Cement Industry: Stable credit outlook - Demand recovery and higher sales realization to result in improved profitability in FY15

FY14 performance impacted due to slowdown in demand and cost pressure

Cement demand witnessed a muted growth, with consumption increasing by about 3.5% in FY14 (refers to the period April 01 to March 31) as compared with 5.3% in FY13 and 6.7% in FY12, mainly on account of slowdown in infrastructure, industrial and real estate projects. Consequently, cement prices remained under pressure for major part of the year. Though few attempts to increase the prices by the cement companies were made during the year, the hikes were reversed most of the times till Q3FY14. The problem was further accentuated by rise in input and freight costs. Apart from the elevated cost of key raw materials, limestone and gypsum, the freight cost increased significantly on account of increase in diesel prices and railway freight rates. Lower realization, higher input costs and freight expenses impacted the operating margins of majority of the players significantly. However, few of the companies optimized their fuel mix and power usage, thereby reducing the power and fuel cost on per tonne basis. The following table shows aggregate financial performance of the major pure-play cement companies* in FY14 and Q4FY14

Table 1- Financial Performance Rs. Crore

	Quarter ended*					Year ended*		
	Mar-13	Dec-13	Mar-14	Y-o-Y %	Q-o-Q %	Dec-12/Mar-13	Dec-13/Mar-14	Y-o-Y %
Total Operating Income	20,326	18,179	21,713	6.83	19.44	76,252	76,208	-0.06
PBILDT	3,883	2,479	3,748	-3.48	51.21	16,302	11,837	-27.39
PAT	2,286	1,077	2,220	-2.88	106.11	7,847	5,739	-26.86
GCA	3,318	2,182	3,374	1.68	54.64	11,953	10,125	-15.29
PBILDT Margin (%)	19.11	13.64	17.26			21.38	15.53	
PAT Margin (%)	11.25	5.92	10.22			10.29	7.53	
Interest Coverage	9.01	4.41	6.87			8.43	5.35	

Source: Company and CARE Ratings

**Aggregate numbers of 16 major pure-play cement companies with total capacity of approximately 220 MTPA*

For the above mentioned universe, grey cement volume grew by approximately 3% y-o-y, while net sales realization declined by approximately 4% to about Rs.4,022 per tonne during FY14.

Deteriorating trend halts in 4QFY14

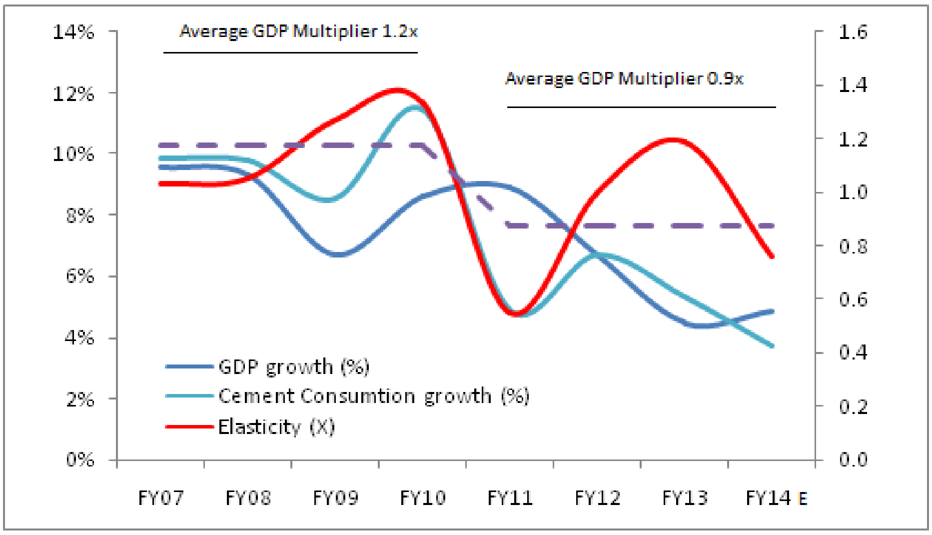
On an overall basis, the cement sector witnessed margin pressure during FY14; however as can be seen from Table 1, the profitability margins improved sequentially during Q4FY14. Region-wise trend during 4QFY14 was however divergent. North focused companies reported improvement in financials, south focused companies continued to report weak financials while pan India players reported stable financials. The key contributor to relatively better scenario in northern and western India during 4QFY14 was shut down of 6.25 MTPA capacity of Binani Cement Ltd in Rajasthan, which led to improved realizations and higher volumes for other north-based players. The south-based cement companies reported weak financials on account of excess capacity and weak demand.

