Rising steel prices: Stealing the thunder of the CME industry

The demand for construction and mining equipment (CME), which has been witnessing growth in tandem with the overall growth of infrastructure construction activities, is a key barometer of the economic activity in the country.

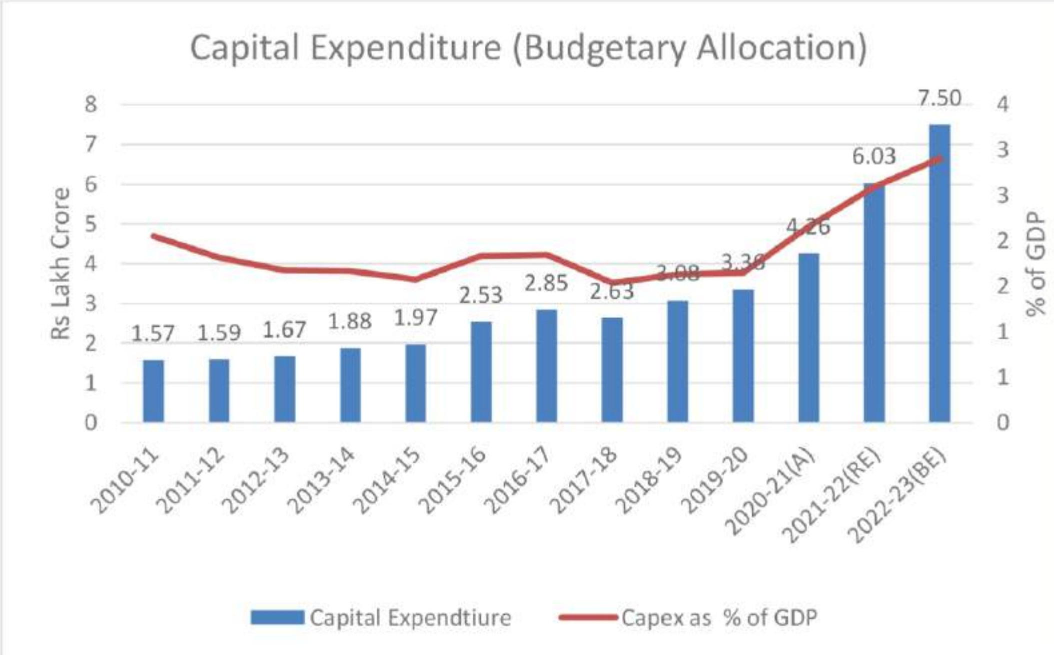
Category-wise, CME mainly includes earthmoving equipment, concrete equipment, material handling equipment (MHE), road construction equipment, mining machinery, and material processing equipment. The road and urban infrastructure segments account for more than half of the CME industry and the balance is contributed by other infrastructural segments. Accordingly, earthmoving and road construction equipment has a significant share in the CME market.

The recent spate of the increase in commodity prices, especially steel, which comprises a major proportion of input costs, has created an upheaval in the CME industry. Additionally, the industry has been impacted on account of the increase in cost due to the change in emission norms and the extraordinary increase in freight costs.

Demand prospects remain strong

With the continued push of the government on infrastructure development and the increasing budget allocation towards capital outlay, the demand prospects for the CME industry remain favourable.

The size of the Union Budget for FY23 (refers to the period from April 1 to March 31) has been raised by 5%, with a 24% increase in capex, which is the highest-ever allocation for capital asset creation.



Growth drivers

Asset creation has remained centred around roads and railways in the Budget. Over half (51%) of the capital outlay in FY23 is allocated to these segments. The budgeted spending on road transport is 58% higher than in FY22.

