ICRA RATING FEATURE

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Sugar outlook weak; ability to negotiate cane prices downwards will be key to profitability for sugar mills in SY 2010-11

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Summary Opinion

- The domestic sugar stock position remains tight for the second year running. However, the demand-supply mismatch showed a reduction, following an increase in sugar production to around 18-18.5 million MT in SY 2009-10 from 14.5 million MT in SY 2008-09 (as against initial estimates made in October 2009 of around 15-16 million MT for the SY 2009-10), although it is still well short of the domestic offtake of around 23 million MT. Thus, even in SY 2009-10 (projected), India remains dependent on imports. While India had imported around 2.5 mn MT in SY 2008-09, the imports for SY 2009-10 are expected to be around 4.0-4.5mn MT.

- While the domestic stock position continues to remain tight, there has been a sharp correction in sugar prices since the peaks seen in January-Feb 2010. Free sugar prices,[1] which had reached a peak of around Rs. 40,000/MT by Q2 SY 2009-10, have shown a steep decline to the levels of Rs. 28,000 by April 2010. This reduction has largely been driven by a steep fall in international sugar prices (to which the domestic prices are linked, given India's supply deficit and removal of duties on sugar imports) to less than USD 500/MT by April 2010 from over USD 700 in January 2010. The fall in international sugar prices followed imbalances in the international supply-demand scenario following higher crop in India (which necessitated lower imports as compared to initial expectations) and expectations of higher production in Brazil. In addition to lower international prices and zero import duties, certain government measures such as shifting from a monthly release to weekly release system and allowing bulk consumers to import sugar freely also led to price falls.

- Sugar prices are not very weak and are even marginally better than the average price in SY 2008-09, which was considered one of the best years in terms of profitability. It is the fact that most mills have crushed cane in SY 2009-10 at extremely high prices that exerted pressure on the profitability of the industry. For instance, most North Indian mills had contracted cane at around 240/qtl while Maharashtra mills had contracted cane at prices as high as Rs.260-280/qtl. These rates made economic sense when they were contracted because of the prevailing expectation of low sugar production and high sugar prices. However, given the current prices, this has resulted in pressures on profitability from Q2 SY 2009-10.

[1] Figures are for UP, ex factory

- ICRA, therefore, expects conversion margins to come under pressure in SY 2009-10 although the impact is not likely to be uniform across all regions. The two largest production belts - Northern India (UP, Uttaranchal, Punjab and Haryana) and the Western Maharashtra-North Karnataka belts are likely to be the worst hit, given the high cane prices prevailing here while some other regions like Tamil Nadu and Bihar are likely to be less affected, given that cane was contracted at much lower prices than in the aforementioned regions.

- By-product prices, however, continue to support the profitability of the sugar industry, although the same is not sufficient to compensate for the lower margins in the core sugar business. Healthy demand from industrial and food grade alcohol have resulted in relatively healthy alcohol and molasses realisations, although there has been a correction as compared to the peaks witnessed in SY 2008-09. If the oil companies start off-taking ethanol at Rs. 27/litre (as is proposed), it could result in further firming of molasses and alcohol prices. Strong demand from paper and cogen/ biomass-based power projects (some of whose output is being sold at merchant rates of over Rs. 5/unit) has resulted in bagasse prices remaining firm at more than Rs. 1,500/MT in several key markets as against less than Rs. 500/MT in SY 2006-07. The SERCs too have lent a supportive regime to cogeneration projects -- most State Electricity Regulatory Commission (SERCs) -- UP, TN and Karnataka notably -- have not only increased tariffs for cogen projects (by close to Rs. 1/unit) but also allowed cogen projects to sell a part of their power through open access in the merchant route.