While the PBILDT margin remained under pressure in Q4FY14 on y-o-y basis due to increased freight cost, a significant improvement (mainly driven by increase in volume and marginal improvement in realizations) in financial performance on q-o-q basis and stable performance on y-o-y basis suggests that the deteriorating trend halted during 4QFY14.

Cement demand expected to improve with release of pent-up demand and infrastructure pickup

The challenging economic scenario on account of slowdown in GDP growth rate and slowdown in infrastructure activities had a cascading effect on the cement industry in the last 1-2 years. Traditionally, cement demand and GDP growth rates have had a positive correlation with cement demand to GDP growth ratio of about 1.2x; however the same has steadily declined to a low of 0.7x in FY14.

Chart 1- Cement consumption and GDP growth rates



Source: Industry and CARE Ratings

Formation of stable government, budget proposals and government policy with a strong focus towards infrastructure growth and expected macro recovery is likely to augur well for housing, industrial and infrastructure sectors and in turn for the cement sector. Apart from the improved demand from future infrastructure development, pent-up demand is likely to propel the cement growth going ahead. Furthermore, since a significant portion of capacity is clustered in the south, where uncertainty in Telangana region accentuated the demand slow down, creation of separate state recently would be key driver for increase in demand in the region. Also, cement companies should benefit from increasing consolidation in the sector.

Profitability margins to improve in FY15

FY14 was a challenging year for the cement industry due to pressure on realization coupled with increased costs. Due to limited availability of coal, pet coke and gypsum, cement companies increased their reliance on imports. Import costs of key inputs also increased on account of weakening of rupee. Also, weaker rupee (depreciating to a low of Rs.68.61/USD in September 2013) leading to higher crude cost and government initiative to eliminate the under recovery of diesel, resulted in a significant increase in transportation and freight cost. The aggregate freight cost increased by about 9% in FY14 and as percentage of sales increased to 22% in FY14 from about 20% in FY13.

Rupee has already strengthened in last one-two months to about 60 per USD and is expected to remain in a narrow range, which would ease the cost pressure for the industry to some extent, towards import of input materials such as coal and gypsum. Also, likely efforts of the government to create fuel security, would improve availability of domestic coal in long-term which coupled with softened imported coal prices is expected to provide some respite to the industry. Although average freight cost during FY15 is expected to be higher than FY14 on account of increased diesel and rail freight rates (hiked by 6.5% recently), higher realizations (cement price has increased during Q4FY14 and Q1FY15 across the regions) are expected to not only negate the impact but also result in improved profitability margins on y-o-y basis. Though there may be partial reversal in cement price hikes in the near term due to monsoon impact, the average cement price during FY15 is expected to be higher as compared with FY14.

New capacities are expected to be absorbed

Chart 2 – Capacity, Production and Capacity Utilization

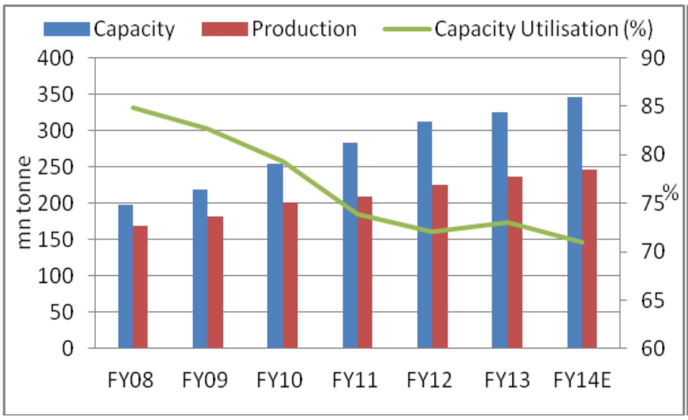
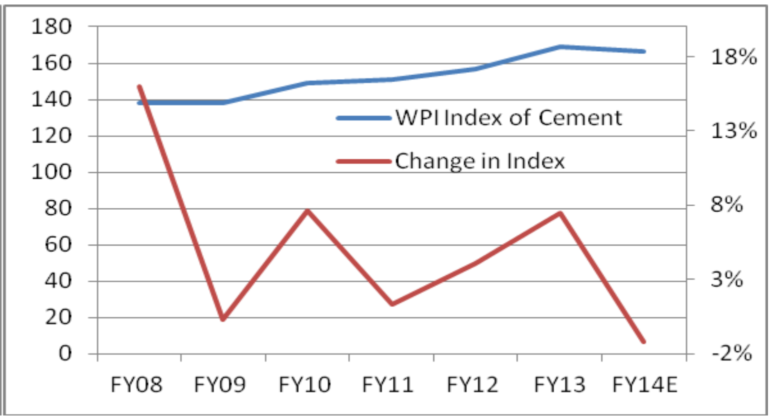


