Rural India

Crop switching: Can cane production be lower next year as well?

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- We interviewed a few farmers in Western UP, a key region for wheat and sugar cane cultivation. A majority of farmers indicated that they are switching from cane to a rice-wheat combination (R-W).
- The economics have shifted in favour of R-W with the rapid increase in support prices. Moreover, rice yields have increased due to the adoption of hybrid seeds in the region. Revenue (per acre) from R-W now exceeds revenue from cane by 12% there. Better cash flow of R-W (biennial inflow) is an added attraction.
- Farmers face a labour shortage (due to rural employment schemes), which affects cane cultivation more than R-W. Cane requires higher labour input and is less amenable to mechanisation.
- The relationship between cane growers and mills has soured due to recent disputes. Farmers feel the risk in cane cultivation has increased substantially. Payment delays only add to the risks.
- We believe cane production could remain muted in this region next season as well. This will likely lead to more cost inflation for alcohol manufacturers. Maintain UNDERPERFORM on United Spirits.

Valuation metrics

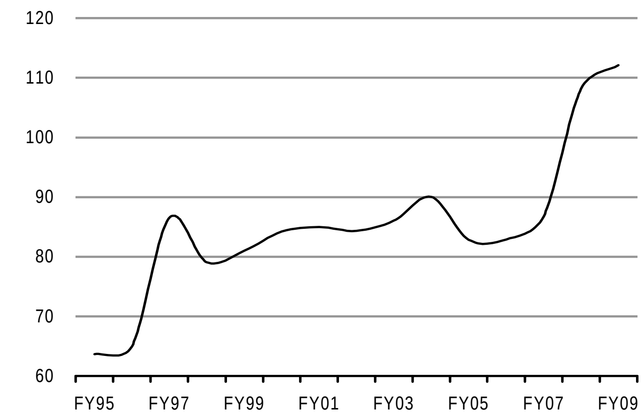
Company	Ticker	CS Rating	Price Local	Price Target	P/E (x) T+1	P/E (x) T+2	P/B (x)
United Spirits	UNSP IN	U	596	388	20.4	15.6	2.3
Balrampur Chini	BRCM IN	O	44.35	64	10.9	6.9	1.0
Bajaj Hindusthan	BJH IN	N	39.9	66.9	n.m.	n.m.	0.4

Note: O = OUTPERFORM, N = NEUTRAL, U = UNDERPERFORM
Source: Company data, Credit Suisse estimates

We recently visited a few villages in Western UP, a key region for sugar cane cultivation. All the farmers we interviewed were large farmers (10-20 acres of land) and cultivate both sugar cane and rice-wheat combination in their fields. However, the area under R-W has increased substantially this season and the shift is likely to be sticky, unlike in the past cycles.

Economics has shifted drastically in R-W's favour: Over the last four years, the increases in rice (+61%) and wheat procurement prices (+69%) have significantly outpaced the increase in cane prices (+31%). At constant yields, the ratio of revenues from R-W to cane has increased from 0.83x to 1.04x. However, while cane yields have not improved, rice yield has increased in these regions due to adoption of hybrid seeds. Wheat yield has also improved marginally with adoption of better agricultural practices. Consequently, farmers earn nearly 12% more income from R-W combination compared with cane and the ratio of revenues from R-W to cane is at its highest ever. Cane price will have to increase to Rs175 per quintal just to take this ratio back to the previous peak (assuming rice/wheat prices stay constant). The cost of production for R-W and cane has increased in sync (mostly due to labour, diesel). In addition, the twice-a-year cash flows in R-W is better than once-a-year cash flow in cane.

Figure 1: Ratio of rice and wheat revenue/cane revenue



Source: Farmer surveys, Credit Suisse estimates.

Labour shortage affects sugar cane more: The government's national rural employment guarantee scheme (NREGA) has resulted in shortage of agricultural labourers in this region. Migration of labour from Eastern UP and Bihar has slowed considerably as work is easily available under NREGA. The average daily labour cost has increased from Rs50-60 per day to Rs80-100 per day (NREGA daily wage is Rs100 per day in UP). Labour shortage and cost affects cane more than R-W. For one, cane requires about 75-90 man days of labour per acre per year, while R-W requires about 60 man days per acre per year. Moreover, many jobs in R-W cultivation is readily mechanisable (harvester combines, threshers etc readily available for hire in the region) while cane is not amenable to mechanisation (due to lack of or high cost of machinery in the area or due to lack of technology).

Perceived risk in cane cultivation has increased: The recent dispute between the mill owners and cane growers (and the subsequent court case) has increased the perceived risk in cane cultivation (lower predictability of price). Payment delays just add to the risk perception. Farmers contrast that to the stable prices (within the season) of rice and wheat as well as prompt payment received at time of sale. Farmers also recognise the improvement in the functioning of food grain markets (mandi) in the recent past.

Some of the advantages of cane cultivation remain unchanged – cane is far more weather and pest resistant than rice or wheat. Farmers are unlikely to completely shift out of cane cultivation. Our analysis is also limited to a small area in UP (which accounts for 30% of India's cane production). However, the risks of cane area being lower next year compared to the current year is high, in our view, and is contrary to what many in the market expect. This implies lower availability of molasses. We highlight this as a key risk to alcohol manufacturers (80% of alcohol in India is produced from molasses). We currently forecast spirits cost to fall in FY11E but see risks to that assumption.

