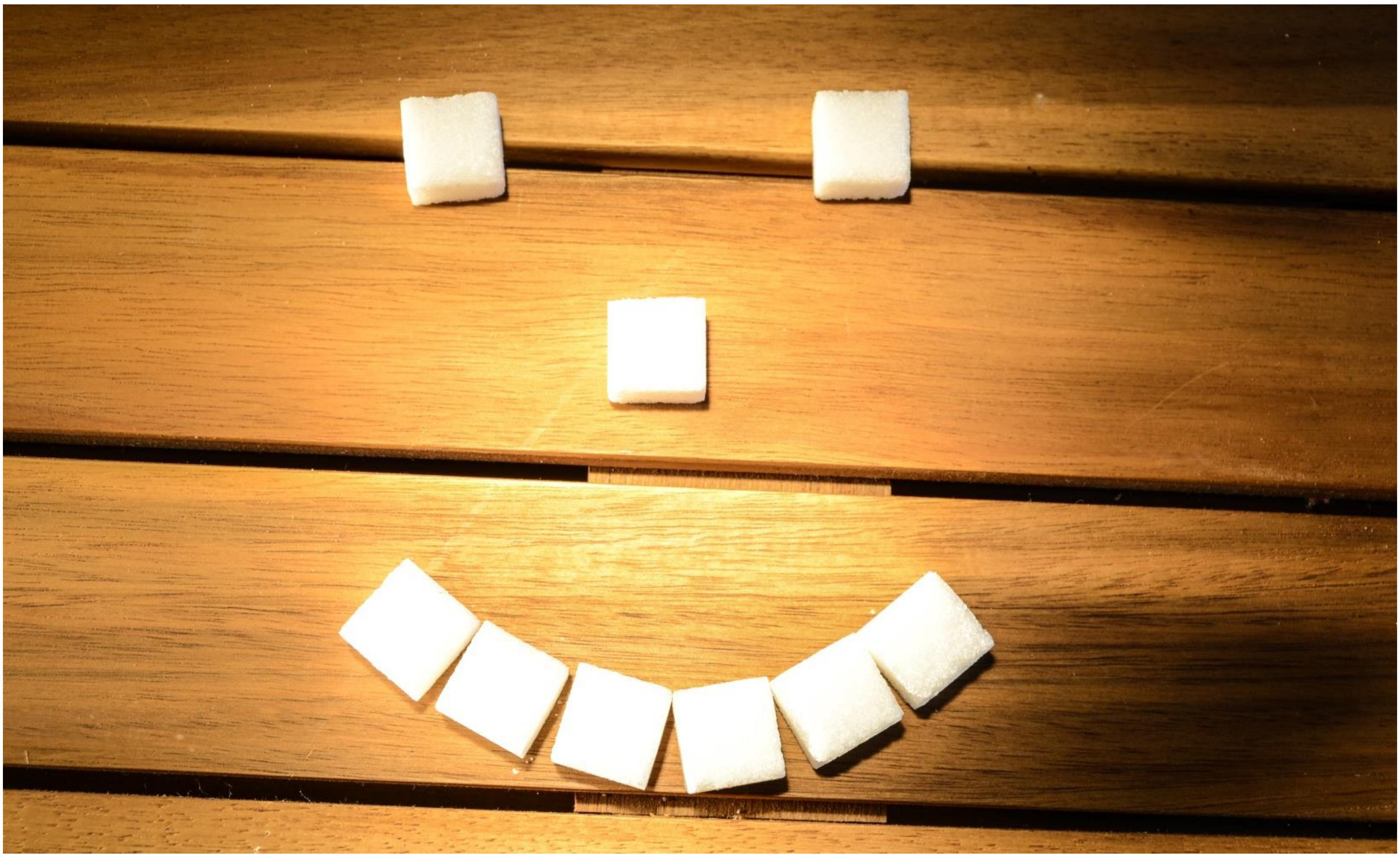
Ratings

CRISIL
An S&P Global Company

# In a sweet spot

## Firm prices, deleveraging to improve the credit profiles of sugar companies

May 2017



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# Executive summary

The credit risk profiles of sugar manufacturers are likely to improve over the medium term with sugar prices remaining firm over the current and next sugar seasons (October 1 to September 30). The resultant higher profit and cash accrual are expected to be used by manufacturers to either reduce their debt or invest in the relatively more stable ancillary business of distillery and electricity co-generation.

