Research

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Another sweetener for sugar mills

Ebitda margins to increase 500-600 bps this fiscal, helped, among others, by buffer stock creation

Impact note | August 2019

Event

Cabinet approves creation of buffer stock of 4 million tonne of sugar for one year from August 1, 2019, to July 31, 2020

The Cabinet Committee on Economic Affairs (CCEA) chaired by Prime Minister Narendra Modi has approved the following proposals:

1. Creation of buffer stock of 4 million tonne of sugar for one year at an estimated maximum expenditure of Rs 1,674 crore. However, based on the market price and availability of sugar, this may be reviewed by the Department of Food and Public Distribution any time for withdrawal / modification
2. Under the scheme, the cost incurred by sugar mills for this purpose would be reimbursed on a quarterly basis. This would be credited directly into the farmers' account on behalf of mills, against cane price dues. The subsequent balance, if any, would be credited to the mills' account
3. Fair and remunerative price (FRP) for sugar season 2020 has been kept unchanged at Rs 275 per quintal. FRP is applicable for all states growing sugarcane except Uttar Pradesh and Punjab.

Background

In the wake of a bumper production in sugar seasons (SS) 2018 (October to September) and SS2019, and given the over-leveraged position and cash crunch of sugar mills, the government has intervened from time to time to improve liquidity of the sugar mills. These initiatives have been aimed at enabling sugar mills to clear cane price arrears of farmers and stabilising sugar prices in the domestic market.

Last year, the government announced the creation of buffer stock of 3 million tonne of sugar from July 1, 2018, to June 30, 2019. As the scheme announced in SS2018 was due to expire on June 30, 2019, a new notification regarding the creation and maintenance of buffer stock was released on June 15, 2019 and was approved by CCEA (cabinet Committee on Economic Affairs) on July 24th 2019.

The upcoming SS2020 is likely to commence with a huge carry-over/ opening stock of 12 million tonne compared with an average 7-8 million tonne over the past five years. With the government's announcement of a buffer stock of 4 million tonne, availability of sugar in the open market would decline to 8 million tonne, which would arrest the sharp fall in its prices. During October 2018-July 2019, sugar prices declined only a marginal 2-3% despite elevated inventory because the government fixed the minimum selling price at Rs. 31 per kg (in February 2019). Further, cane arrears declined to Rs 15,200 crore as of July 2019, compared with Rs 20,000 crore in March 2019

Impact on mills this fiscal

With mills eligible for 6% more working capital loans based on inventory they carry, and a 33% reduction in inventory carrying cost, their liquidity will improve.

Sugar prices will inflate by 6-7% in sugar season 2020 after 3% drop estimated in SS2019. This would translate into 8-9% increase in sugar prices in fiscal year 2020

Sugar mills' profitability will increase by 500-600 basis points (bps) in fiscal year 2020, of which a 200-400 bps increase can be attributed to the latest announcement

Cane arrears to reduce by at least Rs 1,600-1,700 crore up to September 2020

Liquidity of mills to improve

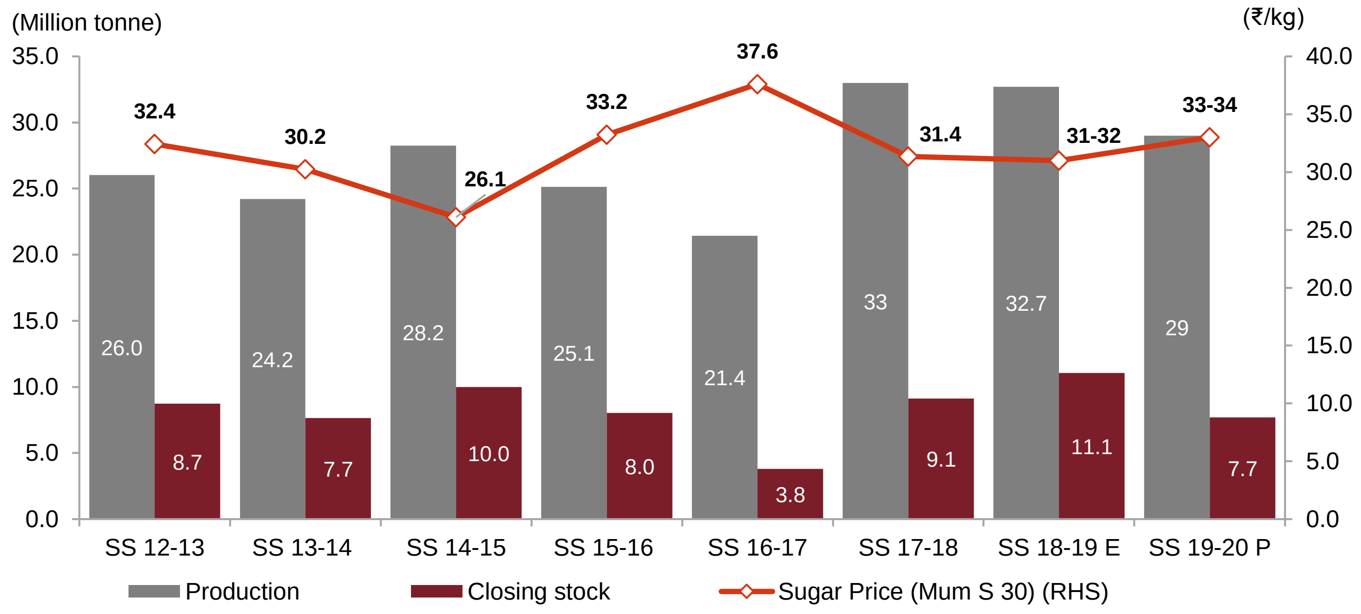
Providing a buffer stock of 4 million tonne (an additional 1 million tonne over the previous sugar season) would offer two benefits to mills:

