



## ICRA Rating Methodology: Indian Cement Companies

The Indian cement industry is the second largest in the world, with a total installed capacity of around 300 million tonnes per annum (MTPA) as on March 31, 2012 and cement production of 225 million metric tonnes (MMT) in FY12. The cement industry occupies an important place in the national economy because of its strong linkages to other sectors such as construction, transportation, power, construction, and coal, besides the financial markets. The industry is also one of the major contributors to the exchequer by way of indirect taxes.

Cement, like other commodities, exhibits strong cyclicity in volume offtake and price realisations. However, the industry is relatively insulated against global trends as the large freight component makes voluminous imports unviable. Thus competition in the Indian cement industry is largely restricted to domestic manufacturers. ICRA has observed that while no Indian cement company, however strong, is immune to the cyclicity inherent in this business, companies with strong fundamentals are able to withstand the cyclicity better as compared with others. In addition to industry risks, ICRA's rating methodology, therefore, attempts to identify such company-specific factors as locational advantages, proximity to consuming markets, regional supply-demand position, cost efficiencies arising out of access to key inputs at competitive prices, and operating efficiencies.

ICRA's rating methodology evaluates:

- Market related factors
- Operational strengths
- Management quality
- Financial strength and future cash flows
- Government policies

### Market Related Factors

**Geographical diversity and regional supply-demand scenario:** Cement being a bulky low-value commodity is highly freight sensitive, and bulk of the cement produced within a region is usually consumed within the region itself, with excess being transported to the adjacent regions. Thus, price trends and capacity utilisation levels are determined more by regional supply-demand dynamics than by the national supply-demand balance. Therefore while rating a cement manufacturer, ICRA projects the likely supply-demand scenario for the region in which the manufacturer operates as well as for the adjoining regions.

While projecting demand, ICRA takes into account past trends, the underlying economic growth drivers, and the cement-intensity of infrastructure projects planned and being implemented in the region. Similarly, ICRA attempts to project the likely supply position by looking at greenfield and brownfield expansion plans of manufacturers, besides low-cost supply additions through debottlenecking of existing capacities and blending<sup>1</sup>.

ICRA takes a favourable look at manufacturers with plants in different regions, as geographical diversification usually allows players to better cope with local downturns.

**Locational economics:** A cement plant has to be set up close to both the source of the main raw material, i.e. limestone, which is a very bulky item as well as the consuming centres so as to have low freight costs and ready market access. While the bulk of India's cement production capacity is concentrated in a few

<sup>1</sup> Clinkerisation capacity is often a constraint in the production of cement. Blending allows a company to produce more cement using the same amount of clinker.

clusters, which are essentially regions where limestone is widely available, the major consumption centres are often States that are far away from these production centres. ICRA favourably views plants that are located close to the major consumption centres and away from the major production clusters as they are likely to enjoy higher naked realisations<sup>2</sup> and hence profitability over the long term on the strength of lower freight expenses. Moreover, plants located within the clusters are also more vulnerable to competition in the longer term as the ready availability of raw materials in these regions offers opportunities for greenfield/brownfield expansion.

In analysing the locational economics, ICRA also evaluates the strategies adopted by individual companies to offset their locational disadvantages, if any. One strategy, for instance, is to set up stand-alone grinding units close to the consuming markets and the clinkerising unit near the limestone quarry. This helps the manufacturers to save the freight cost as clinker can be transported in open wagons or trucks. The benefit of this arrangement is even more marked in case the grinding unit is located close to a source of additive such as fly-ash or slag. Thus, ICRA assesses a company's policy on setting up integrated cement plant vis-à-vis having grinding units and clinkerising unit at different locations and the cost versus benefits of the company's approach.

**Market structure:** The domestic cement industry, which has traditionally been fragmented, has seen some consolidation off late following a number of mergers and acquisitions. Such consolidation has also brought in a degree of supply rationalisation among manufacturers. As a result, cement prices have tended to be steady despite significant supply pressures over the past few years. Thus, while rating a cement manufacturer, ICRA also takes into consideration the degree of consolidation that exists in the region(s) concerned, as that determines the extent of supply rationalisation and the intensity of pricing pressures.

