

Indian Sugar Industry

Date
13/11/09

Sensex
16848

Nifty
4998

Market Cap of the sugar Industry
Rs.11993 Cr

Balarampur Chini
Market Cap
Rs. 3686 Cr
Recom: Hold

Bajaj Hindustan
Market Cap
Rs. 3924 Cr
Recom: Sell

Shree Renuka
Market Cap
Rs. 7173 Cr
Recom: Buy

Summary

The Indian domestic sugar industry has entered into severe shortage phase due to sharp decline in production over the last two years. We expect sugar production to rebound to 16 million tonne for sugar year (SY = from Oct-Sep) 2010 after falling to 14.7 million tonne in SY2009, on account of 0.5 million hectare increase in sugar acreage. But we believe, due to drought in some parts of the country like Uttar Pradesh, Maharashtra, the yield levels of the crop and production of sugar may come down. The domestic consumption is at 23 million tonne for the SY2010.

To meet the consumption levels, government is allowing duty free imports. It is expected that, imports for SY2010E and SY2011E may stand at 8.5 million tonnes and 5 million tones respectively. This has lead to higher sugar prices which have gone up by 72% in the last 12-13 months to Rs.29 from Rs.17 per Kg. We believe, the current supply deficit will continue for another two years led by poor rainfall and low inventory and these prices are expected to sustain for the next 12-18 months.

Due to the high sugar prices, sugar stocks have a run up off late and are looking a tad expensive; however, we believe that there will be moderate gains due to upside in earnings on the back of high sugar prices, and strong operating performance.

In our view, decline in sugar prices, government intervention to control the sugar prices and changes on duty free import norms will be the downside risk.

Global demand-supply scenario (million tonnes)

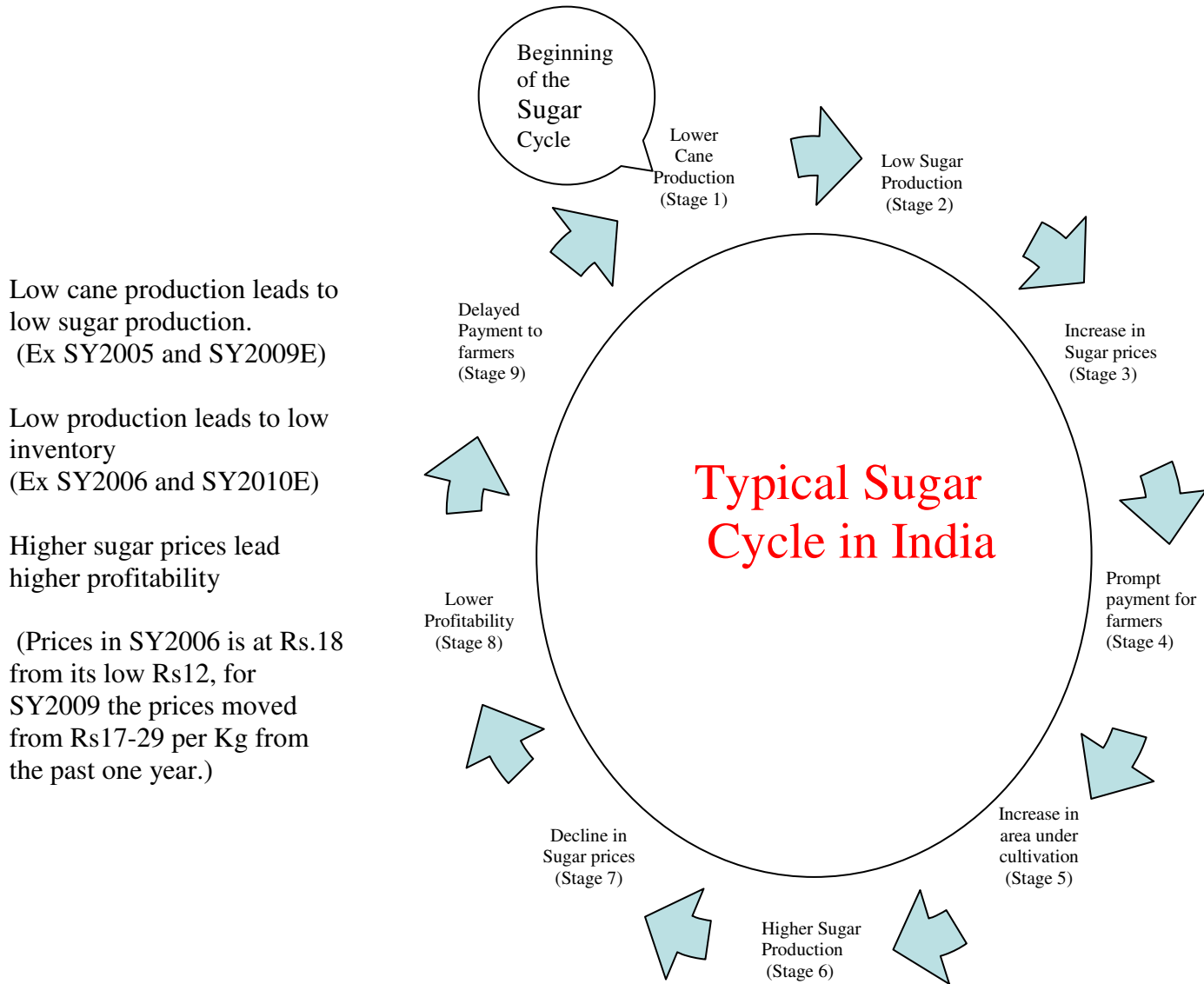
	SY02	SY03	SY04	SY05	SY06	SY07	SY08	SY09
Opening Stock	58.9	58.7	68.1	67.1	61.3	64.3	73.8	78.0
Production	138.3	150.4	143.7	141.2	151.4	167.4	167.8	161.2
Total Availability	197.2	209.1	211.8	208.3	212.7	231.7	241.6	239.2
Consumption	138.5	141.0	144.7	147	148.4	157.9	163.6	163.3
Closeing Stock	58.7	68.1	67.1	61.3	64.3	73.8	78.0	75.9
Inventory (% of consumption)	43.6	48.8	47.5	42.6	44	48.2	49.2	46.9