They are unlikely to set up greenfield sugar capacities given the constraints in cane availability and sub-optimal utilisation of existing capacities.

CRISIL's analysis of 45 large sugar companies (accounting for nearly 30% of the industry's production) indicates cash accrual will increase to Rs 5,600 crore over fiscal 2017 and fiscal 2018, compared with a negative Rs 1,200 crore in the past three years. With higher cash accrual and no major greenfield capex, there could be a debt reduction by Rs 4,600 crore, from the levels seen at end of fiscal 2016 -- contingent upon inventory policy.

Domestic sugar prices are likely to remain firm in sugar season 2017 (SS2017) and SS2018. That's because closing inventory for SS2017 is expected to fall sharply to 2.2 months of consumption compared with 3.8 months of consumption for SS2016 following a fall in production in Maharashtra and Karnataka. Moreover, production for SS2018 is at best expected to match consumption at 25 million tonne keeping the inventory levels unchanged. However, inventory and prices will depend on imports and hence government policy. That, and price control, will remain the key monitorables.

# Credit risk profiles set to improve

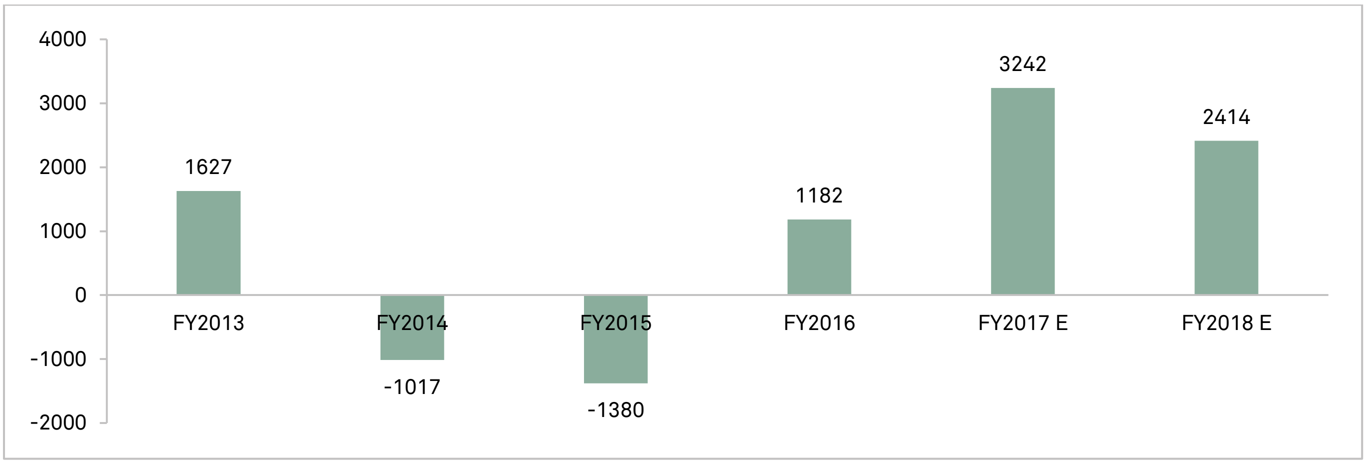
CRISIL expects credit risk profiles of sugar manufacturers to improve over the medium term with sugar prices likely remaining firm in SS2017 and SS2018. The resultant higher profit and cash accrual are expected to be used by manufacturers to either reduce debt or invest in the relatively more stable ancillary business of distillery and electricity co-generation.

While reduction in debt will lead to a significant improvement in balance sheets, higher contribution from distillery and cogeneration operations will cushion profitability during sugar down-cycles. That will make sugar producers more resilient in the future down-cycles and improve their credit risk profiles.

## Accruals to surge in fiscal 2017 and 2018, riding on healthy sugar prices

CRISIL's analysis of 45 large sugar companies (accounting for nearly 30% of Industry's production, including listed entities and those that it rates), shows that cash accrual for the sector could increase to around Rs 5,600 crore in fiscals 2017 and 2018, on the back of healthy sugar prices in SS2017 and SS2018. That's in stark contrast to a negative Rs 1,200 crore accrual over past three fiscals. The impact of higher sugar prices is expected to be partly offset by removal of excise duty incentives and lower ethanol prices.