## Operational Strengths

**Cost efficiencies:** Cement being a commodity item does not allow much premium pricing and thus most manufacturers are price takers in the markets they operate. In such a scenario, control over operating expenses is essential not only to maintain cost competitiveness and maximise profitability, but also withstand cyclical downturns, and is therefore one of the most important rating determinants. The major operating cost head for cement companies (apart from freight) is power & fuel. Power & fuel expenses in turn depend on two factors: the consumption norms, and the cost per unit of input consumed. Thus, ICRA analyses consumption norms such as kCal/kg clinker, kwh/kg clinker and kwh/MT cement produced for the manufacturer being rated. ICRA also assesses the manufacturer's efforts at reducing input costs through measures such as setting up captive thermal power plants<sup>3</sup>, using economic cost power from mini-hydroelectric plants, windfarms, etc., and using alternative fuels<sup>4</sup> that are available locally.

The vintage of a cement plant also influences its cost structure significantly. While an older plant enjoys the advantage of lower capital cost, such benefit is usually offset by higher power & fuel costs, significant repair and maintenance expenses, and generally higher manpower expenses. Size is another factor that determines the overall cost structure of a cement plant, as larger plants usually enjoy better control over infrastructure and overhead expenses.

**Product diversity and Blending:** Ordinary Portland Cement (OPC) which accounts for one-third of India's cement production enjoys a premium over blended cement because of greater acceptability. Cement companies have popularised the use of blended cement, with the result that the proportion of blended cement in the total production has increased over the years. The cost of production of blended cement is lower vis-à-vis OPC as the cost of additives such as fly-ash and slag (which are used in blended cement) is usually lower than the cost of clinker. Further, blended cements allow a manufacturer to produce more cement using the same amount of limestone and clinkerisation capacities. Therefore, ICRA views favourably companies with a demonstrated ability to develop and promote blended products, as also special products such as oil well cement, railway sleeper cement, and sulphate resistant cement. Although the offtake of the special products is limited, they usually offer significantly higher margins, thus providing some stability to the revenues and operating profits of the company concerned.

**Logistics:** Cement manufacturers use a mix of rail, road and coastal sea transport to distribute their product. While rail transportation is more economical over longer distances, for shorter hauls road transportation is more cost-effective and reliable. Coastal sea transportation of cement, as on date, is

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<sup>2</sup> realisations net of excise less selling and distribution expenses, including freight

<sup>3</sup> as the full cost of producing thermal power based on either domestic or imported coal is substantially lower than grid power

<sup>4</sup> such as lignite, petcoke or agro-waste

limited in India because of the limited availability of infrastructure, and is largely confined to supplies by shore-based manufacturers in Gujarat to Mumbai and its neighbourhood.

ICRA assesses a manufacturer's logistics development efforts in terms of reliability and costs. This apart, ICRA assesses the strength of a manufacturer's dealer network as much of the sales takes place in the retail segment. ICRA looks at the strength of the dealer network and its geographical coverage while assessing a company's distribution network.

**Brand development:** In India, brand development for cement is still in a nascent stage, and as of now manufacturers do not get any significant pricing premium on account of branding or the perceived superiority of product quality. Brand equity also remains a largely regional factor (given that sales are regional), with some local players enjoying considerable brand equity in their areas of operations. ICRA views favourably sustained efforts by manufacturers towards brand development, as it expects brand strength to allow market acceptance in the long term.

## Management Quality

As with most other businesses, management quality is one of the most important factors considered while rating companies in the cement business. Of particular importance in assessing management quality is the management's track record on project implementation, the performance of group companies, the company's exposure to such group entities, and the management's ability to implement cost-reduction programmes. ICRA also assesses the company's strategy for growth and possible acquisitions, besides its likely capital outlay for the same. Clearly, consistent operating performance and the observance of conservative financial policies, which however do not compromise the company's ability to grow, provide additional comfort.

In assessing management quality, ICRA also looks at the track record of the company's management during past cycles, particularly the use of surplus cash flows during up-cycles. ICRA views favourably companies that use these surpluses to lower debt, invest in cost-cutting measures and setting up of captive power plants), and engage in low-cost capacity addition through measures such as de-bottlenecking. ICRA takes an unfavourable view of companies that use surpluses for unrelated diversification or investment in group companies.