- ICRA foresees a weak outlook for sugar prices and profitability. For the balance two quarters of SY 2009-10, any improvement in prices and profitability will be contingent on government support measures such as an upward revision in levy sugar prices and re-imposition of import duties on sugar. However, given the political sensitivities to any move which would cause increase in sugar prices (and contribute further to inflationary pressures), it is uncertain whether such a move will be made. The outlook for SY 2010-11 also appears weak. Based on feedback from industry regarding sowing and cane availability position, ICRA expects production in SY 2010-11 to be around 25 million MT which would be marginally higher than the domestic offtake of around 23.5-24 million MT, thus exerting further pressures on sugar prices. On the positive side, it may also be noted here that for most states, the actual cane price has been arrived at based on negotiations between farmers and mills and these cane prices are well in excess of FRP/SAP announced by the central/state governments. A positive outcome of this is that apart from improving future crop availability by encouraging sowing, this will result in some flexibility for mills to reduce cane prices in the forthcoming years, should adverse supply-demand trends result in price reduction. Needless to say, any such reduction will be resisted by farmers. Thus, the extent to which downward reduction is achieved in cane prices in the face of declining sugar realisation will be key for profitability in SY 2010-11.

- As far as the medium to long-term outlook is considered, as in the past, the long-term prices and profitability of Indian sugar companies would remain volatile and dependent on domestic and international supply-demand trends. These in turn would depend on agroclimatic conditions in major producing countries and crude oil price trends, which determine the diversion of cane crop to ethanol. Consequently, the price trends in international markets would be the key determinants of future profitability. Further, government/court action in ensuring a rational linkage between cane prices and sugar prices will also be a key to long-term viability of sugar operations, especially in states governed by SAP.

- Notwithstanding the downward pressures on profitability, the impact on liquidity and capital structure of sugar mills may be less severe at least in SY 2009-10 than the one witnessed in the last downturn (SY 2006-07 and H1 SY 2007-08) because of lower gearing levels for most mills. This was because of moderate capex since September 2007, substantial accruals in the upturn (H2 SY 2007-08 and SY 2008-09), progressive repayment of debt and relatively low inventories. This is also reflected in relatively low cane dues in SY 2009-10 (as compared to SY 2006-07 and SY 2007-08) for most mills across the country. However, any upward revision of production estimates for SY 2010-11 may result in renewed pressures on liquidity, apart from affecting profits.

Recent Developments and Outlook

Demand-Supply Scenario and Outlook

Stock position continues to remain tight in SY 2009-10; SY 2010-11 likely to see a surplus

Table 1 shows the supply-demand position in the domestic industry in the period from 2002-03 to2009-10 and expectation for SY 2010-11:

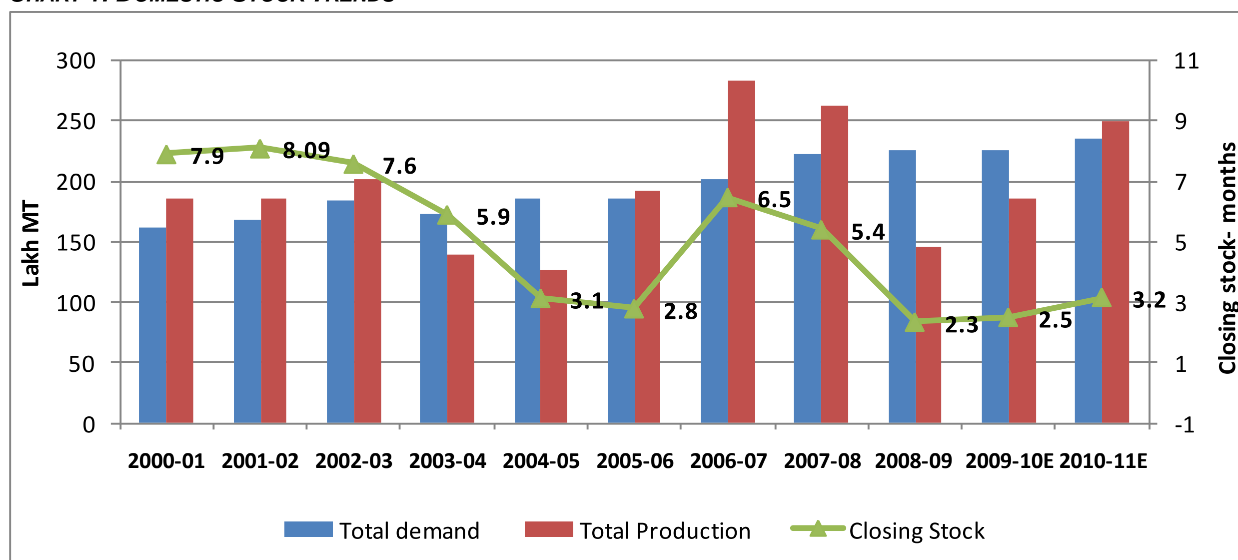
TABLE 1: DOMESTIC SUGAR PRODUCTION AND CONSUMPTION