Globally, production of sugar for the SY09 is expected to be at 161.2 million tonne and the opening stock is at 78.0 million tonne. The total availability of sugar is at 239.2 million tonne. The consumption of sugar is expected to be at 163.3 million tonne and the inventory is at 75.9 million tonne, which is 46.9% of SY2009 consumption levels. We believe the production levels for SY2010 will decline as compared to SY09 on account of sharp decline in sugar production in India and Europe, while the rest of the countries reported near normal production figures.

Domestic Supply-demand Scenario (Million Tonnes)

	SY02	SY03	SY04	SY05	SY06	SY07	SY08	SY09	SY10	SY11
Opening Stock	10.7	11.3	11.6	8.5	4.0	3.6	9.2	8.1	2.3	0.0
Production	18.5	20.1	14	12.7	19.3	28.3	26.3	14.7	16.0	22.0
Total Availability	29.2	31.4	25.6	21.2	23.3	31.9	35.5	22.8	18.3	22.0
Demand-Total	17.9	19.9	17.5	18.5	19.6	22.7	27.5	22.5	23.4	24.6
Domestic	16.8	18.4	17.3	18.5	18.5	21	22.5	22.5	23.4	24.6
Exports	1.1	1.5	0.2	0.0	1.1	1.7	5.0	0.0	0.0	0.0
Imports	0.0	0.0	0.4	2.1	0.0	0.0	0.0	1.3	8.5	5.0
Closing stock- Month	7.6	7.0	5.8	3.1	2.2	4.9	3.5	1.2	-2.6	-1.3
Closing Stock	11.3	11.5	8.1	2.7	3.7	9.2	8.0	0.3	-5.1	-2.6

If we observe the above table, the inventory levels declined to 4 million tonne and 12.7 million tonne in the previous down cycle SY2006. The production levels declined to 12.7 million tonne in SY2005 from its high 20 million tonne. In the SY 2008 up cycle, the sugar production levels increased to 28.3 million with CAGR of 149% from its lows 12.7 million tonne. But if we observe the consumption levels of sugar is constantly increasing on y-o-y. The volatility in the opening stock and production levels is due to the cyclicity in the cane production, which is the main source for sugar production. Below diagram shows the reasons for shortage of sugarcane and how the typical sugar cycle is in India.



Present down cycle

After two consecutive years of bumper production and up cycle with huge inventory of sugar in SY2007 and 2008, domestic sugar industry has entered into down cycle in SY2009 with severe shortage of sugar due to sharp decline in production.