## Financial Strength and Future Cash Flows

The financial strength of a cement manufacturer is an important rating consideration. While assessing the financial position of a cement company, ICRA reviews the Accounting Policies followed by the company, Notes to Accounts, and Auditors' Comments that are part of the Annual Report. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations. Apart from balance sheet strengths which determine a player's ability to withstand a deep down cycle, ICRA also evaluates the profitability and cash generating ability of the business as well as other sources of financial flexibility available to an entity to evaluate its overall financial risk profile.

**Profitability:** Profitability of a cement manufacturer is primarily a function of its cost structure and product mix. However, since cement is a cyclical industry the profitability of the companies in this industry varies significantly along the cycle. Nevertheless, producers having cost structures better than the industry median level can generally be expected to remain profitable across cycles.

**Leverage and cash flows:** As with companies in other commodity industries exhibiting cyclical price trends, a low financial leverage is viewed as a credit quality positive for cement players. Besides protecting the cash flows of players by imposing a lower debt service burden, especially during periods of cyclical stress, a low gearing also imparts greater financial flexibility to cement producers to access funds from institutional sources.

Besides capital structure, ICRA pays special attention to coverage indicators including interest coverage, operating profit and net cash accruals relative to the total debt while evaluating the financial health of a candidate company. ICRA is particularly concerned with a company's capability to honour its contractual obligations under stress conditions. The more robust a company's performance is likely to be under a range of reasonable projections, the better it is from a credit evaluation perspective. ICRA also critically looks at other sources of financial flexibility available to an issuer, which could be in the form of, among

others, availability of a portfolio of liquid financial assets, strategic importance of the entity to the group to which it belongs along with the financial strength of group entities.

**Tenure mismatches, and risks relating to interest rates and refinancing:** Large dependence on short-term borrowings to fund long-term investments can expose an issuer to significant re-financing risks, especially during periods of tight liquidity. The existence of adequate buffers of liquid assets/bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which an issuer could be impacted by movements in interest rates is also evaluated.

**Debt servicing track record:** The debt servicing track record of a company is an important input for any credit rating exercise. Any delays or defaults in the past in the repayment of principal or interest payments reduce the comfort level with respect to the candidate company's future debt servicing capability and willingness.

**Contingent liabilities/Off-balance sheet exposures:** In this case, the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same are evaluated.

**Consolidated Financial Analysis:** In case of groups consisting of companies with strong financial and operational linkages, various parameters such as capital structure, debt coverage indicators, and future funding requirements are assessed at the consolidated/group level.

**Adequacy of Future Cash Flows:** Since the prime objective of the rating exercise is to assess the adequacy of the issuer's debt servicing capability, ICRA draws up projections on the likely financial position of the issuer under various scenarios. Besides, ICRA takes into account the commitments of the company towards other group companies, new ventures, and its investments in subsidiaries/SPVs. Subsequently, future cash flows are projected after taking into account the company's capacity utilisation levels and the likely prices of raw materials and finished products, the growth it envisages for itself, debt repayment schedule, its funding requirements, and the funding options available to it. These cash flows are then used to determine the company's future debt servicing capability under various scenarios. Apart from cash flow projections, the other ratios used to assess cash flows are Fund Flow from Operations (FFO) interest coverage, FFO debt coverage, and FFO capital expenditure coverage.

## Government policies

Government policies influence cement manufacturers in several ways. Currently, the biggest influence comes from fiscal incentives in the form of reimbursement of VAT, transport subsidy, exemption from income tax, excise duty etc. which has been approved by specific states. Given this scenario, ICRA assesses the extent of relative advantage or disadvantage arising out of these benefits that the cement company being rated, has vis-à-vis its competition in each of the States that it operates in. Apart from these incentives, government policies relating to rural housing, infrastructure development, incentives for urban housing (which are significant demand drivers), and captive power generation (covering cess, electricity duty and wheeling charges) also have a significant influence on the financial performance of cement manufacturers.

## Summing Up

ICRA's credit ratings are a symbolic representation of its current opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks, its competitive strengths, its likely cash flows over the life of the instrument being rated, and the adequacy of such cash flows vis-à-vis its debt servicing obligations. As the note has highlighted, for cement companies, special attention is also paid on the company's geographical diversity, raw material security, cost competitiveness, product diversity, management strategies for managing cyclical downturns and an overall approach towards investment and growth.



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