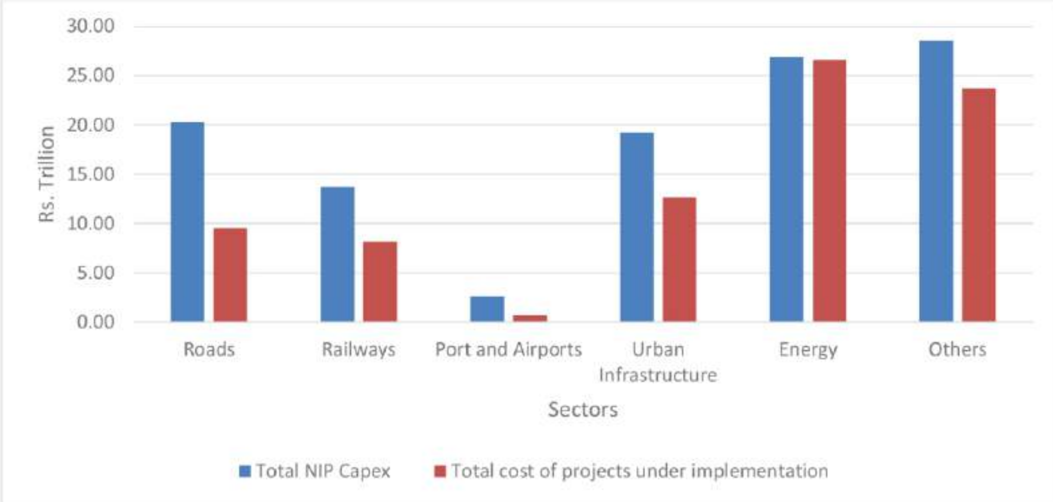
The pace of road construction in the country slowed down in FY22 to 10,457 km as compared to 13,327 km in FY21 due to the disruptions caused by the Covid-19 pandemic and the extended monsoon in some parts of the country, apart from the inflationary pressures on input cost. However, the contracts awarded increased to 12,731 km, a growth of about 14% over FY21. With the increased allocations as above, the demand potential for road construction equipment remains strong.

The increase in mining activities to support infrastructure creation and urban development projects is also expected to significantly contribute to the demand for CME. Real estate activity has also picked up with the receding impact of the pandemic.

Trend in allocation to various infrastructure-related schemes under the Budget driving the demand for CME:

Rs.crore	2018-19	2019-20	2020-21	2021-22 (RE)	2022-23(BE)
National Highways Authority of India	39,287	31,691	46,062	65,060	1,34,015
Road Works	37,811	46,292	53,093	65,687	64,568
Pradhan Mantri Gram Sadak Yojna	15,414	14,017	13,688	14,000	19,000
Pradhan Mantri Awas Yojna (PMAY) – Affordable Housing	25,443	24,964	40,260	47,390	48,000
Atal Mission for Rejuvenation and Urban Transformation (AMRUT)and the Smart Cities Mission (SCM)	12,085	9,599	9,754	13,900	14,100

Projects worth ₹111 lakh crore are proposed to be executed between FY20-FY25 under the National Infrastructure Pipeline (NIP). The proposed sector-wise investments under NIP that are expected to drive demand for CME are as under:



Substantial increase in input cost

The increase in commodity prices, especially steel, copper, and aluminium has significantly impacted the cost of production for the CME players. The cost has also increased due to the change in emission norms from April 2021. Overall, there has been an increase of about 15-20% in the total cost of production due to an increase in steel prices and the higher cost of engines and machines for shifting to the BS-4 regime.

While the direct steel input cost may constitute about 20-30% of the total raw material cost, the bought-out components, like automotive and hydraulic components, sourced by the CME manufacturers also have steel content. Hence, directly or indirectly, steel comprises a significant proportion of input required for producing CME (around 60-70%).

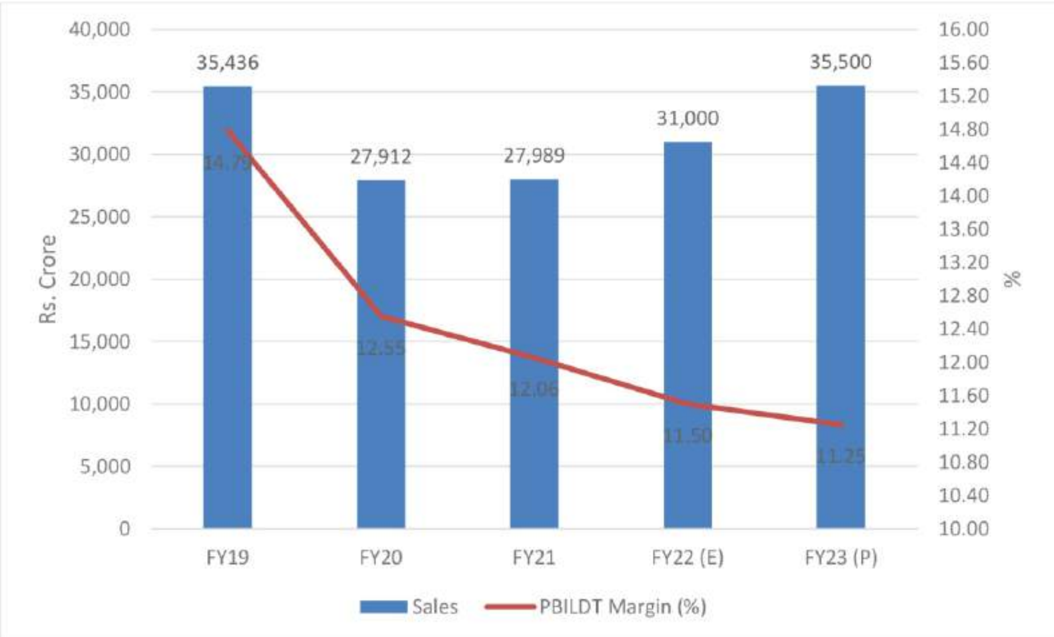
The increase in steel and other commodity prices due to the demand-supply mismatches has resulted in an increase in the prices of bought-out components as well, which have to be absorbed by the CME manufacturers. The industry is also dependent on imports for a decent proportion of bought-out components, and the increase in freight rates amid the shortage of shipping containers has further elevated the costs.