Million MT/SY	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10 (E)	2010-11 (E)
Opening Stock – 1st Oct	11.32	11.61	8.50	4.00	4.3	10.9	10.0	4.4*	4.7
Production (Oct-Sept)	20.14	14.00	12.69	19.27	28.3	26.3	14.5	18.5	25.0
Imports	0.04	0.40	2.14	0.00	0.00	0.00	2.5*	4.3	0.0
Total Availability	31.50	26.01	23.33	23.27	32.6	37.2	27.1	27.2	29.7
Domestic Consumption	18.38	17.29	18.50	18.50	20.0	22.2	22.5	22.5	23.5
Exports	1.50	0.22	0.00	0.47	1.7	5.0	0.2	0.0	0.00
Closing Stock as on Sept. 30	11.61	8.50	4.83	4.30	10.9	10.0	4.4*	4.7	6.2
Closing Stock as Months of Consumption	7.58	5.90	3.13						

Note: *: import figure/CS for SY 2008-09 includes 1.2 million of unprocessed raw sugar lying with sugar mills
Source: ISMA/Industry Sources/ICRA Research

The closing stock position as measured by sugar-year-end domestic closing stock (CS) as months consumption (Cons.) is given in Chart 1:

CHART 1: DOMESTIC STOCK TRENDS



Source: ISMA/Industry Sources

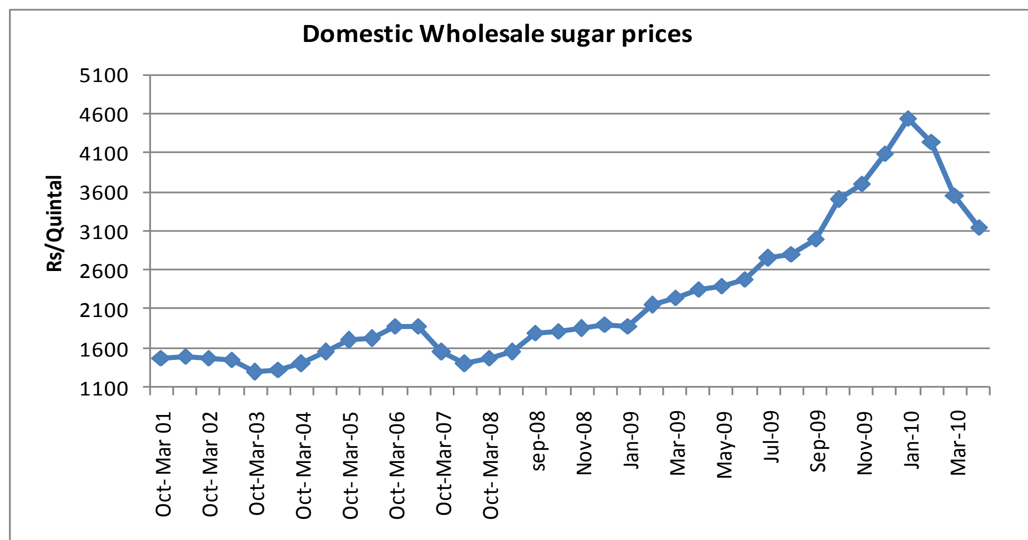
In SY 2009-10, production increased to around 18.5 million MT because of better sowing in SY 2008-09 and favourable agroclimatic conditions in several key growing areas. Despite this growth, production remained well short of domestic consumption (of around 23 million MT) as well as the highs of 26-28 million MT seen in SY 2006-07 and SY 2007-08. The lower production could be attributed to the impact of poor sowing in SY 2007-08 (which affected rattoon availability in the current SY) and also reports of widespread diversion of cane crop for alternate sweeteners and illicit liquor distillation, especially in the initial months of crushing.

