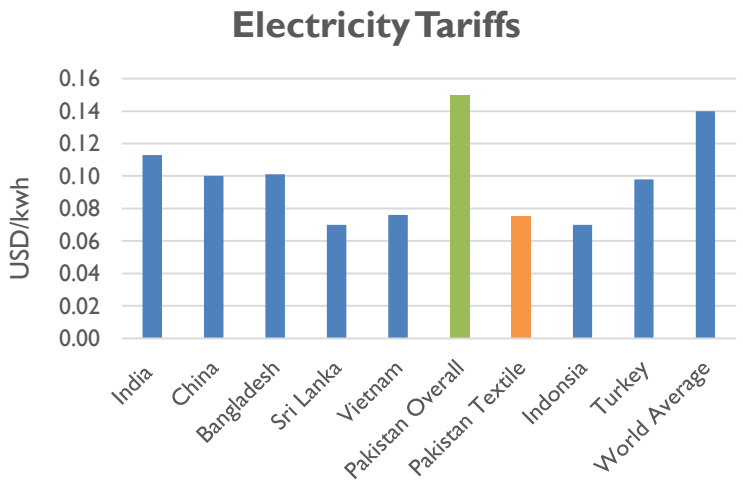


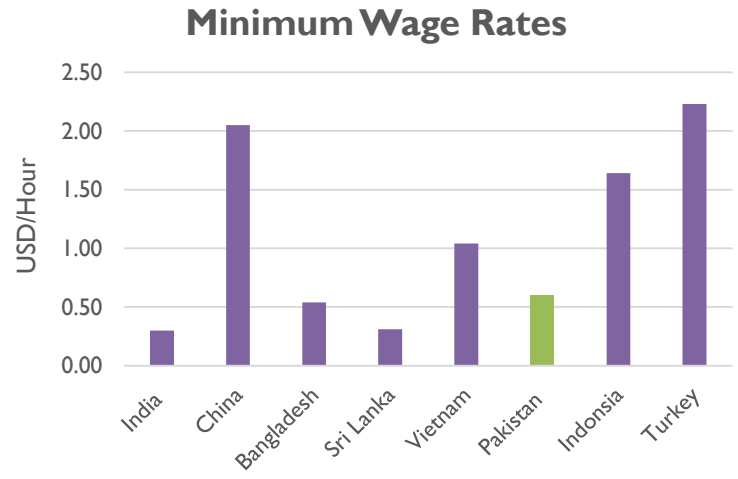
Source: Trading Economics, Business Recorder, PACRA Database

SPINNING | REGIONAL COST COMPARISON

- Pakistan has the second highest interest rate in the region behind Turkey. The high cost of borrowing acts as a barrier to investment in the country. In contrast, China has the lowest borrowing rate. However, the SBP provides subsidized financing at internationally competitive rates to the textile cluster.
- The Pakistani businesses face competitive disadvantage due to the high electricity tariffs it incurs which exceed all regional players. However, the government provides subsidized electricity and gas at internationally competitive prices to the textile cluster. In contrast, Sri Lanka and Indonesia have the lowest electricity tariffs in the region.
- Pakistan's minimum wage translates to 0.6 USD per hour which is higher than countries such as Sri Lanka, Bangladesh and India. However, we maintain competitive advantage of low labor cost over regional players China, Vietnam, Indonesia and Turkey.