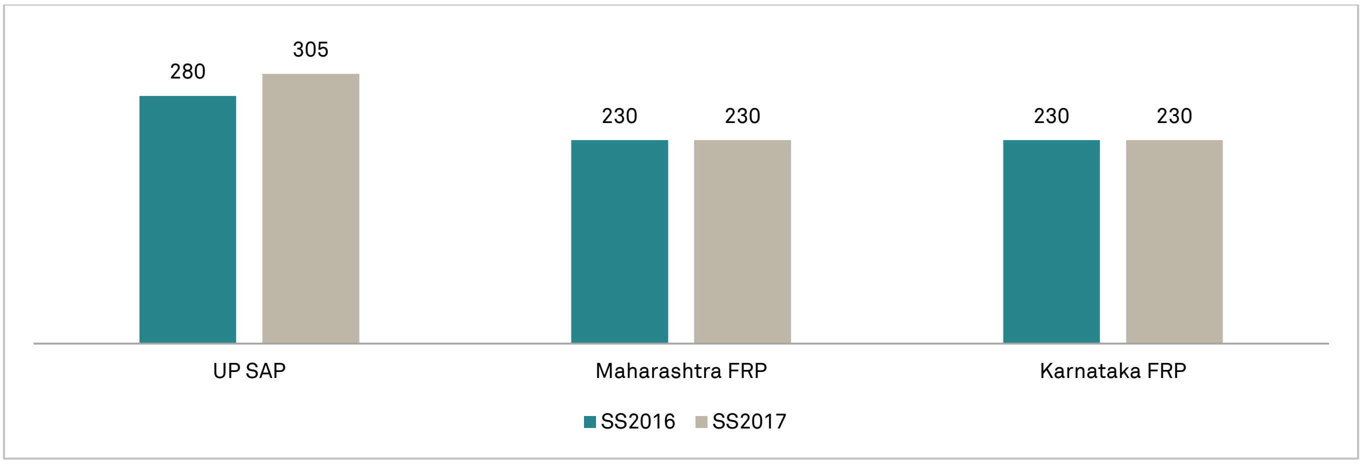
**Cash accrual generation for sugar players (Rs crore)**




*Note: CRISIL's analysis includes 45 companies (including top listed and its-rated sugar companies); E: CRISIL Estimate*

The improved profitability is expected to sustain in SS2018 despite some expected increase in sugarcane prices. The fair and remunerative price (FRP) of cane in SS2017 has been kept unchanged by the central government at Rs 230 per quintal for a 9.5% recovery. However, in Uttar Pradesh (UP), the state advised price (SAP) has risen by Rs 25 per quintal in SS2017. CRISIL has factored a reasonable increase of 7-8% in Maharashtra and Karnataka sugarcane price in SS2018, given that farmers in these states may also demand higher cane prices as in UP. Any change beyond this will have a bearing on the profitability of companies.