At this point in time, a reliable estimate is not possible for the next SY crop, given the nature of the crop itself (especially vulnerability of crop to weather conditions, especially monsoons) and lack of clarity on the current year's sowing. Nonetheless, going by industry feedback and news reports on sowing patterns, ICRA expects sugar production for SY 2010-11 to be around 25 mn MT, with growth being driven mainly by improved sowing as a response to healthy cane prices. Thus, ICRA expects some build-up of stock again in SY 2010-11.

DOWNWARD CORRECTION EXPECTED IN PRICES from Q3 SY2009-10, FOLLOWING UPSURGE IN PRODUCTION ESTIMATES FOR SY 2009-10 & SY 2010-11 AND FALLING INTERNATIONAL SUGAR PRICES

Domestic sugar industry prices had shown a hardening trend since Q4 of SY 2007-08 in anticipation of tightening of the domestic supply-demand scenario. For instance, North Indian sugar prices (ex-mill, net of excise), which were around Rs. 14500/MT in Q1/Q2 SY 2007-08, crossed Rs. 17,000/MT in August-Sep 2008. With SY 2008-09 sugar production showing a significant decline, this resulted in a sustained uptrend in prices and reached a peak of Rs. 40,000/MT by end January 2010. This price rise was driven by anticipation of continued depressed production domestically as well as a surge in international sugar prices (Refer subsequent section) to which the domestic sugar prices got linked given the dependence on sugar imports. However, there was a significant drop in sugar prices since end February, which fell to as low as Rs. 28,000/MT by end-April 2010 and currently stands at around Rs. 27,000/MT. The drop in prices was driven by a number of factors. Firstly, there was an upward revision in production estimates for the current sugar season ending September 2010. Secondly, there was a significant drop in international sugar prices, which in turn was driven mainly by increased production in Brazil as well as lower dependence on imports by India following higher production. In addition, a number of measures taken by Government of India (GoI) to curb sugar prices also played a role. These measures included continued zero duty on imports; allowing bulk consumers to import sugar freely; tight inventory restrictions imposed by the government on buyers and changes in release norms (from monthly to weekly) for free sale sugar.

CHART 2: DOMESTIC SUGAR PRICES



Source: Industry data- based on data provided by ICRA rated mills

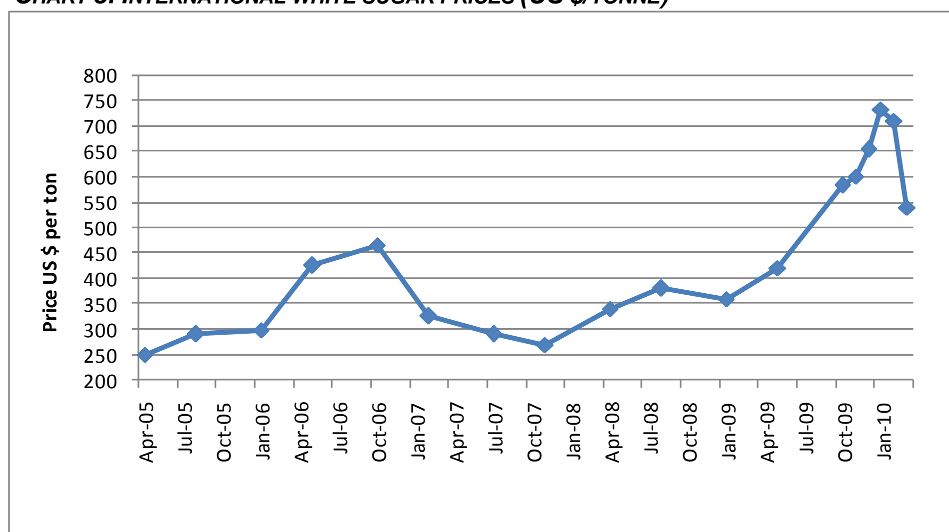
In ICRA's view, any significant strengthening of domestic sugar prices in June-Nov 2010 (before the next season's production enters the market) is unlikely unless import duties are imposed on sugar. However, given the political sensitivities to any move that is likely to cause increase in sugar prices (and contribute further to inflationary pressures), it is uncertain whether such a move will be made. Further, ICRA expects the prices to be subdued in SY 2010-11, given expectations of a further increase in production in SY 2010-11.