Chart 3 – Movement of WPI cement Index



Source: CARE Research, Ministry of Commerce and Industry

A large number of new cement projects having aggregate capacity of about 61 MTPA are expected to be operational in FY15-FY17E. This would lead to increase in cement capacity at 5.5% CAGR during FY14-FY17E. It may be noted that despite relatively slower capacity addition in the last three years (at a CAGR of 6.5% during FY11-FY14 as compared to 19.7% during FY08-FY11), capacity utilization and realizations have moderated on account of slowdown in demand (volume growth CAGR of 5.1%).

Table 2 – Expected Capacity Utilization at different demand growth levels

Demand Growth (FY15 & FY16)	4%	5%	6%	7%	8%
Average Capacity Utilization	70%	71%	72%	73%	74%

Source: CARE Ratings

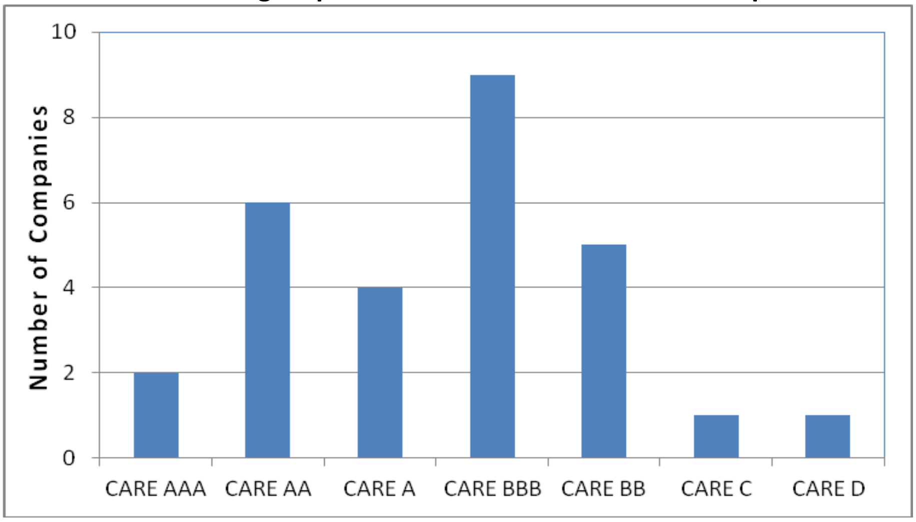
At the expected aggregate capacity addition of 31 MTPA in FY15 and FY16 as per CARE Research, demand growth of 5% would be required to maintain the utilization at the level of FY14. Given the expected improvement in demand, these capacities are likely to be absorbed and higher demand growth could improve the utilization levels. Also, production cost of the new capacities would be higher on account of higher capital cost (capital cost is about Rs.650-700 crore per MTPA currently as against about Rs.400 crore in 2009), which would limit the scope for pricing war through new capacities.

Northern-based cement companies are expected to benefit more in the long term due to high utilization rates (about 80% as compared with pan India average of 71% in FY14) and entry barriers in terms of lower limestone reserves as compared with southern India.

Credit outlook of cement players expected to be stable

Though the decline in realizations, muted volumes and cost pressures during FY14 have impacted the profitability margins of cement companies rated by CARE, most of the players were able to maintain healthy liquidity in terms of cash and cash equivalents and unutilised working capital limits (especially pan India, northern and eastern players) and moderate capital structure. As on June 30, 2014, CARE Ratings had outstanding ratings on twenty eight cement companies, for which rating dispersion is shown below:

Chart 4 - Rating Dispersion of CARE Rated Cement Companies



The following table shows the trend in Modified Credit Ratio (MCR- reaffirmation plus upgrades / reaffirmation plus downgrades) of CARE rated cement and related product companies in the past 3 years:

Table 3 – MCR for CARE rated cement and related product companies

Year	FY12	FY13	FY14	Q1FY15
MCR	1.00	0.82	1.03	1.00

While the cement industry would continue to witness cyclical trends due to the inherent nature of the industry, the long-term outlook for the cement sector is expected to be stable due to following reasons:

- With a stable government, budget proposals and government policy with a strong focus towards infrastructure growth, expected macro recovery and release of pent-up demand, cement demand is expected to improve
- Furthermore, consolidation in the industry and higher production cost of the new capacities due to higher capital cost is expected to result in firm realizations
- Despite the increase in freight cost, ease of cost pressure on other key inputs and higher realizations to result in improved profitability margins in FY15.

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