Companies Mentioned *(Price as of 10 Mar 09)*
United Spirits Ltd. (UNSP.BO, Rs596.35, UNDERPERFORM [V], TP Rs387.79)
Bajaj Hindusthan Limited (BJHN.BO, Rs39.90, NEUTRAL [V], TP Rs66.90)
Balrampur Chini Mills Ltd (BACH.BO, Rs44.35, OUTPERFORM [V], TP Rs64.00)

Disclosure Appendix

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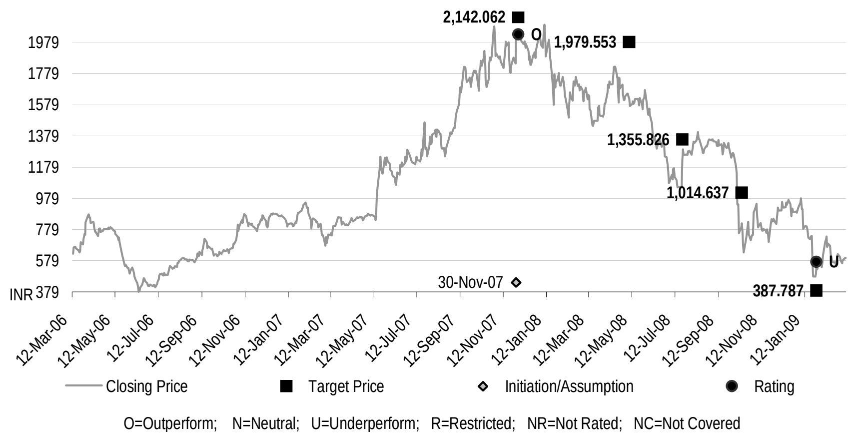
3-Year Price, Target Price and Rating Change History Chart for UNSP.BO

UNSP.BO Date	Closing Price (INR)	Target Price (INR)	Rating	Initiation/ Assumption
30-Nov-07				X
3-Dec-07	2,030.8	2,142.062	O	
8-May-08	1,619.6	1,979.553		
22-Jul-08	1,221.35	1,355.826		
14-Oct-08	819.1	1,014.637		
28-Jan-09	571.8	387.787	U	



3-Year Price, Target Price and Rating Change History Chart for BJHN.BO

BJHN.BO Date	Closing Price (INR)	Target Price (INR)	Rating	Initiation/ Assumption
11-Aug-08	182.25	199.467	N	X
22-Oct-08	53.3	66.896		

3-Year Price, Target Price and Rating Change History Chart for BACH.BO

BACH.BO Date	Closing Price (INR)	Target Price (INR)	Rating	Initiation/ Assumption
11-Aug-08	93.6	119.553	O	X
22-Oct-08	47.85	85.577		
25-Feb-09	47	64		

O=Outperform; N=Neutral; U=Underperform; R=Restricted; NR=Not Rated; NC=Not Covered

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Price Target: (12 months) for (UNSP.BO)

Method: We have valued United Spirits on an EV/EBITDA basis to capture the impact of high leverage and subsequent deleveraging. The EV/EBITDA valuation is in line with leveraged global peers. We have a target price of Rs388 based on an EV/FY10E EBITDA of 8.5x. At our target price, United Spirits would trade at 10.2x FY10E EPS.

Risks: Key risks to our Rs388 target price for United Spirits are: 1) a slowdown in demand, which would get magnified at the bottom line due to the high leverage of the company; 2) government policies and currency risk on account of the Whyte and Mackay acquisition; 3) an increase in cost of key inputs like molasses and glass and subsequent inability to pass on these increases through price increases; 4) a slowdown in global demand for scotch; losses in sports venture and 5) Pledged shares by promoter company

Price Target: (12 months) for (BJHN.BO)

Method: Our Bajaj Hindusthan (BJH IN) target price is set at Rs 67. We have valued the company at FY10 EV/EBITDA (enterprise value/earnings before interest, tax, depreciation and amortisation) of 5.4x. The target price implies a FY10E price/earnings multiple of 7.5x. We prefer EV/EBITDA over discounted cash flow valuation (DCF) due to the cyclical nature of the business and therefore lack of visibility in earnings beyond FY10E. We value Bajaj Eco-Tec on a sum-of-the-parts basis at Rs13 per share at 6x FY10 P/E.

Risks: Risks to our Bajaj Hindusthan (BJH IN) target price of Rs 67 include: 1) the sugar price could be below estimates, 2) sourcing of cane could be below estimates, 3) high leverage, 4) execution risks on account of performance of new subsidiaries, 5) regulatory risks, particularly those aimed at controlling prices.

Price Target: (12 months) for (BACH.BO)

Method: We set our Balrampur Chini Mills (BRCM IN) target price at Rs 64. We have valued the company at 10x FY10 EPS. We prefer P/E over discounted cash flow valuation due to the cyclical nature of the business and therefore lack of visibility in earnings beyond FY10.

Risks: Risks to our target price of Rs64 on Balrampur Chini Mills (BRCM IN) are on account of 1) sugar price could be below estimates, 2) sourcing of cane may be below estimates for FY10, 3) regulatory interventions, particularly those aimed at controlling prices.

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