Source: Trading Economics, Statista.com, globalpetrolprices.com

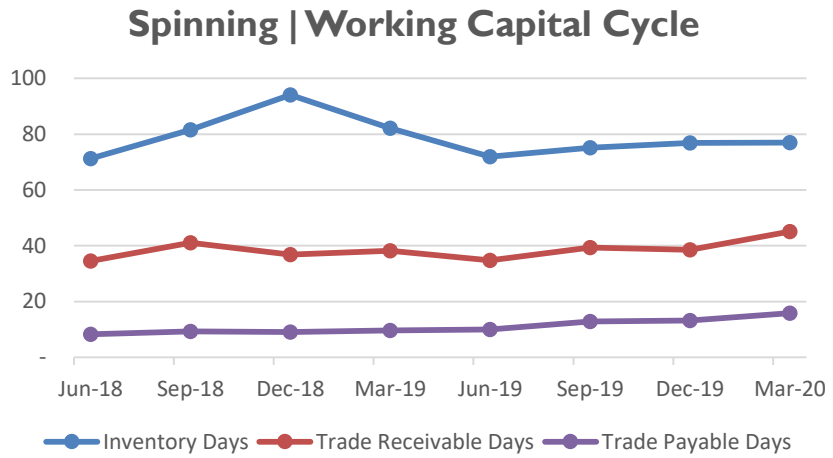
SPINNING | FINANCIAL RISK

- Overall, the spinning sector is moderately leveraged with average sector's borrowings standing at ~50% of total capital.
- Total borrowings of the spinning sector stood at PKR ~439bln as at 30th July 2020. Around 12% of the total borrowings are on SBP's subsidized rates.
    - PKR ~53bln of LTFF financing at end-July 20;
- Most of the borrowings (~65%) constitute short-term borrowings utilized to finance the working capital requirements. Spinning sector does not qualify for EFS or other short-term subsidized borrowing schemes.
- Total banking advances to the textile cluster is PKR ~1.2tln as at end-June 20 with infection ratio of 14.7% (~10% for overall corporate advances).
- Spinning sector has greater proportion of short-term borrowings in overall financing mix with these funds borrowed at normal rates sa it does not qualify for subsidized rates due to lower value addition. Hence, the financial risk of the sector is relatively high.
- SBP's rate cut of 625bps since March 20 is expected to reduce finance cost by PKR ~24bln for the sector.

Source: SBP, PACRA Database

SPINNING | WORKING CAPITAL MANAGEMENT

- The largest component of working capital of the spinning sector is inventory with the sector's average inventory days standing at ~80.
- Inventory consists mostly of raw material (i.e. ginned cotton) and finished goods while work-in-process makes only a small contribution.
- The margins of the sector are largely dependent on cotton procurement terms. Timely and efficient cotton procurement at better prices results in better margins.
- Many players within the organized segment are forward integrated resulting in more efficient working capital management and ease of procurement of raw material.
- The inventory days reach their peak in December on the back of procurement season. The sector then offloads inventory in third & fourth quarter of financial year.
- The sector's average trade receivable days are ~40 while the average trade payable days stand at ~12. The cycle for payables peaks during the second quarter of each fiscal year on the back of local cotton procurement season.
- The sector meets its working capital financing requirements through short term borrowings.



Source: PACRA Database

SPINNING | COVID-19 | IMPACT

- Textile exports are dependent on demand from European & North American markets. Since the spread of COVID-19 and subsequent impositions of lockdowns, major brands in USA and Europe had shut down retail operations resulting in orders on hold or cancellation.
- Local demand was also impacted negatively during 4QFY20 on the back of countrywide lockdowns. The businesses also missed peak demand seasons of Eids for textile products, which represent ~35-40% of total local demand.
- The sector imports a significant portion of cotton from other countries, especially during fourth quarter. The countrywide lockdown during 4QFY20 impacted the supply chain.
- The sector is dependent on imports for supply of chemicals and dyes. The lockdowns disrupted global supply chains. However, businesses carried sufficient inventories of ~2-3 months which provided time to re-establish supply chains.
- Despite being exempted from restrictions, the capacity utilization of spinning sector remained sub-optimal on the back of labor shortages and supply chain issues.
- Lower demand and higher inventory levels resulted in liquidity and cash flow issues.
- The demand and production is recovering since July subsequent to the easing of restrictions both in Pakistan and major demand destinations (USA & Europe).

SPINNING | COVID-19 | RELIEF MEASURES

- In order to relieve liquidity pressure on the sector, the SBP allowed to defer principal repayments for one year to the corporate sector. Further, the SBP also allowed to restructure loans up to 30th June 2020.
- The SBP, over the course of 4 months, reduced benchmark rate by 625bps to 7%. This is expected to improve the bottom-line of the sector, since majority of the borrowings are utilized at commercial rates.
- In addition, the Securities & Exchange Commission of Pakistan (SECP) provided several regulatory reliefs to the companies on a proactive basis during lockdown.

Source: SBP, SECP

SPINNING | DUTY & SALES TAX STRUCTURE

PCT Code	Description	Additional Custom Duty		Custom Duty		Regulatory Duty		Total	
		2019-2020	2018-2019	2019-2020	2018-2019	2019-2020	2018-2019	2019-2020	2018-2019
52.01	Cotton, not carded or combed	0%	0%	0%	3%	0%	0%	0%	3%
52.03	Cotton, carded or combed	0%	0%	0%	3%	0%	0%	0%	3%
52.04	Cotton sewing thread, whether or not put up for retail sale	2%	0%	16%	16%	0%	0%	18%	16%
52.05	Cotton yarn (other than sewing thread), containing 85% or more by weight of cotton, not put up for retail sale	2%	0%	11%	11%	10%	10%	23%	21%
52.06	Cotton yarn (other than sewing thread), containing less than 85% by weight of cotton, not put up for retail sale	2%	0%	11%	11%	10%	10%	23%	21%
52.07	Cotton Yarn (other than sewing thread) put up for retail sale	2%	0%	11%	11%	10%	10%	23%	21%
54.02	Synthetic Filament Yarn (other than sewing thread), not put up for retail sale (includes polyester and nylon)	2%	0%	11%	11%	2.5%	5%	16%	16%
54.03	Artificial Filament Yarn (other than sewing thread), not put up for retail sale (includes viscose rayon)	2%	0%	11%	11%	0%	0%	13%	11%

Description		Sales Tax
Raw Cotton	Imported	5%
	Local	10%
Yarn	Imported	17%
	Local	17%

- In addition to Sales Tax, there is Advance Tax of 1% applicable on the import of these products. However, the amount of Advance Tax is adjustable against final income tax liability.
- Polyester filament yarn is subject to anti-dumping duty in the range of 3.25-11.35% on imports from China and Malaysia. This duty has been in effect since August 2017 providing protection to local players.