**Sugarcane price (Rs/quintal)**



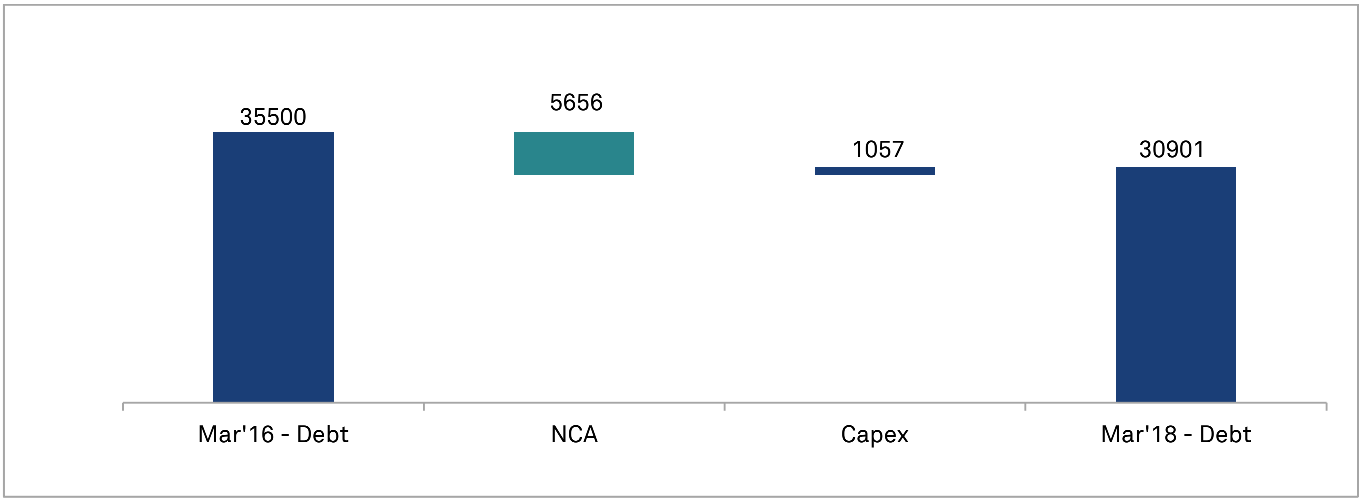

## Debt can be pared by Rs 4,600 crore, depending on inventory policy

CRISIL's analysis shows most of the large manufacturers are operating at 60-75% capacity utilisation. Many of them, particularly in Maharashtra and Karnataka, face constraints with respect to cane availability. Hence, CRISIL does not expect any greenfield expansions over the medium term. There could be some brownfield expansion in regions where cane availability is good, such as UP, but this is unlikely to be material.

CRISIL estimates capex of Rs 1,000 crore for the 45 companies analysed. Most of it is likely to be for forward integration in distillery and electricity cogeneration, or, in some cases, for diversification.

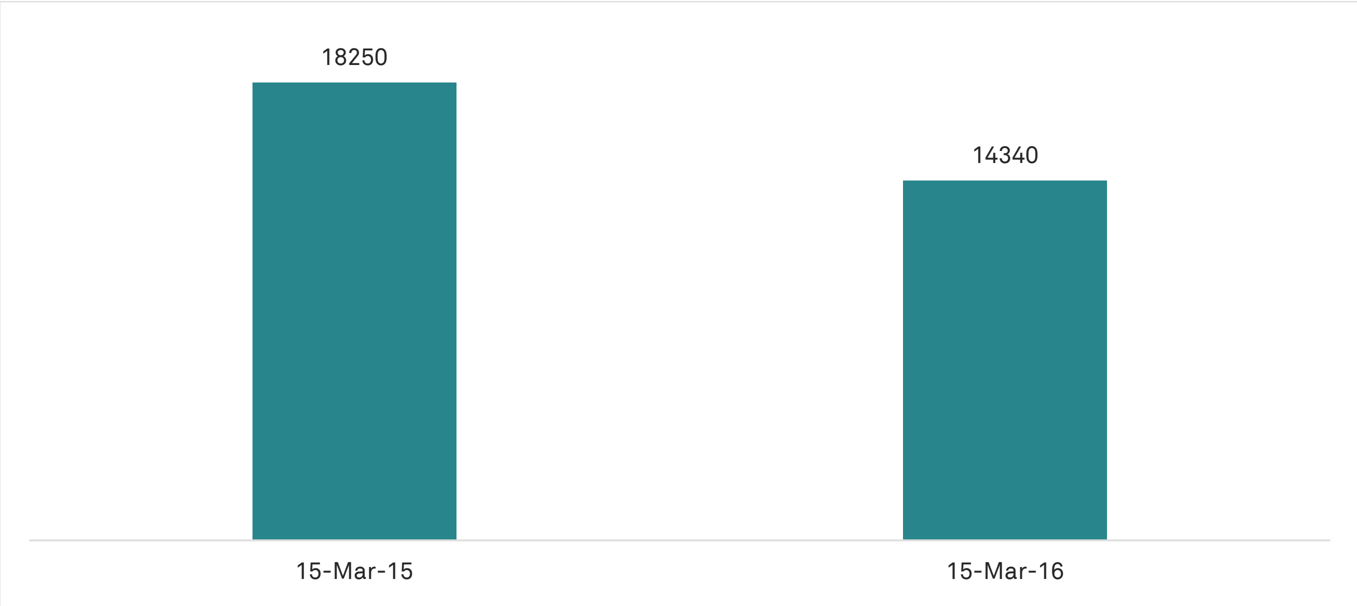
In the absence of large debt-funded capex, the financial profile of sugar companies is expected to improve. They can potentially pare debt by around Rs 4,600 crore, given strong cash accrual and assuming that the reduction in cane arrears is not material. The debt reduction would be significant considering 40% of the debt – worth Rs 12,000 crore -- is working capital by nature and typically peaks at the end of a fiscal due to stocking of sugar inventory. However, the debt reduction will hinge on prudent inventory management.