According to ISMA estimates the country is expected to produce 16 million tonne of sugar excluding the opening stock of 2.3 million tonne for the SY2010E. The production levels of sugar for SY09 and SY10 have come down by 44% and 30% to 14.7 and 16 million tonne respectively as compared to 26.3 million tonne in SY2008. But the current consumption levels are at 23.4 million tonne. The shortage of sugar is around 5.1 million tonne in SY2010E and 2.6 million tonne in SY2011E.

Demand, Supply mismatch – leads to imports

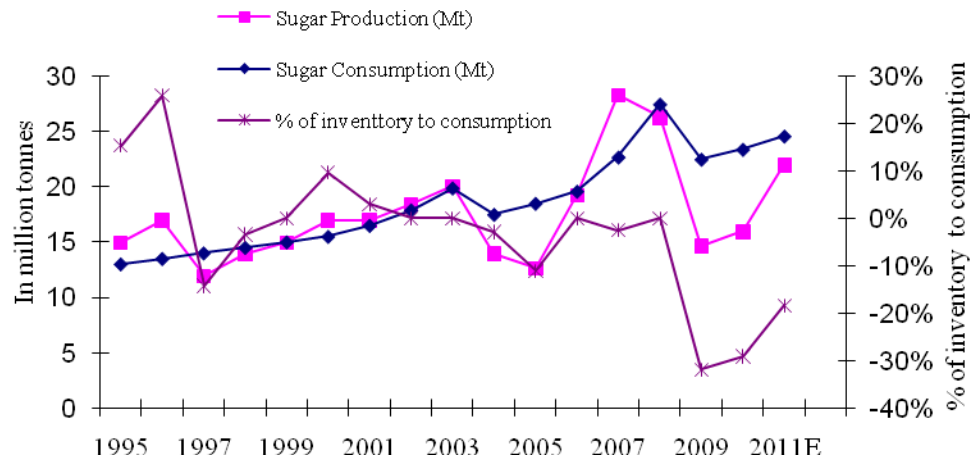
- We expect sugar production to rebound to 16 million tonne in SY2010 from 14.7million tonne in SY09, on the back of increased sugar cane cultivation by 0.5 million hectare.
- According to ISMA, sugar inventory levels will continue to fall 5.1mt by Sep10.This will be lowest level in the last three decades.
- To meet the current consumption levels government is allowing the duty free sugar imports, it is expected that, imports for 2010E may stand at 8.5 million tonnes and for SY2011E 5.0 million tonnes.
- Considering the above factors we expect the demand –supply may remain tight till SY2011 as well implying a 24-30 month down-cycle

India’s tight down cycle

If we observe the below graph, we can find 3 upward cycles in SY1996, 2003 and 2008. Following the up cycle years we can find three down cycles in SY1997, 2004 and 2009. If we observe the previous two down cycles in SY1997 and SY2004, it lasted only for 1 year on the back of less cyclicity in the sugar cane production and hence, improvement in sugar production and inventory levels.

However, the current down cycle is expected to continue for at least 2-3 years on the back of low inventory and less percentage of sugar recovery from sugar cane for the present sugar year production. It is expected that percentage of inventory to consumption levels will fall to negative side in SY2010E and SY2011E. This will lead to increase in sugar prices and companies will benefit even with low volumes with high prices.