Source: Federal Board of Revenue (FBR), National Tariff Commission

SPINNING | REGULATORY ENVIRONMENT

- With respect to Income Tax, the spinning sector is under the Normal Tax Regime (NTR). Further, the sector is also subject to Minimum Tax @ 1.5% of turnover, if tax liability under NTR is lower than minimum tax. However, the additional tax paid under minimum tax is adjustable against future tax liabilities for the next 5 years.
- The sector receives subsidized financing from SBP under the following schemes;
    - Long Term Financing Facility (LTFF) up to PKR 5bln for installation of new plant & machinery @ ~3-4%.
- Govt. provides subsidized electricity at USD 7.5 cents/kwh and gas at USD 6.5 /mmbtu in order to increase export competitiveness in export markets (Total impact of PKR ~40bln/annum to the textile cluster).
- Duty structure of the sector provides protection to the local spinning players.
- Govt. also provides Drawback of Local Taxes and Levies (DLTL) at the rate of 2% on eligible product line of processed fabric (2% additional drawback is also allowable for exports to non-traditional markets).
- All Pakistan Textile Mill Association (APTMA) acts as the national trade association of textile cluster in the country.

Source: Federal Board of Revenue (FBR), SBP, Ministry of Commerce, APTMA

SPINNING | SWOT ANALYSTS

- Local cotton better suited for coarser counts
- Large installed capacity
- Integrated into textile value chain as key raw material
- Government protection from tariff & duty structure
- Strong sector association resulting in high lobbying power
- Recent PKR depreciation leading to improved international competitiveness

- Presence of large unorganized segment resulting in quality variations.
- Low BMR resulting in technological obsolescence
- Low value addition/commodity product
- Periodic imposition of import duties on import of cotton
- Lower focus on synthetic fibers
- Restrictions on sales to unorganized segment creating hurdles

- Geographical export concentration
- Strong bargaining power of buyers
- Withdrawal of tax credits for expansion and replacement has hindered new investments
- Possible withdrawal of subsidies on electricity and gas

- Forward and horizontal integration to produce value added and differentiated products
- Opportunity to increase efficiency through technological upgrade
- Special Economic Zones provide incentives to sector

SPINNING | CONCLUSION

- The absence of value addition, minimal investment in new technologies and relatively lower economies of scale have impacted the position of the sector in international markets in the preceding decade.
- The installed capacity and production of the sector remained almost stagnant over the last several years. Despite relatively stable export quantity, exports of the sector declined in dollar terms by ~6% since FY16.
- The sector has not fully capitalized on strong local supply chain, government policy support, depreciating rupee, and financial support in the form of subsidized financing from SBP and subsidized energy prices.
- Although margins and profitability of the sector have improved in recent years, it largely remains a factor of gains on rupee depreciation and prudent cotton buying. The sector has not been able to gain much in terms of volumes. The margins remained under pressure during 4QFY20 owing to sub-optimal capacity utilization amid lockdowns. Further, the net margins of the sector remained negligible and profitability of the sector will be impacted due to low sales and margins in 4QFY20.
- The sector has moderately leveraged capital structure on the back of lower ability to generate operating cash flows amid low margins. The sector avails majority of borrowings at commercial rates. The infection ratio of the sector is significantly higher than overall corporate sector infection ratio, reflecting financial risk.

SPINNING | GOING FORWARD EXPECTATIONS

- Without any significant investments on new technology, it is expected that spinning sector will continue to operate as a low value addition and relatively low margin sector. The recent BMR activities spurred by SBP LTTF schemes is a good sign and should contribute towards higher production quality. The large players will enjoy better margins. This may result in consolidation as smaller players may struggle to survive.
- The sector remains reliant on the government support as it is a price taker on both ends. It is expected that the duty structure will continue to provide relief to the sector, going forward.
- The sector is expected to face increasing competition from other regional players in the international markets. This may result in increasing pressure on export margins. Timely and efficient procurement of cotton remains critical for the profitability of the sector.
- Although the output volumes declined significantly in 4QFY20, the capacity utilization has improved and volumes have started to recover to historic levels (July 20: 286,115 Tonnes). However, the pressure on margins will remain as demand is expected to remain volatile in current environemnt.
- The sector will face cash flow and liquidity issues in case second wave of COVID-19 spreads, which will result in another round of hold on or cancellation of orders.
- Although the financial risk is high for the sector, the recent cut in interest rates and deferment of loan repayments will provide short-term relief.

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