International Scenario

SUGAR PRICES HAVE BEEN ON A DOWNSWING SINCE JAN 2010 ON ACCOUNT OF INCREASED PRODUCTION OF SUGAR IN TWO OF THE WORLD'S LARGEST PRODUCING COUNTRIES- BRAZIL AND INDIA

In SY 2008-09, the world sugar production stood at a little over 150 million MT, an almost 10% decline in production as compared to SY 2007-08. The chief contributory factor to decline in production in SY 2008-09 was lower production in India (for reasons explained earlier) as well as lower production in Brazil, where unusually heavy rains in key production areas from October curtailed the crushing season by almost two months (Brazil's crushing runs from Apr to Dec). With consumption estimated to have outstripped production by around 10 million MT in SY 2008-09 and expectations of large deficits in SY 2009-10 as well, there was an upward pressure on sugar prices in CY 2009. White sugar prices were around US$300-350 per MT for most of CY 2008 but saw a surge from Jan 2009, reaching a peak of over US$700 per MT by Jan 2010. However, there has been a significant deterioration in sugar prices since Jan 2010, following improved production in Brazil and improved production in India (which necessitated lower dependence on imports as compared to initial projections), as can be seen in Chart 3:

CHART 3: INTERNATIONAL WHITE SUGAR PRICES (US $/TONNE)



SOURCE: ISMA

Cane Pricing and Conversion Margins

DUAL PRICE REGIME REMAINS UNCHANGED EVEN AFTER INTRODUCTION OF FRP....

During the winter session of the Parliament, the GoI announced its decision to replace the statutory minimum price (SMP) (which is the bare minimum cane price that all sugar mills in the country are required to pay to cane cultivators) with a fair and remunerative price (FRP) regime, which was to factor in the production costs, returns from alternative crops and prevailing sugar prices at the ex-factory as well as consumer end while fixing cane prices. The amendment was proposed as a step by the GoI towards checking inflationary trends in prices and ensuring equitable distribution of essential commodities. The FRP was different from existing SMP mechanism. A substantial part of the cane price in the SMP regime was to be paid at the end of the sugar year as a profit sharing element depending upon the inherent profits of the full year (commonly referred to as Clause 5 A). As for the FRP regime, the entire payment was to be made to the farmer upfront. The initial FRP proposal also included a clause which would have required all state governments who wished to continue with the SAP regime to bear the differential between SAP and FRP, should the SAP so declared by them be higher than FRP. The FRP was fixed at Rs. 129.84 per quintal (at a base recovery of 9.5% and a premium of Rs. 1.37 per quintal for every 0.1 % increase over the basic recovery rate) for SY 2009-10.

The promulgation of FRP ran into serious political difficulties with strong opposition from farmers as well as state governments. While farmers objected to the FRP on the grounds of the same being unremunerative, the state governments opposed it as they wished to retain the flexibility of having higher SAP without having to bear the cost of doing so. Finally, GoI went ahead with the FRP regime but dropped the clause regarding SAP. Thus, there has been effectively no change in the cane pricing regime with the FRP replacing SMP and SAP remaining legally valid (in line with a judgement given by the Supreme Court) in all

states that have enabling legislations. While FRP remains valid, the current FRP is merely of academic interest for SY 2009-10 as:

- Several states had SAPs in excess of FRP.
- In most states - SAP as well as non-SAP states -- farmers and millers mutually agreed to cane prices, which are not only in excess of FRP but in some cases even higher than SAP.

SHARP FALL IN CONVERSION MARGINS IN SY 2009-10 FOLLOWING HIGHER CANE COSTS AND FALL IN SUGAR PRICES....

