CRISIL
An S&P Global Company

# Rating criteria for the cement industry

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# Executive Summary

India is the second-largest producer and consumer of cement in the world. The credit profiles of cement companies in India depend on factors such as, a plant's location, demand-supply outlook in the home market, operating efficiencies, raw material and fuel linkages, access to competitive distribution channels, and fiscal concessions. Further, there exists a strong correlation between a company's credit risk and financial policy, particularly with respect to capital structure and acquisitions.

# Scope

While the broader criteria of manufacturing companies[1] applies to all firms in the manufacturing sector, this article[2] details the industry-specific factors impacting the credit profiles of cement manufacturers.

# Business Risk

### Locational advantage

Transportation of cement over long distances is expensive, hence freight costs are among the largest expenses for a cement company. In an increasingly competitive environment, companies that have plants in cement-deficit regions have to distribute products over a smaller radius, which minimises freight costs and maximises profits.

### Capacity additions and regional demand-supply scenario

Demand for cement is cyclical in nature, leading to uneven capacity additions and, therefore, outpacing demand growth during some periods. The consequent periods of depressed realisations and unutilised capacities weaken the finances of players in the region. Hence, CRISIL factors into its analysis the expected capacity additions, which could lead to demand-supply imbalances in the rated company's regions of operation. CRISIL also examines the impact of spillovers from adjoining areas.

### Level of consolidation

Unlike other commodities, which are impacted by global demand-supply cycles and volatility in international prices, the Indian cement industry is largely insulated. High freight costs make sustained imports unviable. Therefore, profitable operations are possible even in surplus scenario if there is production sharing or pricing agreement. There has been significant consolidation over the last decade in the industry. So, while analysing plants in regions with surplus, CRISIL takes a favourable view if the region is dominated by a few large players, as it is easier to develop cohesiveness among a few players than with a larger number.

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[1] *The detailed criteria is present on the CRISIL website under the 'Criteria and Methodology' section—Rating Criteria for Manufacturing and Services Sector Companies and CRISIL's Approach to Financial Ratios.*

[2] *For accessing the previous published document on " Rating Criteria for Cement Industry", kindly follow below mentioned link:* https://www.crisil.com/content/dam/crisil/criteria_methodology/materials/archive/CRISIL-Ratings-crieria-cement-industry_2013.pdf

### Distribution facilities

The quasi-commodity nature of the domestic cement market and the high share of retail sales make distribution a key factor in a company's operations. CRISIL places emphasis on freight options and freight costs while rating cement companies.

Cement is currently transported through road, rail, and sea. For inland transportation, the state-run rail network is the preferred mode because of its lower cost, especially over long distances. CRISIL, however, considers both wagon availability and distance from the railhead, while analysing a company's logistics plan. For short distances, road transport is preferred as it minimises both secondary handling and secondary freight costs.

### Operating efficiencies

Advancements in manufacturing sub-systems have steadily improved production economies. Therefore, on an operating cost basis, new cement plants have an edge over older plants. CRISIL analyses the size of the cement plant and capital cost for establishing the same, as larger-sized plants enjoy economies of scale. Further, the ability of the manufacturer to set up the plant within appropriate cost and timelines also impact the returns generated by the project. In an oversupply situation, companies with superior operating efficiencies are better-placed due to their lower cost structure.

Since power is the largest cost component in manufacturing cement and its tariffs are high in India, companies with lower power costs, either through lower consumption or cheaper per unit costs because of captive facilities, are able to better withstand pricing pressures. Thus, companies with captive power sources have an edge over others because they have control over both the cost and availability of power.

Companies with established coal linkages are less exposed to volatility in international coal prices. A company's procurement of coal mix (domestic, e-auction, and imported coal) is also analysed. Companies with higher reliance on imported or e-auction coal are at a disadvantage because of higher prices. CRISIL also examines the ability of companies to use alternative fuels in managing their overall power costs.

### Split-location plants

In most cases, limestone deposits are located far away from consumption centres, resulting in high freight costs. Further, when the market is in another state, companies are unable to fully utilise their sales tax concessions and also incur considerable freight costs. A split-location plant, where the grinding unit is at a different location, alleviates this problem. Clinker, unlike cement, can be transported in open wagons, reducing freight costs besides allowing the grinding unit to be located close to a pozzolonic or slag source. CRISIL has a favourable outlook on expansions through split-location plants and believes it reflects well on the management's operational acumen.

### Better product mix

From a predominantly ordinary portland cement market, India has transitioned into a blended cement market; the latter accounts for 80-85% of the total cement production. This shift could be advantageous, as blended cement not only conserves valuable limestone resources but also reduces the fixed cost associated with power and freight, thus significantly improving a company's cost competitiveness. CRISIL, therefore, while arriving at a company's rating, considers its product mix and consequent cost advantages and disadvantages against its competitors, besides factoring in the firm's efforts to shift its product mix in favour of blended cement. Consequently, companies with plants close to the supply of fly ash and slag, the key inputs, incur lower costs.

### Government policy

Government initiatives such as the thrust to infrastructure development are expected to boost the sector. Other policies that aid the growth of this sector are those that relate to availability of the raw materials, such as limestone and coal.

### Product perception

Branding can enable companies to realise a price premium. Hence, companies which have invested in advertising and have a communication strategy can enhance their brand proposition, and therefore, get looked upon favourably by CRISIL.

## Financial Risk

For the analysis of the financial risk of a cement company, CRISIL follows the standard criteria used for all manufacturing companies. This criterion is presented in detail in CRISIL's publications, *Rating Criteria for Manufacturing and Services Sector Companies* and *CRISIL's Approach to Financial Ratios.*

## Management Risk

For the analysis of the management risk of a cement company, CRISIL follows the standard criteria used for all manufacturing companies. This criterion is presented in detail in CRISIL's publication, *Rating Criteria for Manufacturing and Services Sector Companies.*

## Conclusion

Thus, the key success factors for companies operating in the cement sector include:

- Location advantage
- Demand-supply trends in the region
- Access to lime stone reserves and energy costs
- Product mix, brand equity, and pricing power

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