Source: CMIE, CARE Ratings Limited

The scarcity of raw materials and disruptions in the global steel demand-supply scenario with geopolitical tensions has increased the prices of the metal. The construction industry consumes about 50% of the world's steel demand. Steel prices are expected to remain elevated in the near term with the ongoing Russia-Ukraine crisis.

Operating profitability bearing the brunt

The performance of 11 large companies in the domestic CME sector indicates a dip in sales and operating profitability in FY20 as compared to FY19 with a subdued economic scenario and the impact of the outbreak of the Covid-19 pandemic towards the end of FY20. While sales remained relatively stable in FY21, the operating profitability was further impacted.



Source: CMIE, CARE Ratings Limited (Financials of 11 large players in the industry)

In FY22, the sales are estimated to have witnessed growth with an increase in sales price realisations and an overall growth in sales volume. However, the industry has not been able to completely pass on the increase in the cost of production, which will impact the operating margins till the input prices normalise.

There is limited escalation available in construction contracts, and steel being a major construction cost component, already has a direct bearing on the costs for construction players. Besides steel, there has been an increase in the prices of other metals and cement as well, which has adversely affected the project profitability. This has left limited room for the CME industry to fully pass on the increase in its cost to its customers.

While price hikes have already been taken, the gap between the price hike and increase in cost is expected to exert pressure on the operating profitability margins in the near term.

The export competitiveness of the industry may also get affected due to the increase in cost, wherein, it would be difficult to compete with other global players. Global players have also set up a manufacturing base in India and with the cost of the products becoming uncompetitive as compared to international prices, these players may look at shifting production to other locations.

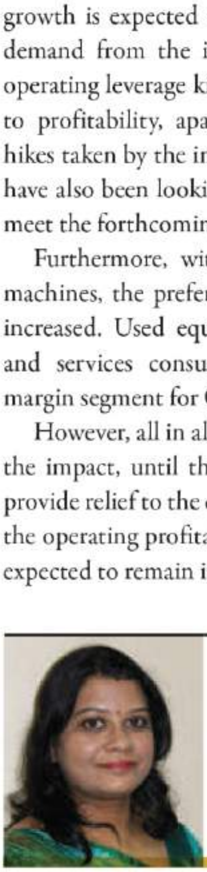
With an increase in the cost of machines and higher fuel prices, the cost of ownership of CME has increased for the rental segment, which is a significant buyer of CME. That said, the rentals have not increased commensurately, with the increase in prices exerting pressure on the profitability of the CME operators, apart from moderate deployment levels on account of the subdued execution scenario.

On the positive side, going forward, the volume

growth is expected to improve with the buoyant demand from the infrastructure sector, and the operating leverage kicking in may provide support to profitability, apart from the periodical price hikes taken by the industry. The dominant players have also been looking at addition in capacities to meet the forthcoming demand.

Furthermore, with the higher prices of new machines, the preference for used equipment has increased. Used equipment entails higher spares and services consumption, which is a higher-margin segment for CME manufacturers.

However, all in all, while the above will cushion the impact, until the input prices normalise and provide relief to the construction sector as a whole, the operating profitability of the CME industry is expected to remain impacted. EPC World



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