**13% reduction possible till fiscal 2018 (Rs crore)**



Another factor that augurs well for the credit profiles of sugar players is a reduction in cane arrears, backed by government initiatives and better profitability. Measures such as notification of soft loans with a moratorium on principal and interest payment, introduction of modified ethanol blending program to achieve up to 10% blending with motor spirit, waiver of central excise duties on ethanol, and announcement of production based subsidy payable to farmers against cane dues contingent on mills undertaking exports and supplying ethanol have led to liquidation of cane arrears.

**Industry cane arrears (Rs crore)**



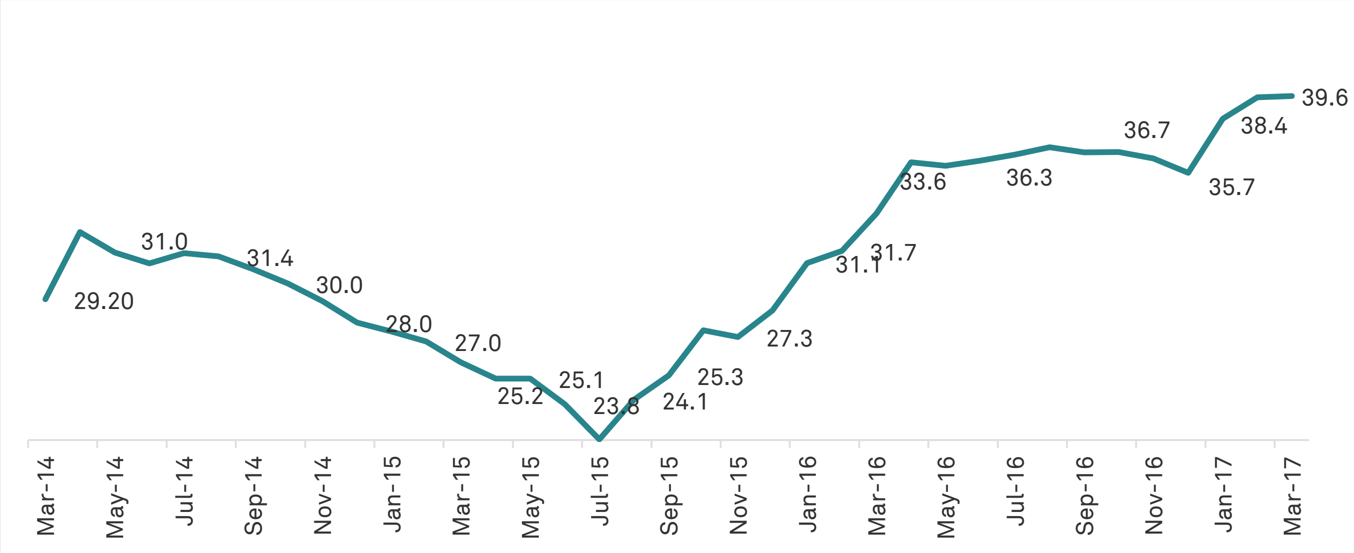

*Source: Department of food and public distribution*

## Prices firm as consumption outpaces production for the first time in 7 years

CRISIL expects sugar prices, which have increased to Rs 38 per kg on average in SS2017 from Rs 33 per kg in SS2016, to sustain at healthy levels in SS2018 as well.

