Cement: Looking Towards a Better Future

The Indian cement industry is at a critical juncture today that could mark the beginning of a new era given its changing dynamics. Although the industry is currently plagued by weak prices on account of a demand-supply imbalance, especially in the western and southern regions, CRISIL expects the scenario to improve significantly in the next three years. While demand has been fairly stable, a fragmented market together with a supply overhang, has constrained the industry’s prospects so far. CRISIL believes that although the process of consolidation will be gradual, the ghost of overcapacity would soon be exorcised, resulting in the industry’s improved performance. This article discusses the emergence of this new scenario and captures the trends that the industry is likely to witness in future.

The Past

The cement industry has seen its share of swings in the past. In a regulated environment, especially, government controls on pricing and distribution on the one hand and the plethora of licensing requirements, on the other, made investments by private players in the sector unattractive.

Realizing the sector’s importance for the economy’s overall growth as well as the need to make players self-sufficient to meet their investment requirements, the central government began deregulating the sector. All controls were removed in 1989 so as to create a market-determined demand-supply scenario. Individual states, however, continued offering various incentives to manufacturers to attract investments, the most important being sales tax concessions.

Sales tax incentives: The key determinant of capacity expansion

Sales tax incentives have been among the most crucial determinants of a cement plant’s viability in the past as prices have not grown enough to absorb rising production costs and the high capital outlay required for a new plant. In fact, while input costs have grown at an average rate of about 5% per annum in the last six years, cement prices have grown by less than 1% during the same period (see graph, Cement prices across regions).
The dismal growth in prices is primarily because of the regular capacity additions made by manufacturers across the country (see graph, Cement consumption and surpluses over the last six years).

<table>
<thead>
<tr>
<th>Year</th>
<th>Consumption</th>
<th>Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996-97</td>
<td>96.60</td>
<td>88.63</td>
</tr>
<tr>
<td>1997-98</td>
<td>104.7</td>
<td>96.60</td>
</tr>
<tr>
<td>1998-99</td>
<td>108.5</td>
<td>104.7</td>
</tr>
<tr>
<td>1999-00</td>
<td>114.5</td>
<td>108.5</td>
</tr>
<tr>
<td>2000-01</td>
<td>129.9</td>
<td>114.5</td>
</tr>
<tr>
<td>2001-02</td>
<td>120.00</td>
<td>129.9</td>
</tr>
</tbody>
</table>

Source: CRISINFAC CEMENT REVIEW July 02

It is clear from the graph above that a consumption growth of about 8% in the last six years has been matched by an almost equal capacity growth rate, thus restricting any correction in the overcapacity situation in the country and thereby, any improvement in prices.

**What prompted the capacity addition?**

*Larger control over the market:* The country’s cement capacities have primarily grown because of a few large players. Out of 50 cement companies, the top four groups, the Associated Cement Companies (ACC)-Gujarat Ambuja combine, Larsen & Toubro Ltd (L&T), Grasim Industries and India Cements Ltd, have accounted for nearly 55% of the total capacity additions in the last six years. That’s because the large players sought to consolidate their business position so as to achieve better bargaining power and price leadership in the market.

*Sales tax incentives made new projects viable even at low prices:* Given the low prices prevailing in the market, the sales tax incentives offered by various state governments contributed significantly to a cement project’s viability. In fact, even after five years of operations, exemptions have accounted for nearly 60-70% of a new plant’s annual accruals.

**Withdrawal symptoms**

In a bid to improve their revenues, however, most state governments decided to phase out the sales tax incentives that they were offering to companies for setting up new capacities. Companies were given a time limit of March, 2002 to commission their projects in order to avail of the benefits.
The fallout? Cement majors rushed to meet this deadline resulting in the commissioning of large capacities, especially in the southern and western regions, in 2001-02. Greenfield plants with nearly 7.4 million tonnes fresh capacity were commissioned in 2001-02 while on the whole, 13.5 million tonne capacity in new and old plants was added in the year, the highest in a single year in the last six years. If you include GACL’s Chandrapur plant in Maharashtra, which was commissioned in April 2002, the figure goes up to 9.4 million tonnes in new plants and 15.5 million tonnes capacity addition in toto.

Life without sales tax exemptions
With the withdrawal of sales tax incentives, the dynamics of setting up fresh capacities has changed dramatically today. In the new scenario, prices would have to go up to levels of nearly Rs 220 a bag for any project to yield comparable returns and accruals. Yet, will prices rise to such levels in future?

The Price Trajectory
The Present Scenario
The last year has been a difficult period for the cement industry as a whole. Among the various regions, the southern and western markets have been particularly affected on account of large capacity additions and low demand in some important states. A look at the dynamics in each region is presented below.

South: At about seven million tonnes in 2001-02, this region saw the largest capacity addition in a single year in recent times. Tamil Nadu accounted for nearly 65% of these additions with Andhra Pradesh accounting for the rest. The capacity additions coincided with a demand slowdown in Tamil Nadu and Kerala. While demand in Tamil Nadu grew by a dismal 2% in 2001-02, that in Kerala shrunk by the same margin. To make matters worse, the Tamil Nadu government imposed higher sales tax rates on sales beyond a consumer price of Rs. 135 per bag for pozzolana portland cement (PPC) and of Rs. 145 per bag for ordinary portland cement (OPC) within the state. These factors caused prices to crash to extremely low levels in the region.