1. **Higher working capital loans from banks:** Usually, banks provide a working capital loan of up to 85% of the total value of sugar stock that a mill is carrying. However, in case of a buffer stock, up to 100% of the stock value can be availed as working capital loan. Hence, of the total 12 million tonne of inventory carried as of August 2019, the mills can avail 100% of the stock value of 4 million tonne as loan. For the remaining 8 million tonne, they can avail loan of up to 85-90% of the inventory value. This is expected to result in increased availability of working capital loan by 6%, thus increasing the mills' liquidity.
2. **Over 30% cut in inventory-carrying cost:** As the government is expected to reimburse the inventory-carrying cost for 33% of the inventory currently carried by sugar mills (4 million tonne out of 12 million tonne), the inventory carrying cost of mills is expected to decline by 33%, thereby increasing the profitability of mills.

Sugar price to rise by 8-9% this fiscal

Production in SS2020 is expected to be down 9-10% because of smaller area under cane cultivation and delayed rainfall in key sugarcane-growing areas. This is expected to trigger a price rise of 8-9% to Rs 32-33 per kg this fiscal. With the provision for an additional buffer stock of 1 million tonne, a sharper rise of 3% is expected in sugar prices from our previous estimate of 5-6%.

Production drop = depleted inventories



Note: SS: Sugar season - October-September

Source: Industry, CRISIL Research

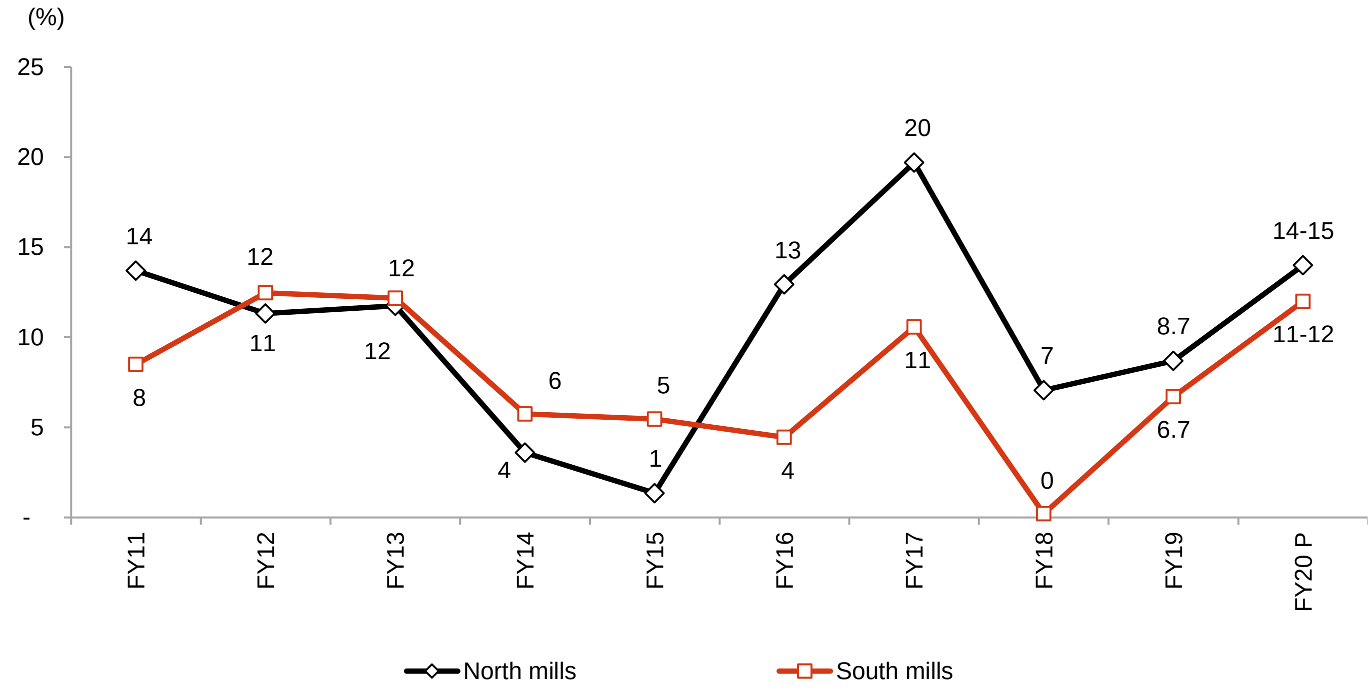
Ebitda margins of large mills to increase 500-600 bps this fiscal