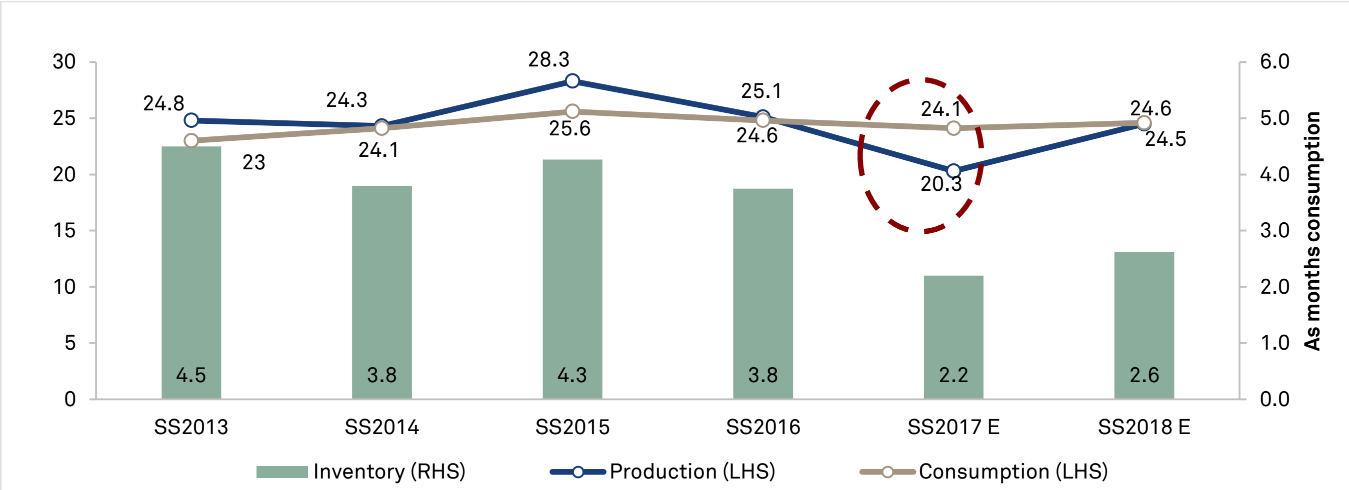
Prices shot up from the third quarter of SS 2016 on anticipated decline in domestic sugar production in SS2017, owing to deficient rainfall and low reservoir levels in Maharashtra and Karnataka. That would imply consumption outpacing production by 3.8 MT for the first time in 7 years, triggering a depletion in inventory to around 2.2 months of consumption at the end of SS2017, which would be the lowest since SS2009. That is despite the recent move by government to allow imports of 0.5 million tonne and some negative impact of demonetisation on sugar consumption.