West: The western market too suffered from the dual impact of capacity additions and low demand growth. The 2.6 million tonne addition by ACC at Wadi, which supplies a good proportion of its production to the western market, and the two million tonne addition by GACL at Chandrapur resulted in almost five million tonnes being added to the region’s existing capacity. The industry’s woes were confounded by the low 1% demand growth in Maharashtra, which accounts for nearly 70% of the total demand in the western market.

East and North: Despite a robust demand growth of about 20%, the eastern market witnessed significant pressure on prices in the second half of FY2001-02 as a result of the addition of grinding capacities by L&T and Ambuja Cement Eastern Ltd. Prices have, however, improved since then by almost 20% due to the sustained demand growth in the region and since no further capacity has been added. The northern market, on the other hand, has remained relatively stable, as it did not see any significant capacity additions.
While the northern and eastern markets are expected to witness stable prices, CRISIL expects cement prices to remain weak in the south and the west for the most part of the current financial year. Any improvement in the industry scenario thereon will depend on a correction in the demand-supply imbalance in these regions.

The Road Ahead
With sales tax incentives having been withdrawn, fewer cement capacity additions are expected in future. At present, apart from Sanghi Industries’ new 2.6 million tonne plant, no other large capacities are likely to come up in the next three years. Against a total cement capacity of 135 million tonnes, the industry has an effective production capacity of about 110 million tonnes (excluding six million tonne capacity of unproductive units and assuming a capacity utilization of 85% for the rest). With consumption of 100 million tonnes in 2001-02 and a demand growth of about 8-10% in the next year, it would appear that the supply overhang might be corrected within a year. CRISIL, however, expects the correction to only take place in the next three years on account of the following factors:

Rising proportion of blended cement: In the last few years, blended cement such as pozzolona portland cement (PPC) and pozzolona blast furnace slag cement (PBFSC) have become increasingly popular (see graph, The cement mix).

A higher proportion of blended cement in the overall production increases cement supplies by nearly 20-25% in the case of PPC and 30-35% in the case of PBFSC. Although the ability to produce blended cement depends on the availability of fly ash and hence, on a plant’s proximity to a power plant, another 10% increase in the share of blended cement in overall cement production would result in additional supplies of about two million tonnes.

Revival of unproductive cement facilities: Large cement plants account for 129 million tonnes of the 135 million tonnes cement capacity in the country. Of this 129 million tonnes, nearly six million tonnes are non-operational. This mainly comprises Cement Corporation of India’s (CCI) and UP State Cement Corporation’s 2.5 million tonne plant each. Should these government companies be disinvested or revived, these would
enhance cement supplies in the market. Some large players, including MNCs, have evinced an interest in these companies.

**Re-routing export volumes into the domestic market:** The country exports about 3.3 million tonnes of cement and 1.7 million tonnes of clinker. Since profitability is very low in the export market, about five million tonnes can be re-directed into the country as and when the demand-supply situation improves.

Thus, it is apparent that the industry has an additional production capacity of about 10-12 million tonnes over and above the existing effective capacity of 110 million. Hence, if current growth rates are maintained, prices would only increase over the next two to three years.

**The Future Scenario**

As in the past, in future too, capacity growth would be restricted to five or six large Indian players, apart from the multinationals. That’s because:

- Almost 50% of the total number of companies are in poor financial health and hence, have a limited ability to grow
- Small companies would not have the financial strength to put up large capacities, particularly in light of the withdrawal of incentives.

**The Growth Strategy**

While hitherto, players had confined themselves to essentially setting up greenfield projects, their future growth strategy will increasingly focus on acquisitions, more so than in the past. On the one hand, CRISIL believes that fresh capacity additions would be restricted because:

- Fresh capacity additions upset the demand-supply equilibrium, thereby impacting prices.
- The payback period without concessions would be longer than it was in the past.
- Limited limestone availability may constrain the companies’ ability to put up fresh capacities in certain regions.

On the other hand, the fact that a large number of cement companies are in poor financial health enhances the prospects for the industry’s consolidation. Hence, acquisitions are expected to be more common than they have been in the past. For instance, in a study of 22 large cement companies done by CRISIL, more than 40% reported losses in 2001-02. A number of them have defaulted on institutional loans. Given the tightening of recovery procedures by these institutions, these companies’ past repayment behaviour may no longer be tolerated. CRISIL believes that a number of such companies, especially those with sound operating efficiencies, may be good acquisition targets.

**So, will there be a rush of mergers and acquisitions?**

Not really. The process is expected to be gradual rather than expeditious because:

- **High prices expected by seller:** Cement prices are expected to recover in the next two years. This would enable many ailing cement plants to turn around, prompting their promoters to quote higher sale prices.
- **Poor operating efficiencies of many plants:** At present, many cement plants suffer from poor operating efficiencies. These companies would require significant investments to bring them on par with the high standards of the acquiring companies. For instance, Narmada Cement Corporation Limited’s poor operating efficiencies have prevented a turnaround even after it was taken over by L&T. Similarly, Ambuja Cement Rajasthan continued to incur losses even during the brief upturn in the industry in November 2000 and between July and August 2001.

**Conclusion**
The cement industry is going through difficult times today, particularly on account of large capacity additions in important cement markets such as the west and south. The scenario is, however, expected to improve by the end of the current year as demand catches up with existing production capacities. The improvement in cement prices in the next three years would also enable some of the weak players to turn around. Thus, although the process of consolidation in the industry is likely to be gradual, large players are likely to increasingly dominate the industry in the years to come.