TABLE 1: CANE PRICES AND CONVERSION MARGINS IN MAJOR STATES (ICRA ESTIMATES)[2]

SY 2007-08	**Cane Price^**	**Recovery rate**	**Cane cost of production**	**Sugar price #**	**Tolling Margin**
	Rs/Qtl	**(%)**		**Rs/MT**	
Uttar Pradesh	120	9.5%	12500	14500	2000
Maharashtra	110	11%	10000	13000	3000
Tamil Nadu	106~116	9.5~9.6%	11040~12200	11900~12100	-100~1060
Karnataka	110	11%	10000	13000	3000
SY 2008-09					
Uttar Pradesh	155	9.0%	17500	21500	4000
Maharashtra	150	10.5%	14500	19500	5000
Tamil Nadu	145-150	10%	14500-15000	21000	6000
Karnataka	150	10.5%	14500	19500	5000
SY 2009-10 (Projected)					
Uttar Pradesh	240	9.25%	26000	28000	2000
Maharashtra	280	11%	25500	27000	1500
Tamil Nadu	190	9.0%	21000	27000	6000
N. Karnataka	260	11%	23500	27000	3500

Note: ^: Landed cost at factory (ICRA's estimate);
#: LEVY SUGAR FOR SY 2009-10 TAKEN AT 20%

While the sugar prices have weakened significantly since March 2010, they are not very weak per se. In fact, these reduced prices are marginally better than the average prices prevalent in SY 2008-09, which is considered one of the best years in terms of profitability. However, most mills have crushed cane at extremely high prices, especially in the two largest production belts -- North Western India (states of UP, Uttaranchal, Punjab and Haryana) and Western Maharashtra- North Karnataka belts. For instance, most North Indian mills purchased cane at around 240/qtl while Maharashtra and North Karnataka mills purchased cane at rates as high as Rs. 260-280/qtl. These rates made sense when they were contracted, given that sugar production was expected to remain depressed and sugar prices. However, given the current prices this is likely to result in pressures on conversion margins and hence profitability from Q2 SY 2009-10. It may also be noted here that for most states, the actual cane price has been arrived at based on negotiations between farmers and mills and these cane prices are well in excess of FRP/SAP announced by state government. A positive outcome of this development is that it would encourage farmers to sow more cane in the current SY and thus improve future crop availability. At the same time, as current cane prices are higher than statutory requirements, some flexibility would be available for mills to reduce cane prices in future years, should adverse supply-demand trends result in price reduction.

[2] Based on data provided by some ICRA-rated mills; cane cost, recovery rates and, hence, conversion margins can vary significantly from mill to mill even in the same region.

INCREASE IN LEVY QUOTA A NEGATIVE FOR SUGAR MILLS; HOWEVER THERE IS A POSSIBILITY OF INCREASE IN LEVY PRICES WHICH MAY OFFSET HIGHER LEVY %....

The GOI has increased the levy quota from 10% of the total production to 20% from October 2009 in order to meet its levy commitments, given the shortfall in domestic production. (It may be noted here that no levy commitment is required against imported sugar.) This is a negative for sugar mills as the levy sugar prices paid to farmers as determined by GoI are around Rs. 13,500 per MT while the cost of sugar production itself is around Rs. 24,000-26,000/MT in most producing areas. On the positive side, however, there is a fair possibility that the levy prices, which have been stagnant for almost six years now may be revised upwards. With the government itself introducing an FRP that has a substantial increase in base cane price as compared to the SMP, the increase in levy price could be quite substantial. In ICRA's view, the increase could be around Rs. 4000-4500/MT for SY 2009-10. Further, the Supreme Court has given a judgement that levy prices should take into account the actual cost of production including the cost of cane paid. In ICRA's view, this could result in the average levy prices for the past five years being refixed at around Rs. 16-17000/MT, which in turn could result in a payout of over Rs. 30-40 billion to the industry for the past years, although it is uncertain whether the GoI will accept such claims.