**Sugar prices, Mumbai S30 (Rs per kg)**




*Source: CRISIL Research*

**Domestic sugar production, consumption and imports (million tonne)**

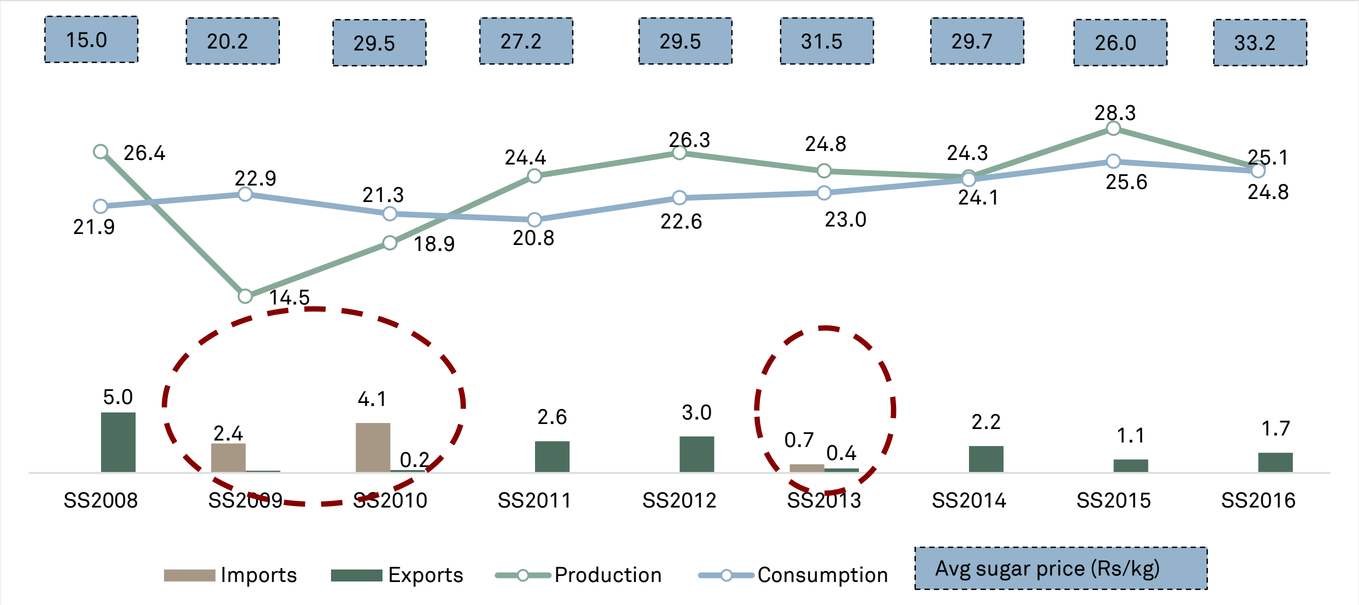



*E: CRISIL Estimate*

A normal monsoon in calendar year 2017 is expected to result in an increase in production by 4 to 5 million tonne in SS2018, with large portion of the incremental production coming from Maharashtra and Karnataka. Yet inventory levels are not expected to increase materially as consumption will tightly match production. That would mean prices remain firm in SS2018. This is further supported by the fact that the government has waited till the end of the crushing season to allow imports of 0.5 million tonne of raw sugar into the country, CRISIL believe imports will remain range-bound at around total of 1.5 million tonne in SS2017 and SS2018 and would be towards targeting physical shortages. Nevertheless, since the extent of imports will have a bearing on sugar inventory and prices, government's policy on imports and price controls would be the key monitorables.

The Government had on April 5, 2017, allowed import of 0.5 million tonne of raw sugar at zero duty till June 12, 2017, in order to address regional production gaps and to maintain domestic prices at reasonable levels. The import will be based on zonal quantity restrictions.

**Since SS2011, the highest import was in SS2013 at 0.7 million tonne (million tonne)**




Prior to this, India had imported around 4 million tonne of sugar in SS2010 as production had declined to 14.5 million tonne against annual domestic demand of 22.9 million tonne. Then India exported 5.5 million tonne over the next two years as production surged.

Currently, global prices for raw sugar are hovering around $540-550/tonne (~Rs 37 per kg) compared with $420 per tonne a year back, due to a fall in production. Lower production in India and Thailand offset higher production in Brazil and the European Union, and resulted in a fall in global production by 10-12 million tonne.

As a result, closing global inventory would decline to be around 2.5 months of consumption in SS2017, lower than the 10-year average of 2.8 months. Global sugar production is also expected to increase in SS2018, driven by higher production from Brazil and India. The resultant decline in global sugar prices will also remain a key monitorable.

## Players in north and south to benefit, though south players facing cane availability issues

The current uptick in sugar prices is expected to last till SS2018 and will lead to better profitability for sugar companies across India.

While the increase in SAP for cane is higher in UP (Rs 305 per quintal in SS2017 compared with Rs 280 previously), leading to much higher production cost for mills, this would be offset by higher-than-normal rainfall in the region that increased cane production. Higher cane availability has resulted in better capacity utilisation for the mills leading to better absorption of fixed costs. Also players which have integrated facilities have benefited even more given higher revenues and profits from cogeneration and distillery operations as a result of higher bagasse and molasses availability respectively. Further, improving recovery rate as a result of use of early variety of cane, which has higher sucrose content, by some of the UP-based millers also partially mitigates this impact.

On the other hand, cane prices in Maharashtra, Karnataka and Tamil Nadu will be lower than in UP. Moreover, declining inventory in the southern and western regions is expected to eliminate the historical discount of Rs 1-2 per kg in sugar prices in these regions compared with the north *(table below)*. But profitability of mills in this region would remain susceptible to cane availability, which has dropped in this sugar season. In Maharashtra and Karnataka, cane availability halved from the levels seen in SS2016 due to lower acreage and significantly lower cane yields.

| Sugar price (Rs/kg) | UP | Maharashtra | Karnataka |
|---|---|---|---|
| **Oct 2016** | 36.05 | 32.90 | 33.20 |
| **Nov 2016** | 35.13 | 32.65 | 32.93 |
| **Dec 2016** | 35.45 | 33.08 | 33.06 |
| **Jan 2017** | 36.50 | 35.30 | 35.70 |
| **Feb 2017** | **37.20** | **36.80** | **37.80** |

*Source: ISMA*

# Conclusion

## Credit profiles to improve on deleveraging, greater forward integration

India's sugar industry is characterised by cyclicality and huge dependence on agro-climatic conditions and government policies. CRISIL believes that a potential reduction in debt by almost Rs 4,600 crore during the current upcycle could improve the financial risk profile of companies by reducing leverage and improving debt protection metrics. The improvement in financial risk profiles will also be supported by absence of large debt-funded greenfield capacity expansions in the sector.

Further, cash flows from distillery operations and co-generation are relatively more stable, and improve overall efficiency of sugar players, and insulates the sugar players towards downturn in sugar prices. These capacities also add to the diversity in the revenue stream of sugar players.

Debt reduction coupled with more stable and improved cash flows will improve the credit risk profile of players. Hence, the players are expected to become relatively more resilient to down-cycles in the future. On the back of this, companies in sugar sector may witness more number of upgrades than downgrades over the medium term.

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