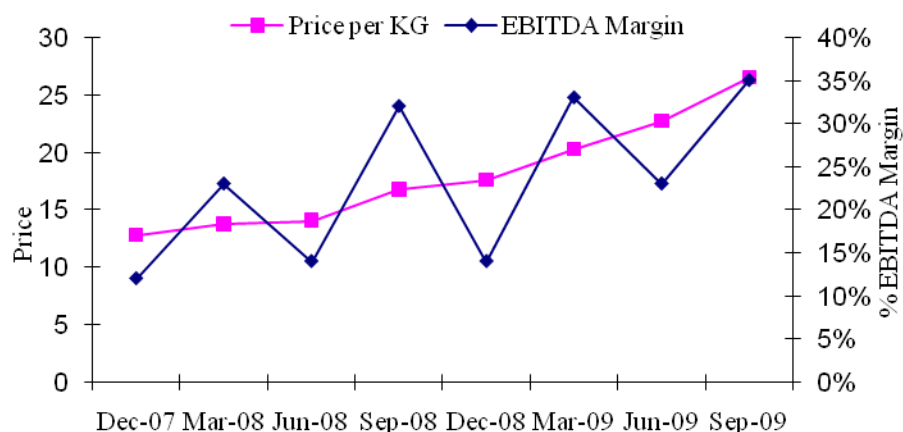
Indian Sugar Production and Consumption



High Sugar prices lead higher profitability

If we observe the graph given below, we can find the prices on QOQ basis have been increasing from Dec 2007 till September ending 2009. The prices of sugar has moved 107% from its low and has doubled from Rs.12.7 in Dec 2007 to Rs.27 in Sep 2009. The EBITDA margins are increasing along with the sugar prices. We believe the prices of sugar and EBITDA margins trend will continue further, until the supply of sugar exceeds the demand.

Sugar Price and Industry EBITDA margins

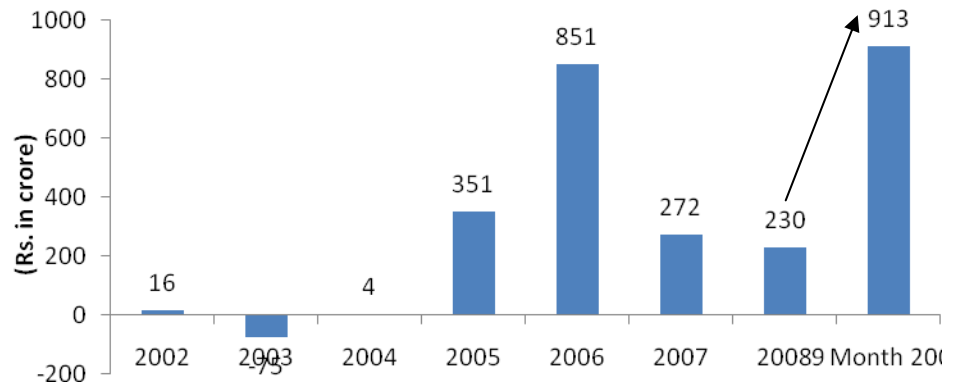


Future looks better than past

In the previous up cycle in SY2006, most companies were in capacity expansion mode, which lead to higher borrowing and resulting in lower than expected profitability due to high interest and depreciation expenses. However, on the positive front the capacity expansion has made the companies more integrated, and we believe this will reduce the cyclicality of profits in the future.

In the current down cycle, the industry is behind its capex cycle, which is expected to lead to better profitability. As seen from SY09, 9-month performance of the PAT has increased by 297% from its low of Rs.230 crore to Rs.913 crore. We believe the increasing profitability trend will continue due to reduction in debt levels as the industry is expected to throw out healthy operating cash during this period.

Industry PAT



Current Scenario

According to Sugar dealers, presently the factory price for the sugar is at Rs.29000-32000 per tonne. For the mills to meet the November month demand will be tough due to nil inventory and delay in sugar cane crushing by one month for SY10 seasons. The delay in crushing is on account of request by farmers and mills to ISMA. It was due to the late rainfall in early October and expectation of increase in the yield of the crop and increase of recovery of sugar from cane. At the same time, the farmers are also demanding high price of Rs.2800/tonne (according to the market price) of sugar cane as against State Advised Price (SAP) Rs.1650 per tonne of sugar cane. The competitors for mills like Jaggery and Khandasari makers are ready to pay at around Rs.2000 to Rs.2100 per tonne of sugar cane. According to dealers, the prices of sugar will stabilize at current price for next 5-6 months on the back of low demand. They further expect, once the summer starts, demand for sugar picks up by breweries and ice cream companies and then onwards the price may shoot to Rs.40/kg.

New developments

- Mills are benefiting with high sugar prices while paying fair remunerative price of Rs.137 per quintal to farmers, instead of paying SAP of Rs.165 per quintal. It has been decided by the government that, the difference between the SAP and fair remunerative price of Rs.28 will be paid by the state government to farmers.
- According to media reports, Bajaj Hindustan may acquire Balrampur Chini promoter stake of 37% at Rs.2400 crore; with a total valuation of Rs.6486 crore. The combined entity will have assets worth \$2.5 billion and \$1.7 billion of revenues. Presently, Bajaj Hindustan has Rs.3400 crore of debt

on SY2008 balance sheet. It has to raise the additional funds for acquisitions.