BY-PRODUCTS OPERATIONS CONTINUE TO SUPPORT PROFITABILITY; FAVOURABLE TARIFF CHANGES MAKE FORWARD INTEGRATION INTO COGENERATION EVEN MORE PROFITABLE

The significant increase in cane production had an adverse impact on the pricing of bye-products such as molasses and bagasse in SY 2006-07. Since then, lower production and higher offtake from consuming industries (namely, power generation and distilleries) resulted in sharper increase in bye-product pricing and demand. Higher demand from industrial, food grade and fuel alcohol resulted in alcohol realisations reaching historic highs (with ENA prices touching as high as Rs. 35/litre in Q2 SY 2008-09), which in turn resulted in firming up of molasses prices to more than Rs. 3,000/MT in most regions. Although alcohol as well as molasses prices have corrected since then with improved supplies in SY 2009-10, they remain at remunerative levels. Should the proposal of oil companies off-taking ethanol at Rs. 27/litre take off, this could result in further firming up of molasses and alcohol prices. Similarly, strong demand from paper and cogen/ biomass-based power projects (some of this output is being sold at merchant rates of well over Rs. 5/unit) resulted in firming up of bagasse prices, which are now above Rs. 1,500/MT in several key markets. The SERCs too have lent a supportive regime to cogeneration projects. Most SERCs -- UP, TN and Karnataka notably -- have not only increased tariffs for cogen projects (anywhere between Rs. 1-1.5/unit) but also allowed cogen projects to sell a part of their power through open access in the merchant route. For example, UPERC has increased cogen tariffs to around Rs. 4/unit in FY 2010 from around Rs. 3/unit in FY 2009 and also allowed companies to sell 50% of their output in the offseason to third parties.

PROFITABILITY TAKES A HIT FROM Q2 SY 2009-10; ABILITY TO SECURE DOWNWARD MOVEMENTS IN CANE PRICES WILL HOLD KEY TO RECOVERY IN SY 2010-11

Sugar mills saw a significant jump in profitability from improved conversion margins and by-product prices in SY 2008-09, although the growth in profit, margins and returns was affected by cane shortages and affect output and volume sales of sugar as well as its by-products. However, significant correction in sugar realisations from March 2010, following increased estimates of sugar availability for SY 2009-10 and the resultant decline in conversion margins (given the high rates at which cane was contracted for SY 2009-10), has resulted in pressures on the profitability of sugar mills from Q2 SY 2009-10. Further, many mills have booked significant write-downs on inventories as well in Q2 SY 2009-10. Any improvement in profitability in the remaining quarters of SY 2009-10 will be contingent on government support, which could include an upward revision in levy sugar prices when they were fixed and re-imposition of import duties on sugar. However, given the political sensitivities to any move which would cause increase in sugar prices (and contribute further to inflationary pressures), it is uncertain whether such a move will be made. With prices likely to fall further in SY 2010-11, any recovery in profitability will be contingent on the ability of sugar mills to renegotiate cane prices downwards. However, their ability to do so will face resistance from farmers (and possibly other stakeholders such as governments and courts). Besides, mills will have their own compulsion to pay remunerative prices to farmers to avoid diversion to alternate sweeteners and switch to competing crops like wheat and paddy.

On the positive side, the impact on the liquidity of sugar mills liquidity has been less severe than the one witnessed in the last downturn (SY 2006-07 and H1 SY 2007-08) because of lower gearing levels for most mills. This was because of moderate capex since September 2007; substantial accruals in the upturn (H2 SY 2007-08 and SY 2008-09); progressive repayment of debt and relatively less pressures on inventory carrying pressures. This is also reflected in relatively lower cane due positions for most mills in SY 2000-10 as compared to the last downturn. Needless to say, any upward movement on production in SY 2010-11

(as compared to the current estimates of 25 million MT) and inability to lower cane costs could see renewed reversal of this trend.

In the medium-to-long-term, the long-term prices and profitability of Indian sugar companies would remain volatile and dependent on domestic and international supply-demand trends. These in turn would depend on agroclimatic conditions in major producing countries and crude oil price trends, which determine the diversion of cane crop to ethanol. Consequently, the price trends in international markets would be the key determinants of future profitability. Further, government/court action in ensuring a rational linkage between cane prices and sugar prices will also be a key to long-term viability of sugar operations, especially in states governed by SAP.

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