With a buffer stock of 4 million tonne, domestic prices are expected to rise, leading to an 8-9% increase in the sugar price and 33% lower inventory-carrying cost for mills. With no change in FRP, margins would improve further – applicable only to mills following FRP. Overall, Ebitda (earnings before interest, tax, depreciation and amortisation) margin of large sugar mills will improve by 500-600 bps in fiscal 2020, backed by:

- 300 bps increase due to rise in sugar prices
- 200 bps increase due to part of the inventory-carrying cost being borne by the government
- 100 bps increase due to no change in fair and remunerative prices (FRP)- applicable only to mills following FRP

As for Ebitda margins, mills in north India would continue to earn more than those in the south, as sugar prices in the north are expected to be Rs 1.00-1.50 per kilogram higher. However, southern mills should see a sharper rise in Ebitda margins this fiscal because unchanged FRP would reduce their raw material expenses.

Significant Ebitda margin expansion ahead



Note: Companies considered in the sample set that collectively account for 30-35% of industry market size:

North-based mills - Bajaj Hindusthan Ltd., Balrampur Chini Mills Ltd., Dhampur Sugar Mills Ltd., Oudh Sugar Mills Ltd., Rana Sugars Ltd., Simbhaoli Sugars Ltd., Triveni Engineering & Inds. Ltd., Upper Ganges Sugar & Inds. Ltd., Uttam Sugar Mills Ltd, and Dalmia Bharat Sugar & Inds. Ltd.

South-based mills - Bannari Amman Sugars Ltd., Dharani Sugars & Chemicals Ltd., K C P Sugar & Inds. Corpn. Ltd., Kothari Sugars & Chemicals Ltd., Ponni Sugars (Erode) Ltd., Rajshree Sugars & Chemicals Ltd., Sakthi Sugars Ltd., Thiru Arooran Sugars Ltd., Ugar Sugar Works Ltd., and Andhra Sugars Ltd.

Note: Segmental revenue share of large mills: Sugar- 75-80%; Distillery: 10-12%; Power- 8-10%

Source: Industry, CRISIL Research

Standalone mills to make only marginal profits

Mills operating solely in the sugar segment are expected to make low single-digit margins at the Ebitda level, as compared to integrated mills, as sugar prices just about cover the production cost of sugar. Currently, the cost of sugar production stands at Rs 32-33 per kg, whereas sugar prices are trending at Rs 31.5-32 per kg. Sugar mills with a higher capacity utilisation and exposure to exports may be able to make low-to-mid-single-digit margins. However, their stretched liquidity position and thin margins would make it difficult for them to pay off cane arrears.

Cane arrears to reduce at least by ~13% in SS2020

Higher liquidity and profitability of mills is expected to reduce cane arrears that stood at Rs 15,200 crore as of July 2019. The government is expected to reimburse the cost of carrying inventory of 4 million tonne by paying Rs 1,670 crore directly to farmers, thus reducing cane arrears by ~13% to Rs 13,000-13,500 crore in SS2020. Arrears could decline further if sugar mills use their additional earnings to pay off cane farmers. That said, there have been instances in the recent past wherein some mills did not pay off their cane arrears in spite of sharp revival in profitability, as they diverted funds towards expansion of distilleries, which has been subsidised by the government. Hence, cane arrears are expected to remain at high levels if stringent measures are not taken against those who do not pay their cane farmers.

For further information,

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