- Shree Renuka acquired “Vale Do Ivai S.A Acucar E Alcool (VDI)”, a Brazilian sugar and ethanol production company. VDI has an enterprise value of \$240 million. Shree Renuka will acquire 100 per cent of the equity capital of VDI for approximately \$82 million and the balance is assumed debt, which is to be repaid over 8 years.

Risks for the Industry

Weak monsoon to impact sugar production

Weak monsoon and possible drought situation in the major sugarcane producing states like Uttar Pradesh and Maharashtra will impact the sugarcane crop in SY2010E. We believe Uttar Pradesh farmers will be impacted by a lesser extent, due to high irrigation penetration, but low reservoir levels may impact the crop.

Government controls the whole manufacturing process:

Government controls the entire chain of the sugar industry, from input price to production and sales. The government controls cane pricing, area of procurement, and monthly release of quotas on the sale of levy sugar. The government is currently discussing with various industry members to control the increase in sugar prices. We believe the two possible scenarios are:

Increase in levy sale quota and levy sale price: The government is planning to increase its levy sales quota from 10% to 20-25%. It is also planning to increase levy sale price to Rs.20 per Kg from the current price of around Rs.13.25 per Kg. This impacts the margins of the companies by declining revenues in free sale market.

Possibility of subsidizing the sugar price: The government may also put administered price on free sale sugar, subsidizing the sugar companies on price difference between market price and administered price, which is similar to the fertilizer and oil companies.

Conclusion

We believe the sugar manufacturers with refining capacity of raw sugar will benefit more on the back of low sugar cane production, high sugar prices and duty free sugar imports. The mills that depend on sugar cane for production of sugar will also benefit on the back of high sugar prices. We believe the farmers will also benefit on the high prices of cane.

Our picks

We have covered three companies, Bajaj Hindustan, Balrampur Chini and Shree Renuka in this down cycle. These three companies are benefiting by high sugar prices. These companies are expected to generate huge revenues and free cash flows for SY2009, 10E and 11E. With these free cash flows, companies reduce their debt levels and strengthen their balance sheets.

Companies' Free cash flows (Rs. In Cr)

(Rs. In Crores)	Bajaj Hindustan		Balrampur Chini		Shree Renuka	
	Sales	Cash flow	Sales	Cash flow	Sales	Cash flow
2006	1,444	263	1,920	36	801	65
2007	1,699	192	1,375	38	732	49
2008	1,750	139	1,455	214	1,824	116
2009E	2,111	386	1,529	406	2,703	280
2010E	3,561	666	2,020	666	5,035	494
2011E	3,628	921	2,336	734	6,283	583

Company Valuations

(Rs. In Crores)	Bajaj Hindustan			Balrampur Chini			Shree Renuka		
	2009	2010E	2011E	2009	2010E	2011E	2009	2010E	2011E
Sales	2,111	3,561	3,628	1,529	2,020	2,336	2,702	5,034	6,283
EBITDA	621	1,018	1,387	661	1,053	1,155	335	575	666
EBITDA%	29	29	38	43	52	49	12	11	11
PAT	188	454	697	299	566	644	240	450	534
PAT%	9	13	19	20	28	28	9	9	9
EPS	11.0	26.5	40.7	11.7	22.2	25.2	8.6	16.1	19.1
Price	223	223	223	144	144	144	227	227	227
P/Ex	20.2	8.3	5.4	12.3	6.5	5.7	26.4	14.1	11.8
EV/EBITDAx	8.5	5.6	3.8	8.4	7.3	6.6	16.8	12.1	9.4

Recommendations

Balrampur Chini: We recommend **HOLD** on the expectations of increase in sugar prices. Increase in prices will generate huge free cash flows and strengthen the balance sheet by reducing the debt levels. Buy, when the stock goes for correction.

Bajaj Hindustan: We recommend **SELL**, even though the valuations are attractive and healthy free cash inflows on account of high sugar prices. The company has debt burden, and it will increase if, it acquires Balrampur Chini.

Shree Renuka: We recommend **BUY**, even though valuations are high. The company will benefit from duty free imports and with huge refining capacity. It also generates healthy cash inflows in this up cycle.

Our Team

Mrunmay Das

mrunmay@dascap.com

Ph:91-80-28440501-Ext 31

Mob: 91-9845026333

Arun Thirumalai

arun@dascap.com

PH:91-80-28440501-Ext 32

Mob: 91-9740077809

Mamatha Pendurthy

mamatha@dascap.com

PH: 91-80- 28440501-Ext 26

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